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SUBSTANTIAL PRICE TO PAY: Barry O'Neill . . . harsh facts are that trading costs and high levels of trading cost a lot

Active approach not best value for investors

Funds: Trading costs continue to erode equity risk premium

BY BARRY O'NEILL

A recent survey found the majority of investors still feel that investment costs are not being clearly disclosed to them, despite efforts by the regulator to increase transparency.

A contributing factor to this is the apparent reluctance by fund-management groups to publish a truly comprehensive "total cost of investing".

The industry has had several attempts at this over the years but, to date, disclosures have excluded one fundamental piece of the jigsaw; trading costs.

The average actively managed UK equity fund typically holds shares in 50 to 100 companies.

Fund managers have a team of sector analysts whose job it is to carry out in-depth research on the companies in their given sector in the hope that they can spot, in advance, those companies most likely to outperform.

> **"Additional turnover costs often push the real cost of investing above 3% a year"**

Analysts are rewarded when companies they recommend make it into the portfolio.

Faced with these often-compelling recommendations, fund managers regularly "buy in" to the story and replace one of the existing companies in the portfolio.

This trading activity, although seemingly well intentioned, is at the very heart of why investors get a raw deal from most actively managed funds.

If such changes (called "turnover") could be implemented without incurring fees, then active management might work for the end investor.

However, the harsh facts are that trading costs and high levels of trading cost a lot.

Numerous studies into the costs of trading have concluded that, on average, it adds at least a further 1% per annum to the published cost of the fund, plus local taxes; known as stamp duty in the UK.

It is little wonder therefore that retail investors have been poorly served by traditional active management when these additional turnover costs often push the real cost of investing above 3% a year and in some cases, above 4% a year.

The "equity risk premium", or the long-run additional return from equities compared to government bonds, has historically been 4% to 5% a year.

Investors in actively managed funds with high levels of turnover have therefore been taking on all of the risks associated with equities but the expected additional return has been eroded almost entirely by costs.

Institutional investors across the world such as pension funds and local authorities have increasingly been shunning traditional active management in favour of lower-cost, more academic approaches to investing.

Retail investors should consider doing the same.

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