
The Lowdown on Fees

Investment Management Fees and Costs – Part 1

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Investment Management Fees and Costs – Part 1

Investment management fees and costs vary wildly depending on the investment style, asset class, and investment strategy.

When it comes to investment management and superannuation, “fees” typically dominate the headlines. However, fees have a number of components, and understanding their nuances is critical if you want to compare apples with apples.

Morningstar’s Total Cost Ratio helps investors make meaningful comparisons. It is a single figure encompassing the total nondiscretionary fees and costs (“fees”) associated with managing a fund in Australia. It incorporates investment management fees and costs; performance fee costs; and total annual dollar-based charges. This three-part series looks at the components of the TCR and how to bring them together to compare across a range of funds.

Here, we will focus on investment management fees and costs and how they can vary across asset classes and strategies.

Key Takeaways

- ▶ Investment management fees and costs are charged regardless of how a fund performs.
- ▶ Actively managed funds typically charge higher fees than passively managed funds.
- ▶ Small-cap and emerging-markets managers typically are more expensive.
- ▶ The devil is in the details for fees on more-complex strategies.
- ▶ Net returns matter.

What are investment management fees and costs?

Investment management fees and costs are paid to the fund manager to cover the costs of running their business (for example, staff costs, rent, and technology) and the costs of operating the fund (for example, legal fees, audit fees, and custodian fees). It also normally includes a profit margin.

Investment management fees are charged regardless of how the fund performs. It is important that fees are kept as low as possible for investors; however, it is in investors’ interest that the asset manager is able to cover their costs—especially salaries for good staff—and remain solvent.

Expect investment management fees to vary depending on the investment approach, asset class, and the investment strategy.

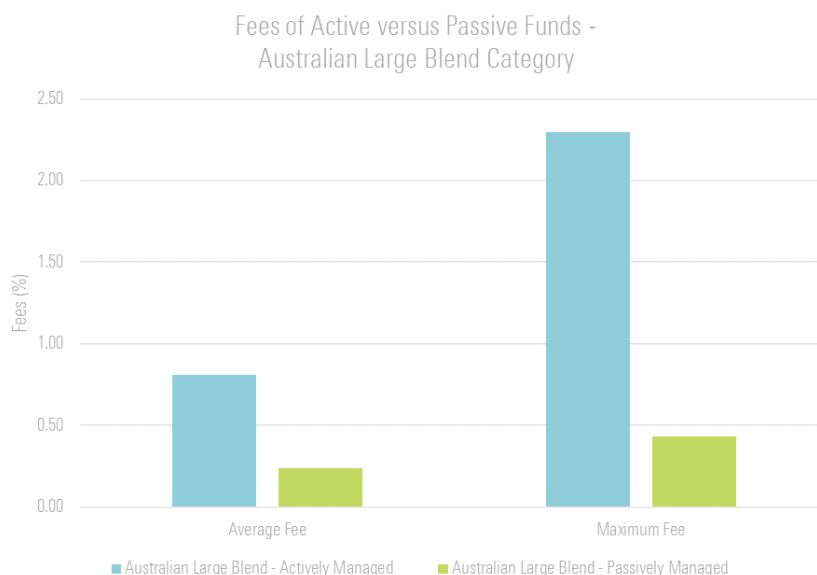
Active versus passive funds

Fees on actively managed funds are typically higher across the board. There is also a much larger difference between the minimum and maximum fees you would be charged by an active fund compared with a passive fund. Exhibit 1 takes the Australian large blend Morningstar Category and shows that the

average annual investment management fee for an actively managed fund is just over 0.80% compared with 0.25% for a passively managed fund. It also shows that the maximum investment management fee for an actively managed fund in this category can be up to around 2.30% per year.

The difference between active and passive investment management fee rates is largely due to the costs associated with investment research staff and, in some cases, what the manager thinks it can get away with charging based on past success or effective distribution networks.

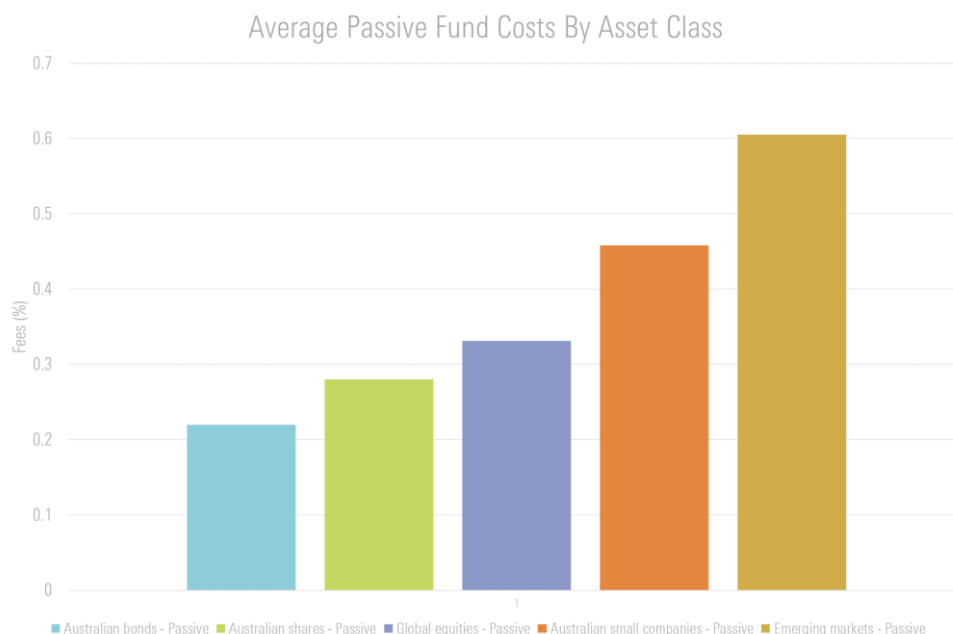
Exhibit 1 Fees of Active versus Passive Funds - Australian Large Blend Category



Source: Morningstar Direct as at 30 September 2021 (data excludes exchange-traded funds and any funds that are offered exclusively on platforms).

Bonds to emerging markets: fees across the asset classes

Investment management fees also tend to vary depending on the asset class—funds investing in defensive assets are generally cheaper than those investing in growth assets. Let’s use the average investment management fees of passive funds in Morningstar’s Direct database to highlight how fee levels generally increase in line with the risk or complexity of the underlying investments (Exhibit 2). This difference in fees across asset classes is driven by numerous factors including the risk and complexity of the asset class, the liquidity of the underlying investments, and the number and type of underlying jurisdictions invested in.

Exhibit 2 Average Passive Fund (including ETFs) Costs by Asset Class

Source: Morningstar Direct as at 30 September 2021 (data includes exchange-traded funds and excludes any funds that are offered exclusively on platforms).

Capacity and complexity

Exhibit 2 shows that Australian small companies is one of the more expensive asset classes. This holds for both active and passive small strategies. Why? Firstly—capacity. The amount of money able to be invested in an asset class is a significant factor. Small-cap managers face all manner of size constraints. For example, consider a manager who wants to be able to invest 2% of a fund in a sub-\$200 million market-cap company. Assuming the manager doesn't want to hold more than 5% of the company, the maximum investment is \$10 million. If the manager wants to invest 2% of the fund across a number of these types of stocks, it means the fund size is probably capped at about \$500 million. Compare this to managers focused on the largest companies only, with multi-billion-dollar market caps. They are able to manage much larger funds and therefore are likely to have lower investment fees because the overall dollar fee they earn can be much higher. Secondly—complexity. An Australian large-companies-focused manager is normally focused on researching the largest 200 companies. And many of these companies are already well researched by other researchers in the market, namely stockbrokers. On the other hand, Australian small-companies-focused managers have a research universe of up to 1,000 companies, and many of these companies are not researched by others in the market. As a general rule, this makes the research task more complex and time-consuming for small-companies' managers.

Emerging markets typically have very high investment fees as well. As with small companies, there is a diverse and fragmented opportunity set and the markets are also geographically vast, complex (politically and culturally), and generally more expensive to trade in. For active managers, covering this

takes substantial time and resources, and you would expect your emerging-markets manager to have a global team, either with staff located around the emerging markets or prepared for frequent travel—both of which can be expensive.

Complexity counts: investment management fees for two actively managed Australian share funds

A fund with a more complex investment strategy may also charge a higher investment management fee. In some cases, this can be done in a way that is confusing for investors. The Perpetual Wholesale Australian Share Fund and the Perpetual Wholesale SHARE-PLUS Long-Short Fund provide a good example of a simple investment strategy and a more complex strategy and how the fees are charged differently.

The Perpetual Wholesale Australian Share Fund is a “long only” strategy (it buys shares and profits when they rise in value). This fund does not employ any leverage and charges 0.99% per year on the assets it manages (referred to as the *net asset value*). That is, if the fund was managing \$100 million in *net assets*, it would receive \$990,000 each year in investment fees.

On the other hand, the Perpetual Wholesale SHARE-PLUS Long-Short Fund (Long-Short Fund) employs a long-short strategy and profits when the “long” positions rise in value and the “short” positions fall in value. Under the fund’s Product Disclosure Statement (as at 1 June 2021), the fund sums the value of the long and short positions together for the purposes of the investment fees. The sum of the long and short positions can exceed the value of the fund’s *net assets*. For example, if the fund was managing \$100 million in net assets, the PDS states that the total *gross assets* (when adding long and short positions together) on average will equate to \$140 million of *gross assets* being managed (as the short positions create a leverage effect).

Why is this relevant from a fee perspective? Perpetual’s PDS says that it will charge 0.99% per year on the *gross assets* (that is, \$140 million multiplied by 0.99%, which equates to \$1.39 million) of the Long-Short Fund. But remember that the Perpetual Wholesale Australian Share Fund charged 0.99% per year on *net assets*. To properly compare the two funds, investors should consider fees charged on net assets (not gross assets). The Long-Short Fund’s investment fee is actually 1.39% per year (that is, \$1.39 million divided by the \$100 million of *net assets* (and not the \$140 million of *gross assets*)) on an apples-to-apples basis.

The impact of investment fees on your return

Let’s look at two hypothetical funds to fully understand what a difference a high investment management fee can make to your return over 30 years (see Exhibit 3). In this example, it changes the final outcome by over \$87,000 of your initial investment amount.

Exhibit 3 The Impact of Investment Management Fees on Returns

	Fund 1	Fund 2
Gross investment return (per year)	7.00%	7.00%
Less: investment management fees (per year)	0.50%	1.00%
Net investment return (per year)	6.50%	6.00%
Balance after 30 years (\$100,000 initial investment)	\$661,437	\$574,349

Net investment returns are the key. In a world of unknown future returns, investment management fees are a certain deduction from your investment return. Fees can make a material difference to the ultimate outcome, so it definitely pays to be aware of them.

Fees are not straightforward. They can vary wildly depending on the asset class, investment style, or strategy. There are also nuances to be aware of when assessing fees to ensure you are making an apples-to-apples comparison. But there's no doubt that investment management fees are an important part of an investment decision. And **Morningstar's Total Cost Ratio** has been designed to provide an investor with a figure quantifying the cost of investment across all types of investment products.

Stayed tuned for Part 2 of The Lowdown on Fees, where we will look at the performance fees' component of the Total Cost Ratio. ■■■

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