Fund management

Cheap is cheerful

The business of managing other people's money is being commoditised. About time

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THE first stockmarket index fund was created more than 40 years ago, in 1973. Two years later Jack Bogle of Vanguard launched the first index fund for retail investors. Dismissed at the time as a folly, the fund started with $11m in assets; it now runs $166 billion, on which the annual costs paid by investors are less than one-fifth of a percentage point. That compares with the 1-2 points a year that investors can pay for active fund management, where the experts try to beat the index.

The surprise is that the Vanguard fund is not even bigger. In all, the asset-management industry runs $64 trillion. In many other businesses a cheaper competitor would sweep all before it. But index funds still comprise only 11% of the market.

Two things have held them back. One is distribution: the people who sell funds to investors have had little incentive to sell cheap ones. Either they work for banks (and try to flog their own firm's products), or they are paid commission by the fund-management firm rather than by the client—and the higher a fund's fees, the greater the incentive to sell it.

The other problem is a belief that investors can do better than the index by picking a hot fund: money for old hope. Some funds will indeed beat the index, whether by luck or skill. It is easy to identify those funds with hindsight, but hard to do so in advance. And the index represents the performance of the average investor before costs; the higher the costs, the greater the odds that a fund will do worse than the market.

Thankfully the industry is changing. It is slowly being commoditised, like others before it. PwC, an accountancy and consultancy firm, thinks the market share of tracker funds will double by 2020.

The change is happening for three reasons. First, more advisers are being paid a fee by their clients, rather than taking a commission from the fund provider. This allows them to recommend cheap products such as exchange-traded funds (ETFs), which track indices and can be bought and sold like regular shares. The ETF sector has increased sevenfold in a decade and is now nearly as big as hedge funds. Almost any asset class you can imagine can now be found in ETF form.

Second, many active managers try to exploit anomalies in the market—for example, that smaller companies often beat larger ones, or that companies that look cheap relative to their assets or dividends subsequently outperform the market. But such strategies can be replicated by "smart beta" funds at very low cost. This segment is also growing fast.

The third change is the demise of defined-benefit pensions, where retirement income is linked to a worker's final salary, in favour of defined-contribution (DC) ones, where the employee bears the risk. Employers that run DC schemes tend to use trackers, as an obvious way to show they are protecting their workers' interests; the average cost of such schemes in large British companies is now 0.41%. That in turn puts pressure on the charges even of those active managers with a good record.

Might a market dominated by trackers be more prone to bubbles, as investors pile into the biggest stocks regardless of their value? Not really. As the dotcom bubble showed, active managers are themselves prone to chase trends. And most smart-beta funds, by their nature, buy stocks that are unpopular; they will provide a natural counterweight. So the rise of index funds is one financial fashion that should be welcomed.

Sins of commission

Indeed, it should be encouraged by governments that would like citizens to save enough to give themselves a comfortable old age, rather than depending on the state. Governments should ensure that financial advisers are paid, not by product providers, but by clients (much as you would not want doctors to be paid by the drug companies). More countries should follow Britain's example and stop the use of commissions. And the European Union should make more effort to ensure that funds are bought across national boundaries, rather than leaving people in the clutches of banks at home.

In a world of slower growth, low inflation and Treasury-bond yields of 2.5-3%, future investment returns are likely to be low. All the more reason for them not to be eroded by the fees of an industry with such a lacklustre performance.

http://www.economist.com/news/leaders/21601511-business-managing-other-peoples-money-being-commoditised-about-time-cheap-cheerful