

When is a Total Expense Ratio not a Total Expense Ratio?

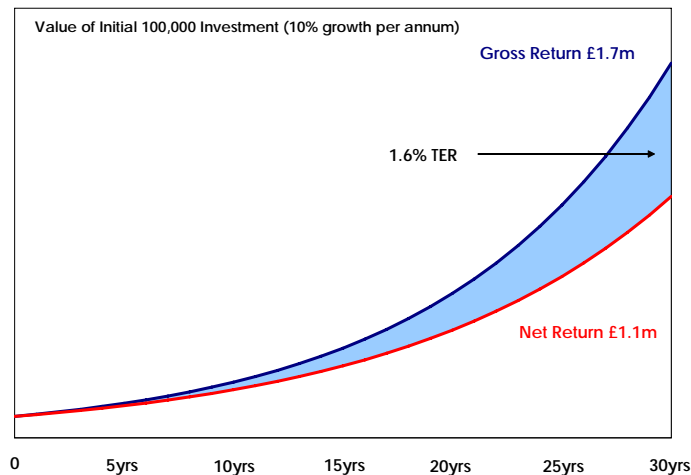
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It is well known that minimising costs is one of the keys to achieving superior investment returns. Investors and intermediaries are wise to ascertain a fund's total expense ratio (TER) before investing. However, it is equally important to be aware that a TER can sometimes represent less than half of the full costs incurred by funds.

Why are Costs Important?

Costs are an ever present drag on investment performance and it is very important to be aware of the compounding effects of this reduction in yield. Consider the situation for an average UK large cap equity fund that has a quoted TER of approximately 1.6 per cent.¹ Based on an initial investment of £100,000 and 10 per cent annual returns, after 30 years the investment, gross of expenses, will have grown to £1.7 million (Figure 1). However, compounded expenses over this period would amount to £0.6 million and reduce the net investment returns by roughly 35 per cent.

Figure 1 – Impact of TERs on Returns



Source: Frontier Capital Management

What are TERs?

In the UK the FSA requires TERs to be published by all UCITS schemes, and also specifies the calculation method to be used.

The TER of a fund is defined as the ratio of its total operating costs to its average net assets. Whilst the calculation of average net assets is fairly straight-forward, the calculation of total operating costs is not. It is important to understand those costs that are included in total

¹ Lipper Fitzrovia (2006).

operating costs and those that are not. Under the FSA calculation method total operating costs include:

- fund management fees
- administration costs
- audit fees
- legal costs

However, total operating costs specifically exclude:

- transaction costs
- interest on borrowings
- entry and exit costs
- soft commissions

Of the operating costs excluded from TERs, often only entry and exit costs are also disclosed to investors, albeit separately. These other costs can be referred to as “hidden” costs because they are not easily identifiable by investors. Transaction costs are perhaps the most significant of these and arise from buying and selling securities; they include brokerage fees, bid-offer spreads, market impact costs as well as stamp duty here in the UK.

What Is the Size of “Hidden” Costs?

The impact of “hidden” costs (such as transaction costs) can vary greatly depending on the operational style of the fund. There are two key principles to observe:

1. Active funds incur greater transaction costs than passive funds. Very simply put, the more often a fund buys and sells securities the greater the level of costs incurred.
2. Transactions in less liquid markets (e.g. emerging markets or small companies) will incur greater costs than those in more liquid markets

Figure 2 illustrates transaction costs for a variety of US equity funds. Transaction costs range from 5 basis points in US large cap index funds to 700 basis points in actively managed emerging market funds.

Figure 2 – Full Annual Costs of US Equity Funds

	Active Fund			Index Fund		
	Lge Cap Fund	Sml Cap Fund	Emerging Mkt Fund	Lge Cap Fund	Sml Cap Fund	Emerging Mkt Fund
TER	1.30%	1.60%	2.00%	0.18%	0.20%	0.57%
<i>Commissions</i>	<i>0.30%</i>	<i>0.50%</i>	<i>1.00%</i>	<i>0.01%</i>	<i>0.10%</i>	<i>0.10%</i>
<i>Bid-Ask Spread</i>	<i>0.30%</i>	<i>1.00%</i>	<i>3.00%</i>	<i>0.02%</i>	<i>0.15%</i>	<i>0.40%</i>
<i>Market Impact Costs</i>	<i>0.30%</i>	<i>1.00%</i>	<i>3.00%</i>	<i>0.02%</i>	<i>0.15%</i>	<i>0.40%</i>
<i>Total Transaction Costs</i>	<i>0.90%</i>	<i>2.50%</i>	<i>7.00%</i>	<i>0.05%</i>	<i>0.40%</i>	<i>0.90%</i>
Total Costs	2.20%	4.10%	9.00%	0.23%	0.60%	1.47%

Source: Bernstein (2001)

In the UK where funds are on average a smaller size than in the US and so do not enjoy the same economies of scale, “hidden” cost are typically higher than those in the US. A research paper by the FSA estimates the average transaction costs of trading for UK large cap active funds at 1.8 per cent (based on 100 per cent of asset turnover).² Moreover, “hidden” costs can be even greater for some equity funds as almost a quarter have a turnover greater than 100 per cent.³ In contrast, the median UK index tracking fund has a turnover of only 13 per cent and investors in these funds will pay much lower “hidden” costs as a result. Fortunately in the UK the FSA requires all UCITS schemes to disclose their turnover, so for UCITS funds at least investors can estimate the likely size of transaction costs.

As a guide for UK intermediaries and investors that wish to calculate the total costs of investing in mutual funds, Figure 3 illustrates estimated transaction costs for a variety of fund types. The smallest transaction costs are for funds with low turnover rates – the 10 per cent turnover row has been selected to represent index funds as this is their typical turnover rate. Conversely, high turnover emerging market funds have the highest level of transaction costs of the fund types reported below.

Figure 3 – Estimating Transaction Costs in Mutual Funds

Turnover	UK Large Cap Equity	Balanced Fund	Global Equities Fund	Emerging Markets Fund	Multi Manager Fund
10%	0.2%	0.1%	0.2%	0.8%	0.3%
50%	0.9%	0.5%	0.8%	3.8%	1.3%
100%	1.8%	1.0%	1.7%	7.6%	2.7%
200%	3.1%	1.9%	3.0%	11.0%	4.9%

Source: Frontier Capital Management

Note that these transaction costs are not included in the published TERs of funds. In order to get closer to the total costs of a fund, these costs need to be added to the published TERs.

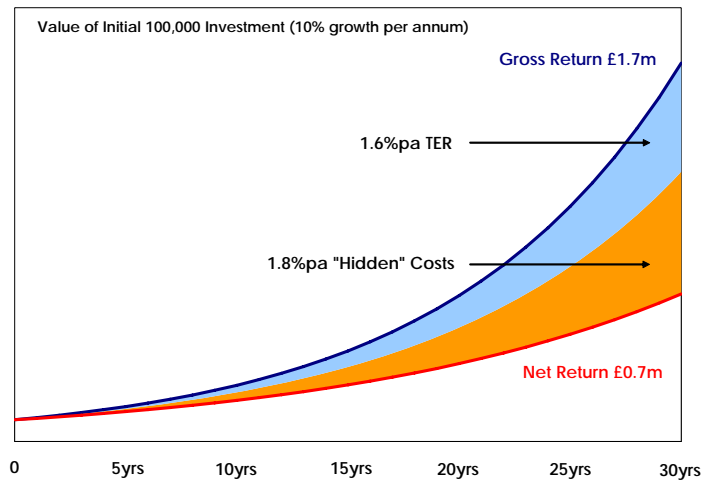
What Is the Impact of Total Costs on Performance?

The impact of “hidden” costs on investment performance can be substantial. Taking the example given in Figure 1 of the average UK large cap equity fund, we can now consider the impact of the additional “hidden” costs. Assuming 100 per cent asset turnover results in additional annual “hidden” costs based on our matrix above of 1.8 per cent. After 30 years and with the same initial £100,000 investment, net returns after all costs are now reduced to only £0.7 million (Figure 4). Total costs in this situation have reduced returns by £1 million, with transaction costs accounting for 53 per cent of the reduction in yield.

² Financial Services Authority (2000). 100 per cent asset turnover occurs when a fund sells out of a position in its assets and fully replaces it with a new position in other assets within the same year.

³ Lipper Fitzrovia (2007).

Figure 4 – Impact of Total Costs



Source: Frontier Capital Management

Concluding Remarks

This note has highlighted the impact of fees and costs on net investment returns and drawn particular attention to the compounding effect of costs on returns over time. Intermediaries and their investors should now also be aware of the costs excluded from published TERs, and that these "hidden" costs can in many instances be greater than the TERs themselves. This means that a published TER can understate the total costs of a fund by 100 per cent or even more. We have provided a matrix that can be used in order to estimate the real total costs of a fund based on its security type and annual turnover. The matrix highlights the incremental costs of actively managed funds versus index strategies.

Frontier Capital's Multi-Asset Funds seek to minimise all forms of costs for our investors. We would be happy to provide further information on low cost index investing upon request. Please contact info@frontiercm.com or call +44 (0)20 7317 6900.

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