

Outside the Flags

May 2011

Why Costs Count

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A positive consequence of the financial crisis is a dawning among investors about the difference fund fees can make to what they ultimately receive in their pockets. Even better, this new climate of transparency is a global phenomenon.

A report last year from fund rating service Morningstar¹, no less, found that low mutual fund fees were better than “star” ratings systems in predicting winning funds.

“If there’s anything in the whole world of mutual funds that you can take to the bank, it’s that expense ratios help you make a better decision,” the study’s author Russel Kinnel said, noting that in every time period and data point tested in the four-year study, low-cost funds beat high-cost funds.

These findings have been echoed this year by another research firm Lipper.² In an analysis commissioned by the London Financial Times, Lipper found that in the decade to the end of March, 2011, global equity funds in the US market delivered total returns of an average 66.22 per cent for the full 10-year period, against 50.02 per cent for UK funds. The results are on a local currency basis and gross of tax.

Lipper attributed the superior performance to a traditionally greater focus in the US on fund fees by independent boards of directors.

Even so, the UK market is changing, with new regulations stemming from a review of retail funds distribution due to come into force in 2013. The changes include a ban on commissions and a requirement that consumers receive upfront information about the fees they pay for advice.

While the review has not mentioned fees charged by funds themselves, the move by UK advisors toward a fee-for-service model is expected to result in advisors pressuring funds to lower their own management fees.

“The proposed changes to the way funds are distributed are such that the previous glacial pace at which apparent price wars had been fought over the previous 12 years has begun to quicken,” Lipper’s head of consulting Ed Moisson said in a separate study earlier this year.³

The Dutch government is following the UK lead, announcing last month that it also will ban commissions on financial services products and force banks and independent advisors to be more transparent about costs.⁴

In Australia, a similar revolution is underway. The federal government late last year, in response to an 18-month inquiry, announced proposed reforms⁵ aimed at lowering costs of superannuation, or pension fund saving.

¹ Russel Kinnel, ‘How Expense Ratios and Star Ratings Predict Success’, Morningstar, Aug 2010

² Lipper performance comparisons, April 2011

³ Ed Moisson, ‘The Pressure to Perform’, Lipper Research, March 2011

⁴ ‘Holland to Ban Commission in RDR-Style Reform’, Money Marketing, April 27, 2011

⁵ Australian Treasury, ‘Stronger Super’, Dec 2010

Fully implemented, the proposed reforms are estimated to have the potential to lower fees by up to 40 per cent, lifting the retirement savings of a 30-year-old on average wages by \$40,000 or 7 per cent.

Separately, the government in Canberra recently confirmed plans⁶ to ban all commissions to financial advisors from July 1, 2013, as well as other initiatives to bolster consumer protection.

"Fees and costs matter," the Australian pension reforms' authors said in their report. "They detract from members' retirement savings and need to be managed as diligently as the generation of investment returns."

The evidence supporting the case for a greater focus on fees and costs has been growing steadily for years. In 2007, analysts of the Harvard and London business schools published research⁷ on fees charged by 46,580 mutual fund classes offered for sale in 18 countries. Total assets covered more than \$US10 trillion or about 86 per cent of the funds sold worldwide.

This study found a substantial variation in the level of fund fees around the globe, even after allowing for the size of funds, whether they sell to institutions or the retail market and whether they are index or traditionally active.

"The remaining differences are associated with a variety of factors, the most robust of which is that stronger investor protection is associated with lower mutual fund fees," the authors found.

This new global focus on the costs of investing is no accident. It represents an understanding, finally, that for too long investors have focused on things outside their control – like market ups and downs and media noise – at the expense of factors *within* their control – like adequate diversification, costs, fees and taxes.

As we have seen, legal systems and regulations are moving quickly in many jurisdictions to improve transparency around fees and ensure greater power to consumers in making smart investment decisions.

These changes are in keeping with the philosophy that Dimensional has embraced since its own founding three decades ago. Because the firm focuses on capturing broad dimensions of risk rather than the random movements of individual securities, it can trade patiently and keep costs low.

This unique approach results in lower fees to investors than those charged by traditionally active managers, while adding value beyond what can be achieved via a simple index approach.

Costs and fees make a difference. We have known that for a long time. And now the rest of the world is discovering the same lesson. That's good news for investors.

⁶ 'Future of Financial Advice', Information Pack, Australian Government, April 28, 2011

⁷ Ajay Khorana, Henri Servaes, Peter Tufano, 'Mutual Fund Fees Around the World', SSRN, July 2007

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