

Cost transparency for unit trusts

Darren Botha welcomes expenditure disclosure

Unit trusts have an improved fee disclosure with the introduction of total expense ratios (TERs), but investors need to understand what they are comparing.

In the investment world, disclosure of fees and expenses has come under the spotlight recently. And, in a move that will increase disclosure within the unit trust industry greatly, the Association of Collective Investments (ACI) has implemented a standard that requires all its members to publish TERs from April 2007.

TERs represent the annual operating costs of running a given investment portfolio, which include management fees, fixed operating costs, trading and brokerage costs and performance fees.

This is a positive move, but caution is needed when comparing TERs and investors must be aware of the value of these numbers in the investment decision-making process.

While greatly increasing under-

standing of the cost structure within a portfolio, all investment decisions should be based on the net-expected, risk-adjusted return of a portfolio (relative to an individual's overall portfolio). A concern is that comparing TERs could cloud the process, possibly resulting in individuals investing in underperforming, cheap portfolios, rather than in ones that are expensive, but outperform in time.

Internationally, expenses usually do not include costs associated with the trading of underlying securities and are limited to fixed operating and management costs. Internationally, however, include marketing, legal and start-up costs.

Lipper Fitzrovia calculates and publishes TERs for United Kingdom mutual funds, although legislation in the UK does not require management companies to publish explicit numbers (it is a statutory requirement in the United States).

Fitzrovia defines a TER as "the annual percentage reduction in



Newly introduced total expense ratios will help people keep an eye on the running costs of their investment portfolios. Photo: Paul Botes

investor returns that would result from largely fixed operating costs if markets were to remain flat and the fund's portfolio were to be held and not traded during that period". Globally, the general approach has been to exclude all expenses directly related to creating returns within a portfolio; in other words, all trading expenses.

Because methodologies differ, local unit trust TERs cannot be compared easily with global numbers, which are usually between 1% and 2% (excluding trading costs), with trading costs ranging between 0,2% and 1%. South African TERs could easily be 20% to 100% higher than international numbers, even though the expenses are identical. A standard along the lines of the CFA Institute's Global Investment Performance Standards would be welcomed.

A major drawback of published expense ratios globally and locally is that they do not include the upfront costs of investing.

While it is practically impossible to include initial fees due to their elastic nature (they are highly negotiable and often work on sliding scales), these costs need to be taken into account when comparing portfolios as they are a significant expense to the investor.

US studies showed that portfolio operating expense increases during a 20-year period (1979 to 1999) coincided with a decrease in upfront fees, indicating that managers could have been changing the mechanics of the fees. This trend has been mirrored in South Africa, with management companies reducing or even eliminating initial fees. If TERs become

an integral part of the investment decision-making process, managers may be induced to increase upfront fees while reducing management fees to compare more favourably on surveys and in publications. Other factors influencing TERs are the size of the portfolio, investment sector and style of the investment manager.

A US Securities and Exchange Commission report found that as a portfolio size increased, the expense ratios decreased, the difference in expense ratios between the largest and smallest portfolios being as much as 0,8% a year. As a portfolio's assets increased, the fixed operating costs remained constant, resulting in an ever-decreasing TER (and reflecting the economies of scale within the operation of portfolios).

The report also showed that larger portfolios tended to charge lower management fees, further reducing the TER. This trend was not limited to single portfolios; it was also found that where a portfolio formed part of a large family of portfolios, expenses tended to be lower, reflecting further economies of scales within large management companies. It might, however, be more difficult for larger portfolios, though cheaper, to outperform smaller, more nimble ones.

TERs will increase the transparency within the South African unit trust industry and enable investors to correctly assess the costs managers build into the portfolios. But they must be just that – an indication of costs, not an integral part of the investment decision-making process.

Darren Botha is head of the department of pricing and projects at Investment Solutions

