Don't let high management fees drain your portfolio

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With all the rankings that show Canada among the worst in fees for financial products, most investors have at least an inkling that their investing costs are high. But investors seem to have a shakier understanding of how high-priced investments can sap their portfolio growth.

“If you can shave 1 per cent or 2 per cent off the cost of your investments, it immediately, massively improves” the accumulation of retirement funds, says Kurt Rosentreter, a senior financial adviser and chartered accountant with Manulife Securities Inc.

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The Toronto-based adviser recently taught a course to a room of chartered accountants. He says one student quickly calculated that saving just 1 per cent on investment fees on his existing portfolio would save him $400,000 over 25 years.

Swapping out high-cost investment products such as actively managed mutual funds for lower-priced ones, including exchange traded funds (ETFs), can work the same way that compounding gains do – provided that the lower-cost products generate similar gains over time.

Mr. Rosentreter produces a quick example: a 40-year-old with $300,000 in his investment portfolio saving for 25 years and aiming for a 5-per-cent average annual return. That will grow to $1.015-million over that span (with no additional contributions for ease of calculation). Bumping that rate of return to 7 per cent, by dropping fees to 1 per cent from 3 per cent over that span, would increase the investment pile to approximately $1.628-million – or 50 per cent more.

With average management expense ratios of about 2.5 per cent and the added costs of commissions and embedded trading costs within actively managed funds, those costs can easily
top 3 per cent annually, he says. Dropping costs to 1 per cent is possible to do with an adviser given the right mix of low-cost products such as stocks, bonds, guaranteed investment certificates (GICs) and ETFs.

He estimates that 80 per cent of his first-time clients are heavily invested in expensive funds and paying about 3 per cent in fees over all. “It doesn’t matter whether you are a CEO or a fireman, people are lost in terms of what’s going on,” he said. “I attribute it to overdelegation and not putting enough time in” on their finances and investments.

The Manulife adviser is not dead set against actively managed funds. He says they have a place in portfolios when they offer exposure to specialized or emerging sectors such as small-cap companies, provided they have a decent track record of success.

“There are three variables that really affect retirement forecasts, because they reverberate every year: rate of return, tax rates and inflation,” he says. “It’s not whether you defer retirement for one or two years or even savings rates, it is those three.” Most Canadians have limited ability to change their tax rate and have no influence over the rate of inflation. They can, however, do something about the fees that they pay to invest and save for retirement.

It is a simple argument that is behind much of the growth of low-cost options such as ETFs as investors look for a way to avoid embedded mutual fund fees. “The Canadian industry currently is really set up where you do have to provide trailer commissions in order to get [broker] distributions. There isn’t really a large direct market for mutual funds in Canada, at least not yet,” says Atul Tiwari, managing director and head of Canada at Vanguard Investments Canada in Toronto.

Some advisers are not putting clients in ETFs for a simple reason: They can’t. Investment advisers licensed by the Mutual Fund Dealers Association are able to sell mutual funds but not ETFs. The smaller group of advisers licensed by the Investment Industry Regulatory Organization of Canada (IIROC) can sell individual stocks or ETFs to clients.

Vanguard, whose U.S. parent pioneered retail index mutual funds in the mid-1970s, has swelled to about $2.5-trillion in assets. After two years in operation in Canada, Vanguard has approximately $1.5-billion in assets through its 16 equity and bond ETFs which carry an average management fee of 21 basis points or 0.21 per cent.

Canadian investors need to do more than simply complain about high investment fees, he says. “There are two sides to the equation. One is for investors to become more aware. The other is for the investment industry as a whole to also help with that education and transparency.”

“These are things that over time I think will change with more education for investors and perhaps some greater regulatory announcements,” he adds.
Fees should be a consideration for investors, especially in today's low-rate, low-return, fixed rate investment environment, but they should not be the only factor used to determine whether to use a particular adviser or financial product, says David Sung, president of Nicola Wealth Management in Vancouver.

“Absolutely investors need to search out the most competitive costing they can on their investments,” Mr. Sung says. Bargain shopping for the lowest cost investments may make sense for do-it-yourself investors, but less so for those requiring professional advice.

“A lot of our clients tend to be very busy professionals and business owners,” he says. “While they may be able to go out and find some extremely cheap investments ... will they on their own be able to constantly monitor and manage their portfolio and rebalance it when necessary in a timely fashion? For most of our clients the answer is no and that is why, included in our fee that we charge, is what we call the price of advice.”

Mr. Sung adds that the financial services industry should provide more informative and comprehensive statements about shareholder returns and also offer a statement that shows the total fees paid by the investor.

**Changes afoot?**

Fee transparency is the subject of heated debate within the financial services industry. This year, the Canadian Securities Administrators issued a discussion paper and request for comment on the subject of mutual fund fees, outlining a series of proposals it says “will significantly impact the current distribution system for mutual funds in Canada.”

Specifically, the CSA cited:

- Imperfect investor understanding of mutual fund costs and control over adviser compensation.
- Potential conflicts of interests at the mutual fund manager and advisor levels
- Potential for cross-subsidization of commission costs
- Potential lack of alignment between adviser compensation and services provided
- Limited low-cost options for do-it-yourself (DIY) investors.

Last year, the Investment Industry Regulatory Organization of Canada, which regulates the Canadian brokerage industry, introduced reforms intended to improve investor disclosure on fees, services, conflicts of interest and investment performance.

The changes, set for implementation this year and next, deal with improved disclosure of services and fees, suitability of investments for individual investors, conflicts of interest and investment performance reporting.
“It is going to rock the industry,” says Kurt Rosentreter of Manulife Securities Inc. “We now have to publish rates of return, we now have to disclose compensation on trade tickets. It could go as far as eliminating embedded compensation. There is huge debate and [there are] battles in conferences going on nationally right now.”

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