



Will This Upcoming Threat Crush Canada's Mutual Fund Companies?

Description

Investors who don't want to go to the trouble of picking individual stocks have a number of different options.

The most popular one these days is using exchange-traded funds (ETFs). These products give investors the benefit of diversification without paying high fees. The cheapest ETFs out there have management fees of less than 0.10% per year. For somebody just starting out with \$10,000 in assets, it's possible to pay just \$10 per year in management fees.

That's a terrific deal.

Mutual funds have been the more traditional option. Funds in Canada charge anywhere from 1% to 3% in management fees. In exchange for that fee, investors get the council of a qualified financial advisor who usually helps pick the fund. They also get professional management of the fund itself and the potential to beat the market. A mutual fund manager tries to outperform the index, while an ETF just hopes to match it.

Some mutual funds do outperform their indexes, but most don't. The funds that do underperform usually suffer from the same setbacks. Fund managers don't want to look bad, so they don't buy the truly undervalued stocks that lead to market outperformance, choosing instead to buy expensive, sexy stocks.

Expensive fees mean a manager has to outperform by 3% or so annually just to beat the index after investors pay management fees. Some funds even charge sales loads that penalize an investor for withdrawing funds before a certain amount of time passes.

In short, mutual funds are a good business for the fund managers and not so much for consumers putting their life savings inside the vehicles.

I'm not the only one who has noticed this. Other, more important folks have taken notice. And it could spell very bad news for some of Canada's leading fund companies such as **IGM Financial Inc.** ([TSX:IGM](#)), **AGF Management Limited** ([TSX:AGF.B](#)), and **CI Financial Corp.** ([TSX:CIX](#)).

A flight away from fees

Investors have already started seeing changes in the way fees are disclosed to them.

Starting at the end of last year, Canadian mutual fund companies are now required to disclose the annual cost of holding a fund in dollar terms, rather than just percentage terms. Somebody that holds, say, \$100,000 in funds will tolerate a 2.5% annual fee, but might be quite upset when that fee is expressed as \$2,500 per year.

Compare that to an ETF that might charge \$100 in fees for a similar result. Once investors see for themselves the huge difference in costs, it'll make it easy to justify making the switch.

Some financial advisors are starting to embrace a different model than just taking trailer fees from mutual funds. They realize the future points away from expensive funds and towards much cheaper ETFs.

These advisors are willingly taking a little less in commission in an attempt to gain assets under management. They take a fee of approximately 0.5% a year to manage a simple portfolio of ETFs. Combine the two fees together, and customers get all the benefits of a financial advisor for less than 1% of their assets annually.

That's a good model for everyone but the traditional mutual fund companies. They will either be forced to cut fees considerably or continue to slowly but surely lose market share to cheaper options. Either way, that's not good news for folks who have money invested in the mutual fund providers.

Some of the fund companies are priced at reasonable valuations. IGM Financial only trades at 11.7 times trailing earnings. AGF Financial is even cheaper, trading at 8.7 times earnings and at less than book value. CI Financial boasts a monthly dividend of \$0.11 per share, good enough for a 4.6% yield. CI's dividend is actually the lowest out of the three, too.

These stocks could easily move higher in the short term, especially if markets continue to recover. But over the long term, I think these companies have to either evolve or die a slow death. Either way, it's probably not a sector investors should be getting excited about today.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:AGF.B (AGF Management Limited)
2. TSX:CIX (CI Financial)
3. TSX:IGM (IGM Financial Inc.)

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