Reminder: Higher Fund Fees = Lower Fund Performance

Description

Earlier in June, independent research conducted for the Canadian Securities Administrators (CSA) published a report on mutual fund fees that (at least from where I sit) seemed to underscore the obvious.

The CSA asked The Brondesbury Group to review existing research on mutual fund compensation and determine the extent to which fee-based or commission-based compensation changes the nature of advice and thereby impacts long-term investment outcomes.

Not surprisingly, when it came to advisor compensation, the Brondesbury report found that funds that pay commission underperform, that distribution costs raise expenses and lower investment returns, and that advisor recommendations sometimes are biased in a way that the advisor can generate more compensation.

When I first read mass-media coverage the day this came out (June 12), I wondered what the fuss was about. After all, it's been fully 20 years since the famous report by the Ontario Securities Commission's Glorianne Stromberg was released, which pointed out many of the alleged evils of the mutual fund sales structure in Canada.

The extensive reform that could have flowed from Stromberg's recommendations for curbing some of the potential conflicts of interest in the industry for the most part didn't come to pass, but her work—and the media coverage of it in the late 1990s—certainly left a significant group of investors with a bad taste in their mouths for retail mutual funds sold this way.

Equally famously, the Harvard studies featuring Peter Tufano and others (starting in 2005) showed that Canada's mutual funds were among the most expensive—if not THE most expensive—in the world. Those two reports alone I'd argue moved a lot of Canadian investors out of funds sold with deferred sales charges (DSC) and into no-load mutual funds or ultimately out of mutual funds altogether in favor of exchange-traded funds (ETFs).

And yet…

Here we are midway through 2015 and we're again reminded (by an independent third party) that "Returns are lower than funds that don't pay commission whether looking at raw, risk-adjusted, or after-fee returns."

John De Goey, a fee-based advisor whose book *The Professional Financial Advisor III* makes the case for moving from commission-based compensation to fee-based (i.e., asset-based), called the Brondesbury report "self-evident stuff. Cost is a negative and embedded compensation of any kind. Nothing new."

The report also cited academic research that found advisors sometimes "push investors into riskier funds" and that investors often make poor choices because they can't easily assess what form of advisor compensation is in their best interests.

There is, of course, a strong do-it-yourself investment culture in Canada (readers of Motley Fool Canada included!) where so-called DIY investors eschew financial advice altogether in favor of picking their own individual stocks or ETFs.

The Brondesbury report suggests fee-based compensation is likely a better alternative for consumers than commission-based compensation, but caution there's not enough evidence to state unequivocally that it leads to better long-term outcomes for investors.

But the DIY crowd would argue that they're better off not paying fees based on assets under management. At a discount brokerage you are in fact paying commissions, but at $10 a trade or less, these are minimal. Compare to a fee-based or asset-based model, under which an advisor charges 1% of a portfolio value per annum. On a $500,000 portfolio, that's $5,000 a year. You could buy and sell *a lot* of stocks or ETFs at $10 a trade for that, although of course DIY investors will be paying modest fees on the underlying ETFs: typically 10-55 basis points per annum.

Yes, advice is worth something. But there is an alternative to using an advisor paid either by portion of assets under management or by commissions. You can have your cake and eat it too by investing in stocks, ETFs, or even no-load or F class mutual funds at a discount brokerage, AND get advice by using a true fee-for-service financial planner: sometimes called "fee-only," but that's a misleading term.

When I was editor-in-chief at *MoneySense* magazine, we launched an online fee-only financial planning directory (which can still be found at MoneySense.ca); it made an explicit distinction between fee-based advisors and fee-for-service (charging by the hour or other time unit, or by the project).

It may be obvious, but it's a good reminder…

A second piece of research by Brondesbury has also been commissioned by the CSA, to be completed later in the summer. De Goey expects it to be more meaningful, since it will gather actual data to determine whether embedded commissions skew advisor recommendations.

In my view, the study will again underline the obvious. It's long been known that certain quality low-fee fund families that do NOT pay trailer commissions tend not to be recommended by advisors when there are comparable funds that DO pay trailers.

The old Claymore group of ETFs used to have two classes of ETFs: an "Investor" class with lower fees, and an “Advisor” class that paid advisors a 0.75 trailer commission, and which therefore sported fees that were 0.75% higher than the Investor class that DIY investors would buy.

We’re seeing this practice slowly spread to a handful of other ETF makers in Canada. I suppose there’s nothing wrong with it if it’s disclosed properly, and there have been studies by both BMO ETFs and Vanguard Canada that quantify the value of the advice that’s accompanied by trailer commissions.

What I’m less sure of is the value of studies that prove the obvious.

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