The Economist

Buttonwood

Against the odds

The costs of actively managed funds are higher than most investors realise

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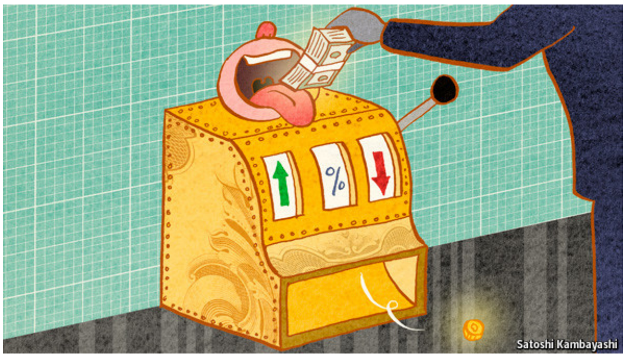

EVERYONE knows that if you go to a casino, the odds are rigged in favour of the house. But people still dream of making a killing. The same psychology seems to apply to fund management, where investors flock to high-cost mutual funds even though the odds are against them. Russel Kinnel, the director of fund research at Morningstar, has described fund costs as “the most dependable predictor of performance”.

It is really a simple matter of maths. A stockmarket index reflects the performance of the average investor, before costs. Given that the costs of active fund-management are higher than those of tracker funds, the average active investor must underperform his passive counterpart. But many do not realise just how substantial the costs can be. In an article* in the latest *Financial Analysts Journal* (FAJ), Jack Bogle of Vanguard, a fund-management group that specialises in index-tracking, goes through the sums. The annual gap between the expense ratio cited by the average large-stock mutual fund and Vanguard’s index fund is 1.06 percentage points. That comes mostly in the form of investment-management fees.

But these costs are only the beginning. Active fund managers also trade more than index funds. One study put these trading costs at 1.44 points a year; Mr Bogle uses a more conservative estimate of half a point. A further factor is the drag of holding cash. Index funds are usually fully invested; active managers hold about 5% of assets as cash so they can seize opportunities to buy their favoured stocks. Since equities tend to beat cash over the long run, this reduces returns still further; Mr Bogle estimates by about 0.15 points a year.

Then there are the sales costs paid by investors in American mutual funds. Happily, so-called front-end load funds, which could take up to 8% of an investor’s capital at the start, are less common than they once were. But most investors still buy funds through some kind of adviser or broker, for a charge or a fee; Mr Bogle estimates this cost at 0.5 points a year.

Yet another cost arises from the tax treatment of American mutual funds: every year, funds distribute to investors the capital gains they make within the portfolio. Investors must then pay tax on the proceeds. Because active funds trade more than index funds, investors in active funds face a higher tax bill.

Add all these costs together and the net return to investors may be reduced by 2.66 points a year, a huge differential considering that long-term real returns from American equities have been 6.45%.

Some will argue that Mr Bogle's numbers are exaggerated. Not all passive funds successfully track the index; some have substantially higher fees than the example he used; some investors buy passive funds with the help of brokers or advisers and incur sales charges or extra fees. Costs are not everything; asset allocation is also important. And some active managers do outperform the indices over the long term.

However, such arguments do not make much of a dent in Mr Bogle's case. Without the benefit of a Tardis, we cannot know the best asset allocation in advance; the costs are pretty certain. There is little evidence that outperforming managers can be identified in advance. Worse still, the search for the best managers leads clients to buy hot funds at the top of a bull market; this further reduces their returns as they buy high and sell low. Morningstar estimated that the average large-stock fund earned 4.5% a year in the 15 years to June 30th, 2013, but the average investor earned just 2.59%.

Annual numbers are one thing but the real damage for the long-term saver is cumulative. A journalist at the *Financial Times* was recently sent a statement that showed, on conservative assumptions, that if he kept saving for another 22 years, his pension pot would be worth less in real terms than it is now: the charges would more than eat up the returns.

In a previous FAJ article**, Bill Sharpe, a Nobel laureate for economics, calculated that someone who saved via a low-cost fund would have a standard of living in retirement 20% higher than someone who saved in a high-cost fund. That calculation was made using the impact of investment-management fees alone. If Mr Bogle is even close to right, the hit to retirement incomes is substantially greater. Yet hope springs eternal. Just as the slot-machine addict believes the next spin of the reels will bring the jackpot, savers still insist on trying to beat the odds.

* "The Arithmetic of 'All-In' Investment Expenses", *Financial Analysts Journal*, Volume 70, Number 1

** "The Arithmetic of Investment Expenses", *Financial Analysts Journal,* Volume 69, Number 2

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