



Much greater transparency is needed in relation to portfolio turnover

# The true cost of TERs

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Viewpoint



The FSA has proposed that total expense ratios (TERs) should be included in collective investment scheme prospectuses.

The problem is that in an age of treating customers fairly and with the majority of fund managers consistently failing to outperform their benchmark, TERs will only tell half the story about the true cost of active fund management.

Widespread publishing of TERs in the US is common and the move by the FSA should be welcomed. However, the definition of a TERs, according to research company Fitzrovia international, is "the annual operating cost of an investment fund which includes administration, custody, audit and legal expenses, in addition to the annual management fee". Therefore, as a measure it excludes perhaps one of the most important factors of total costs affecting performance – portfolio turnover.

Portfolio turnover numbers can be alarming and from our research of major

fund management groups and individual stockbrokers, we would advocate not only a level of urgency on the regulator's part to bring forward the widespread publishing of TERs but also greater transparency with regard to portfolio turnover and its associated costs.

One example we have seen is where a stockbroker, operating an active portfolio management strategy, turned over 60 per cent of the portfolio within the first 10 months of managing the portfolio, creating dealing charges equivalent to 7 per cent a year of the portfolio value and most of the sales were made at a loss, not due to share price movements, but down to the cost of transactions.

In the FSA Occasional Paper Series 6 entitled: The price of retail investing in the UK, the paper's author Kevin James estimates the cost of a round-trip trade to be about 180 basis points (1.8 per cent),

therefore a typical UK equity portfolio with a turnover of 64.2 per cent (source: Portfolio Turnover of UK Funds December 2003) is charging a further 1.16 per cent in addition to their TER. When added to a typical TER for UK equity funds of between 1.5 per cent and 2 per cent, an investor in an active UK equity fund needs to receive a return of about 3 per cent a year to cover costs alone.

The performance drag created by the stock turnover of active portfolio managers is one reason why actively managed funds consistently under-perform against the market.

The answer to this dilemma has been to use index-tracking funds as an alternative to active fund managers. The move by Fidelity to reduce the TER on its Moneybuilder UK Index Fund to 0.3 per cent is proof that the cost of running a fund that simply replicates an index is significantly lower than the cost of

active management.

However, rigid index-tracking has its critics as the fund manager is forced to purchase and dispose of stock at pre-set regular intervals, enabling other investors to exploit the inflated demand and equal lack of demand for certain stocks, creating price anomalies.

Therefore, the recent introduction to the UK of passive pure asset class funds, where funds aim to capture the return of the asset class in which they are investing as well as controlling costs, even at the expense of a higher tracking error, allows investors to gain exposure to the asset class without excessive and unnecessary costs.

Fiscal Engineers believe that markets are efficient and that the cost of active fund management is not worth paying and that time and effort should be spent on ensuring that the asset allocation of a portfolio is appropriate for each client in relation to their appetite for risk and desire for returns. Our client portfolios are then invested in funds that seek to achieve market returns and do not aim to out-perform the market, using lower-cost, passive asset class funds.

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