How Do You Pay And What Do You Pay For?

Summary

In this section I'll walk you through a history of investing in Canada and how the financial services and financial planning sectors arrived at where they are, how you pay and what you are paying for, and how to determine what you pay, plus a few other tidbits. The ultimate question arising from this section is: are you getting value commensurate with the cost?

Brief history of investing in Canada

Prior to the creation and popularity of mutual funds, retail investors had a choice. You hire a financial advisor, better known as a stock broker at the time, or you invest in GIC's at your bank. Those who hired a financial advisor were substantially wealthier than the average population. Their portfolios were invested in stocks and bonds. Proper diversification principles meant that the client would purchase a basket of stocks and bonds individually. The stock broker got paid per transaction. The average population had little access or ability to invest in Canadian or global companies.

The creation of mutual funds and the invention of the deferred sales charge option changed all this. Clients with limited means could now invest in one or two mutual funds and obtain complete diversification. The invention of the deferred sales charge option meant that smaller clients were profitable to the stock broker. For a refresher on the DSC option, the fund company pays the advisor 5% of the value of the purchase. The fund company recoups the payment by ensuring the client remains invested for 8 years. If the client redeems out of the fund company before the end of the 8-year period, there is a sizeable charge to the client. If a client invested $25,000 in a fund, the advisor and advisor's firm shared $1,250 up front and ongoing smaller trailer revenue. The DSC option meant that middle class clients were profitable. The revenue generated by offering the DSC sales option created a whole new clientele that were previously unprofitable to the advisor.

Mutual funds allowed the smaller investor access to stock and bond markets and allowed the advisor to earn a lot of revenue. Advisors quickly began offering mutual funds to all clients. Mutual fund companies aggressively marketed their funds to financial advisors.

Financial advisors transitioned their business from investment picking to financial planning. The fund manager was now performing the investment picking task. Their business transitioned from "I like investment A because the P/E is low and cash flow is high" to "I think you should invest in an RRSP instead of a non-registered account. If you do so, and save $10,000 per year, you will be able to retire at 60".

Everyone was happy. Financial advisors were getting rich, clients had access to higher earning equity and bond markets and fund management companies were booming. Well, not all were happy. Banks were not offering mutual funds to their clientele. Many of their clients moved from bank GICs to independent financial advisors and invested in mutual funds. Banks eventually succumbed and now offer all sorts of pooled funds and hold a large market share of the investment management industry.

Then came along research that proved that fund management companies and professional fund managers were not creating value. Few funds could consistently outperform the benchmarks pre-cost and especially after-cost. As posted on the Active vs. Passive tab, 93% of large cap (big companies), actively managed U.S. investment funds underperformed the S&P 500 index over a 15-year period. The link between high total cost and underperformance became clear.

The passive investment management industry was born. John Bogle, a passionate advocate for low-cost, passive investment management, created the investment management company Vanguard in the early 1970s. TIPS, an ETF that replicated the returns of the Canadian market, was created in the early 1990's. The passive investment management industry has grown steadily since.

We are not far from this period now. Still though if you want financial planning advice you likely must accept high cost actively managed investment funds. Very few advisors offer passively managed ETFs or index mutual funds to their clientele. They are not nearly as lucrative to the advisor and investment management industry as the actively managed pooled fund.

How do you pay and what are you paying for?

How Do You Pay

When we purchase a good or a service we typically pay a transaction fee. If I buy a TV I pay a one-time fee. If I pay someone to clean my home's eavestroughs, I pay a one-time fee. I know the price in advance and pay the fee for the work done or product purchased. This is not so with financial advisory.

Pooled funds (both mutual funds and exchange traded funds plus other categories are pooled funds) come with a Management Expense Ratio. Management Expense Ratio is cost to the fund investor. If a fund has a 2% MER, the fund manager is removing 1/365 x 2% out of the fund each day. It is a 2% annual fee charged daily. Fixed income funds typically come with a lower fee because there is less investment research to perform.

Two percentage points of anything sounds small. This is not the case with investing. The pre-cost return is also small. If investments within the fund average a 7% return, a 2-percentage point charge results in a post-cost return of 5%. Cost at 2 percentage points reduced growth from a 7% pre-cost return by 29%. Or, post-cost return is 71% of pre-cost return. This adds up to an enormous reduction in account value over the long-term. The difference in portfolio value with a 2 percentage-point return difference.

This ignores all other potential cost such as DSC charges and account fees.

An example helps. Let's say you hold $100,000 in a fund with a 2% MER. The fund delivers an annual 7% pre-cost return and a 5% post-cost return to investors per year for 5 years. I will ignore trading expenses for the moment. (Trading expenses are incurred when the fund manager makes a trade. The more the fund manager trades, the greater the relevance of trading expense. Passively managed products have trading expenses but because they are managed passively they don't trade much and expenses are low. (If a company in an index gets removed from the index, passively managed products that track the index must sell the company out of the portfolio.))

At the end of:

Year	Value	Approximate Cost Paid
1.	$105,000	$2,000
2.	$110,250	$2,100
3.	$115,763	$2,205
4.	$121,551	$2,315
5.	$127,629	$2,431

At the end of the 5th year you have $127,629 invested in the fund and have paid $11,051 in fees. You have not seen a charge on a bill or invoice. If cost was 0% per year you would have $140,225 in your account. Total cost to you is $140,225 – 127,629 = $12,626. The difference of $12,626 - $11,051 = $1,575 is the fees paid not compounding in your account over the 5-year period. Your account is 8.98% less valuable because of the cost paid and not compounding in your account.

Most ignore this. They look at their statement and are pleased that their account has grown to $127,629. The financial service industry takes advantage of this.

What Are You Paying For

You are buying two services. You are buying the day to day management of your savings through the fund manager and you are buying the financial planning services of the financial advisor or planner. As an approximation, the fund management company keeps 45% of the MER as company revenue and sends 45% of the MER to the financial advisor's firm to be shared with the financial advisor. The remaining 10% is allocated to fund expenses such as accounting fees, statements, etc. In year 1 of the above example, the fund management company takes $2,000, keeps $900 as company revenue, spends $200 on fund expenses, and sends $900 to the financial advisor's firm to be shared between the firm and financial advisor. In year 2 the amounts increase to $945 each and so on. This goes on for as long as you have money invested in the fund.

After reading the Active vs. Passive tab you should understand that the active fund manager is not adding value. Investors are paying for professional management and are likely underperforming the relevant benchmarks over the long-term pre-cost and underperforming worse after cost. As seen in the Active vs. Passive tab, 93% of large cap. US funds in the US underperformed the S&P 500 over a 15-year period.

The financial advisor or planner, on the other hand, if they are skilled at their profession, is most likely adding value. However, if the client is an employee earning T4 income, there isn't that much potential value to add.

Are You Getting Value Commensurate With Cost?

A two percentage-point cost factor is taking an enormous amount of wealth from you in the long-term. We see that with the above linked spreadsheet. Even a one percentage point cost factor is difficult to justify. Are you getting that much value? Is it not worth a few hours to learn and a few hours per year to maintain your accounts to slash your high-cost factor? There is not much financial planning complexity when earning T4 income.

Over a 40-year period, a two percentage-point cost factor off a pre-cost return of 7% reduces the growth of a one-time, lump-sum investment by over half by year 40.

Over a 40-year period, a two percentage-point cost factor off a pre-cost return of 7% reduces the growth of a systematic annual savings (ex $10,000 per year for 40 years) by over a third by year 40.

Something to think about regarding the value of advice is that many Canadians have Group RRSP accounts or (maybe as well) Defined Contribution Pension Plans. Very little advice is delivered with these plans. A representative of the plan, typically an employee of an insurance company, will come and give a group presentation twice a year if that. But, I bet your group RRSP or DC pension plan is doing just fine. Are you missing out by not receiving any advice?

I Should Explain The Deferred Sales Charge Sales Option

Deferred sales charge, and versions of it, are popular with independent financial advisors. Approximately 5% of the value of a fund purchase is sent from the mutual fund company to the financial advisor's firm. The client does not pay this. 100% of the client's money is invested in the fund. The fund management company finances the 5%. They recoup their money by sending less to the financial advisor's firm on an ongoing basis for typically the first 7 or 8 years. If the client redeems this specific chunk of money out of the fund management company (the client can switch between the fund management company's funds) within the first 7 or 8 years, the client pays a hefty redemption fee. If the client redeems after this period, there is no fee. The fund company has recouped its 5% payment. This fee can be avoided if you don't redeem. The unwelcome news is that you are somewhat committing your money to the firm for 7 or 8 years. Life can get in the way of this commitment. Many people end up paying a hefty DSC charge.

Why does this exist? In the above example, a $100,000 purchase results in annual revenue to the financial advisor of approximately $450. Successful advisors get more, unsuccessful advisors or new advisors get less. A new or struggling advisor needs a whole bunch of $100,000 accounts to make a living. $100,000 accounts are not that easy to come by. With the deferred sales charge sales option, the financial advisor's firm gets approximately $5,000 up front and lower ongoing revenue for the first 7 or 8 years. If a new advisor gets 20 $100,000 accounts per year and negotiates the DSC sales option with each client, they will earn $50,000 of revenue per year with a 50 /50 split with the firm.

The industry is slowly moving away from the DSC sales option.

How To Find Your Cost Factor

Grab your statement and search the internet for the exact name of the investment on your statement. Try to find the Fund Fact. Here is how the Ontario Securities Commission describes a fund fact: https://www.getsmarteraboutmoney.ca/tools/fund-facts-interactive-sample/. In this example total cost is MER + TER = 2.3% found near the bottom of fund fact. It is Canadian law for each non-insurance fund to maintain and present a Fund Fact.

If you hold more than one fund your total cost factor will be a weighted average of the total cost of each fund. Let's say you hold $50,000 in fund A with a cost of 2.10% and $25,000 in fund B with a cost of 1.85%, then total portfolio cost is 2.02%.