

Brief Guide to the True Cost of Investing

Holland Hahn & Wills investment approach aims to bring transparency to your decision making process.

Only when the veils of hidden costs are lifted will the investor have sufficient knowledge and information needed to assess which funds will provide value for money within a managed portfolio.

Introduction:

The true cost of investing in the UK is made up of disclosed and undisclosed charges:

1. Disclosed charges:

- Initial costs associated with purchasing the securities (including broker commission)
- The annual management charge (AMC), sometimes rounded up and referred to as total expense ratio (TER)

These are displayed on client quotations and are included in the 'reduction in yield' (RIY).

2. Undisclosed charges:

These are the hidden costs associated with 'trading' securities within the individual funds:

- Commission
- Bid/offer spread
- Price impact
- Stamp duty

These hidden costs can be substantial! The average cost of a 'round trip trade' can be up to 1.80% of the amount traded. In other words if 100% of the fund were traded over the course of 12 months, this would add 1.8% to the annual charge.

Investment Styles:

There are two investment styles – 'active' fund management and 'passive' fund management

1. Active fund managers:

Active fund managers aim specifically to 'manage' a fund by achieving growth in excess of a benchmark index. They do this by stock picking, or speculating on market movements and by actively 'trading' securities within a fund.

The buying and selling of underlying securities is known as 'portfolio turnover', active fund managers have high 'turnovers' in order to try and generate excess returns.

2. Passive fund managers:

Passive fund managers aim to replicate or 'track' the movement of a particular benchmark index. They will therefore only trade securities when required to in order to match the index that they are tracking.

Passive fund managers have lower 'turnovers' as they merely have to 'track' the movements of their indices.

Effect on charges:

The average turnover of actively managed equity funds is in the region of 60% per annum and passive index funds is up to 30% per annum¹. The effect of this is to add charges between 0.6% and 1.2% per annum.

¹ 'Portfolio Turnover of UK Funds' a Lipper Fitzrovia Consulting Report, Dec 2005

Paul Myners, who led HM Treasury's review of institutional investment in the UK, has perhaps been even more outspoken on this issue, estimating that the cost of actively trading UK equity portfolios is around £2.5 billion each year. He was quoted as saying, "There is no evidence that this huge payment – a tax on investors – yields a positive return."²

The drag effect of annual charges:

A £5,000 investment growing by 7% a year should grow to be worth £19,348 after 20 years (with no annual expenses). But if the annual expenses (or TER, see below) are just 1% these will drag down the performance to £16,036. An extreme example of a TER of 3% drags it down even further to only £10,956 - around £8,400 has been taken in charges.³

Which approach is best – active or passive?

There is substantial evidence to suggest that active fund management adds no benefit. In fact studies show that over 90% of the returns are derived from being invested in the market in the first place! (and over 96% if a structured approach is adopted).

To quote from the FSA document "The Price of Retail Investing in the UK" February 2000⁴:

"... Active management does not enhance individual fund performance (though it does create benefits for the economy as a whole)."

And

"High explicit charges, on the other hand, do have a strong and predictable negative impact upon net performance".

The long term effect of active management on charges:

Life Insurance company statistics between 1987 and 1998:

"Over the entire sample period, the average market rate of return on the combined life office portfolio equals 8.45%, and the average return obtained by investors as a whole equals 4.44%.⁴

Conclusion:

"Retail investors cannot easily measure the price of investing through the investment funds they must choose between, in part because a significant element of this price is mostly not disclosed at all."⁴

Clearly, there is more to investing than putting all of your money into a FTSE 100 tracker. For more information on building a structured cost-effective portfolio please request our '**Brief Guide to Maximising Investment Return**'.

How you can find out more about the true cost of investing:

Contact Holland Hahn & Wills or

<http://www.fsa.gov.uk/pubs/occpapers/OP06.pdf>

<http://www.fitzrovia.com/>

Risk Warnings

The value of your investment can go down as well as up and past performance is no guarantee as to future performance.

² The Times, 15 February 2003

³ 'Portfolio Turnover of UK Funds' a Lipper Fitzrovia Consulting Report, Dec 2005.

⁴ 'The Price of Retail Investing in the UK' FSA Occasional Paper Series 6 by Kevin R James, Feb 2000