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It pays to know your investment costs

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While investment costs are a fact of life, investors should know how much they are paying and the impact on their returns. Ignorance can be expensive.

There is one subject that the Canadian investment industry avoids like the plague — the costs associated with investing. This topic is particularly touchy because Canada is such an expensive country for investors. A 2011 Morningstar study compared the total expense ratios of money-market, fixed-income and equity funds in 22 countries and found that Canada had the dubious distinction of having the highest overall expense ratios.

Investment management involves a stupefying range of costs. Yet many Canadians aren't even aware of what investment management is costing them. One recent survey found that nearly one-half of fund investors aren't sure what their annual management fees are. Yet many of these same investors wouldn't hesitate to drive an extra block or two for a cheaper tank of gas.

While management fees aren't exactly posted at the pump, they are the most visible investment cost. Typically, they are expressed as an annual percentage of assets under management. Fees vary considerably across asset classes and companies. Certain fund share classes often have a higher management fee to pay trailing commissions to advisors.

However, management fees themselves aren't the whole enchilada. Investment funds also incur operating costs including audit, custody and administrative costs. On smaller funds in particular, these can add up, sometimes to as much as 1.0% or more of assets.

Affluent individuals who invest in hedge funds face additional costs. Hedge funds often have incremental securities borrowing and interest expenses. Sometimes, there are two layers of costs such as when a trust invests in an underlying partnership or a Canadian trust holds units of an offshore trust. Certain tax deferral structures involve addition financing expenses. These costs can really add up.

Hedge fund managers normally charge performance fees as well. These typically range anywhere from 10% to 20% of the increase in net asset value (NAV) as defined in the offering documents. Having read hundreds of offering memoranda, I can tell you the devil is in the detail. Some funds calculate the fee based on a permanent high water mark where the investor will only pay performance fees if positive returns have increased the NAV above that of their initial investment or the NAV the last time such a fee was earned. Other definitions are tilted in the manager's favour and involve "temporary" high watermarks that allow performance fees to be paid even when the investor is in the red.

Many investors are not aware that trading commissions are not included in the total expense ratio disclosed by funds. You have to dig these numbers out yourself from either the financial statements or the management reports of fund performance. Other trading costs include bid-ask spreads – the difference between the highest price offered by the buyer and seller of a stock, and market impact costs – the movement of price against a buyer or seller due to the impact of their transaction. Trading costs can really take a bite out of returns. One study of 1706 US equity funds from 1995 to 2005 found that the total trading costs averaged a whopping 1.44% per annum.

A further cost ignored by many investors is the hefty drag of taxes. Unfortunately, this occurs at two levels. First, asset management services are subject to GST/HST. Second, investment income and gains are taxable in non-registered accounts. A study of 10-year returns of 343 Canadian equity and balanced mutual funds found that taxes on distributions cost investors at the highest marginal tax rate approximately 1.35% per annum, an amount equal to about 15% of their pre-tax returns.

Fortunately, there are a few pieces of good news to offset this crushing litany of fees, expenses and taxes. First, fees for investment counseling and custody services that meet certain requirements are tax-deductible. Second, the explosion in exchange-traded funds which generally offer lower management fees, operating expenses, trading costs and tax drag has presented investors with many attractive options and placed downward pressure on the cost of actively managed funds.

While investment costs are a fact of life, investors should know how much they are paying and the impact on their returns. Ignorance can be expensive.

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