Weekly Digest
13 August 2018

Investec
Wealth & Investment

The weekly insight into world stock markets

Never Too Much

Luther Vandross once said that "the best things in life are free" but Coco Chanel added that "the second best things are very, very expensive". It's not often that a former member of a disco band and fashion creator can together encapsulate a crucial investment debate: the importance of fees in active fund management. Earlier this month investment management giant Fidelity announced two new index funds with zero fees. Let's put to one side Fidelity's motivations (these might be loss-leader products and thus not widely replicated) or the small print (Fidelity may earn revenue from "lending out" the assets in these index funds). This clearly – and correctly – continues to place a harsh spotlight on the matter of fees and sets a new and welcome standard.

At Investec Wealth & Investment we believe that exposure to market returns (the benchmark) – as index funds do – should typically cost investors very little. After all, there is little effort or skill required nowadays to run an index fund that replicates a benchmark. We also believe that it is necessary to pay an appropriate fee for exposure to skilful managers who can outperform the market. After all, skilful managers will want to be paid for their efforts. However, we need to avoid overpaying: there is strong evidence showing a negative link between fees and future performance. The crucial question to which Luther and Coco allude (in the absence of evidence to the contrary, almost certainly unwittingly) is what is the right fee to pay for an actively managed fund?
We have identified seven ways the appropriateness of fees should be assessed and we measure all of our actively managed funds against these criteria.

First, fees should be a modest but reasonable percentage of expected outperformance. If we expect an active manager to outperform its benchmark by 1% a year before fees, clearly a 1% p.a. fee leaves us with no outperformance at all and we would be just as well off in an index fund. A fee of 0.5% p.a. means splitting the 1% p.a. expected outperformance 50:50 with the fund manager, which also seems way too high. In our experience a modest but reasonable percentage of expected outperform to be paid away in fees is about 20-30%.

Second, it is the net result that counts. A fund that we expect to outperform by 5% a year before fees can charge a 3% p.a. fee and still leave investors with 2% net outperformance each year. In this scenario that is more appealing than a fund that we expect to outperform by 1% a year before fees but charges a much lower 1% p.a. fee.

Third, fees should reflect the potential to outperform. If a fund's investment strategy or approach is such that, regardless of the fund manager's skill, there is little prospect of outperformance, all other things being equal we should not be willing to pay much of a fee for the fund. Thus the more flexible the fund, the higher the potential to outperform.

Fourth, fees should reflect the scarcity or access to an asset class or strategy. Fund managers that invest in popular areas with investors but with little competition will, like any other industry, be able to charge more for their services than fund managers investing in sectors with lots of competition. Niche asset classes or first movers into a field often have the ability to charge premium prices simply because there are no other options for investors if they want a particular type of investment exposure.
Fifth, fees should reflect the skill, resources and experience of a fund management team. By this measure the better qualified and more skilled the fund management team, the higher the fee we should be willing to pay because it is a premium product. Of course, this must manifest itself in a higher likelihood they will deliver outperformance.

Sixth, fees should reflect the cost of running the product. A focused strategy that requires little manpower or technology is cheaper to run and thus should charge a lower fee than a fund with a strategy that requires, for example, a large team of analysts or access to lots of paid-for data or research.

Seven, fees should be set to ensure an adequate return for the fund manager. Recent work by the FCA showed the asset management industry as a whole benefits from very high profit margins, indicating that fees overall have scope to come down considerably. However, within the sample was great variation and profit levels are determined by many factors, not just a company's pricing policy. In a complex area, investors should be cognisant at least of the degree to which a fund management company's profits might be reflecting undue pricing power.

Collectively these seven criteria boil down to a simple fact: fees for actively managed funds should be commensurate with the value it creates. After all, Luther Vandross might have sung "The Best Things In Life Are Free" but he also sang "Never Too Much".

Andrew Summers
Head of Collectives

FTSE 100 Weekly Winners

Standard Life Aberdeen	6.2%
WPP	4.9%
AstraZeneca	4.5%
Burberry Group	4.4%
Ashtead Group	3.8%
Carnival	3.7%
NMC Health	3.6%

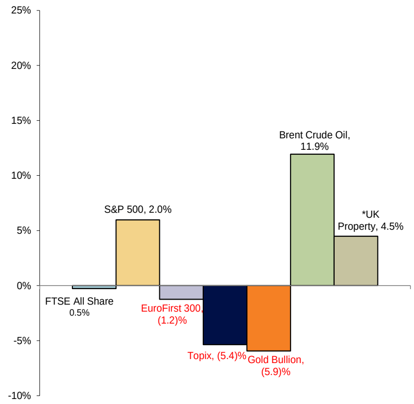
Source: FactSet

FTSE 100 Weekly Losers

Paddy Power Betfair	-10.9%
Intertek Group	-8.7%
Evraz	-6.9%
Rio Tinto	-4.7%
Rolls Royce Holdings	-4.6%
Direct Line Insurance Group	-4.4%
BT Group	-4.0%

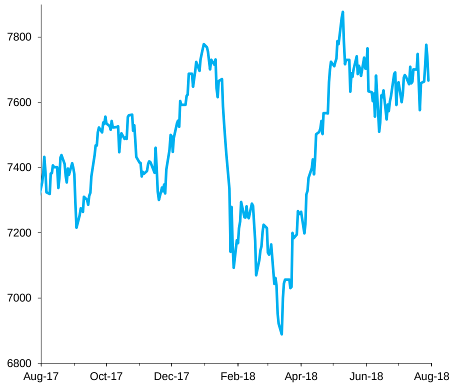
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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