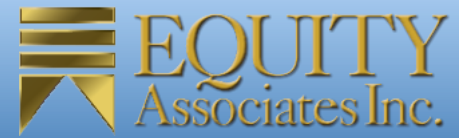




# INNOVA

## Market Insights



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June 2015

### Issue #36 - "Understanding Investment Fees!"

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*"Price is what you pay, value is what you get."*

- Warren Buffett

Over the last few years, a large part of the investment discussion has been focused on the fees pertaining to investing in managed products such as mutual funds, hedge funds, segregated funds and exchange-traded funds. Until recently, the bulk of investment management fees were hidden and difficult for most investors to understand. In this month's issue of Innova Market Insights, we peer behind the curtain and shed light on how investors pay for the advice, services and products they receive.

#### **What are you paying for?**

Managed funds are the pooled investment dollars of many individuals, invested and administered by a professional management company. The primary benefits of investing in these structures include immediate diversification, economies of scale for research and trading costs, and access to the brightest and best-connected investment professionals in the industry. The primary drawback is the topic of this article: the fees paid for these products, which act as a direct erosion of the benefits gained from the structure.

The fees levied by managed products can vary greatly, depending on the product and the services included. At the most basic level, an exchange-traded fund simply mimics an underlying index or pre-determined list of securities, essentially buying everything on the stock market, or at least a subset that would represent a purchase in the entire market. In some cases, no research, advice or selection process goes into these funds and as such, a very low management fee, ranging from 0.1% (one tenth of one percent) to 0.5% (half of one percent) per year, is common in the marketplace.

On the other hand, managed products offering access to premiere money managers offering complex investment strategies across multiple markets and currencies can levy fees as high as 5% per year. These fees are typically disclosed as the Management Expense Ratio (MER) and include the entirety of the management, research, trading, legal, accounting, marketing and compliance costs. In some cases, these will also include financial advisor's compensation and even the taxes. These amounts are summed up in one easy-to-compare number. In other words, the MER is entirety of what you pay to invest in a managed product, after tax.

#### **How are you paying?**

But how are you, the investor, paying for this MER? As a percentage, the Management Expense Ratio (MER) is levied and deducted on a daily basis from the investment you have in a portfolio. In a simplified example, if you had \$100 in a mutual fund with an MER of 3.65%, you would effectively see  $(\$100 * 3.65\% / 365 \text{ days in the year})$  \$0.01 (one cent) taken from your investments every single day in MER fees, the summation of all the fees for your account. This 'hidden' fee, can add up quickly on large amounts and if you are not careful, it can greatly erode your long-term rate of return, particularly if you are not getting value for your money. It is important to note that the returns posted by all managed products are always displayed AFTER all the fees have been levied.

#### **Fees versus Value**

The end goal of investment management is not paying low fees, but rather meeting your investment objectives. These can range from growing your investments as quickly as possible, to protecting the assets you've accumulated, to earning more interest than you'd get from a bank on your savings for a child's education. With this in mind, choosing a product that can best help you reach your goals is the primary concern, and although the fees you are paying influence that outcome, they are not the only consideration.



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For example; which of the two following investments would you have preferred to have invested \$100,000 in a decade ago, assuming they had the same risk levels?

Fund A) MER of 0.5%, Returned 9% per year over the last 10 years after fees

Fund B) MER of 2%, Returned 10% per year over the last 10 years after fees

An investor in fund A) would have \$236,736 after fees in his account after a decade, while an investor in fund B) would sit with \$259,374 in investments after fees despite having paid \$25,000 more in management fees along the way. Any rational investor would prefer the additional \$22,638 in savings, despite what they had to pay to get there.

As with any product or service that is purchased, research is the key to ensuring you get good value out of your hard-earned dollars. The world of investment management is definitely an example of a marketplace where you do not always get what you pay for. In fact, many of the higher-management-fee funds frequently underperform against their lower-fee counterparts precisely because of the fees they've levied along the way. The MER on the Investor's Group Dividend Fund, the second largest fund in the country, stands at 2.39%<sup>1</sup> while the industry asset-weighted average for funds offered with advice sits at 2.18%<sup>2</sup>.

### **Portfolio Construction & Fund Research**

Due diligence and fund research entail examining the methodology and past actions of an investment manager and attempting to forecast how that will perform in relation to your expectations of future market performance.

For example, if you believe that the markets will do very well over the next five years, you may want to choose a managed product that is focused on, whose methodology is built upon, and whose track record supports, its ability to select investments that have a multiplier effect on the market.

Conversely, if you are expecting a down or bear market, you may want to look for managed products that offer strategies to mitigate or even eliminate the downside exposure of an investment. Combining the various managed products into a portfolio in line with your investment objectives is the goal of your investment advisor.

### ***The Advisor's Role***

With regard to managed products, the advisor's role in the investment management process is to research the products available on the market and combine them in such a way as to build a portfolio that suits a client's stated risk tolerance and objectives, which they have ascertained and defined during one-on-one meetings. Once the investment portfolio is established, the advisor's office is responsible for handling and executing trade requests, monitoring and managing the portfolio to ensure that it continues to perform in such a way as to reach the client's objectives.

### ***Compensation***

Compensation for managed product can be earned in two ways; commissions at the time of sale or as an on-going management fee for servicing the account.

### ***Commissions***

In the province of Ontario, an overwhelming majority of investment advisors earn compensation by way of commissions and management fees. Commissions can be earned in one of two ways and generally occur at the time of 'sale' or initial investment. The first involves paying a flat fee (trade execution cost) or a negotiated commission between 0 and 5% of invested amount, effectively reducing the amount of your money that is to be invested. This is similar to the realtor model, wherein the sale of a \$100,000 home with a 5% realtor fee for service, would see you receive a cheque for \$95,000, as the fee is taken at the time of sale. Similarly, an investor who brings in a cheque for \$100,000 to an advisor charging a 5% commission up-front, will be left with \$95,000 to invest. As this commission or fee is being levied up-front, it is called a Front-End Loaded fee, abbreviated as FEL.



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Alternatively, commissions can be generated by means of counterparty compensation, in other words, being paid by someone other than the client, typically in exchange for a hold-period on the investments. In the world of mutual funds and segregated funds, this is very common.

Rather than having the investor pay for the 5% commission, the fund company with which the funds are invested will pay this commission to the advisor's firm in exchange for selecting that investment. The fund company will then introduce a sales charge that it will only be levied if the funds are withdrawn within a declining time scale, for example 6% if withdrawn in year one, 5.5% in year two, and so on until the investments are finally free of redemption charges, usually in year eight. As these charges are levied on a declining scale, and only when the funds are withdrawn, they are called Deferred Sales Charge loaded funds, or DSC in a business that loves acronyms.

### *Management and Service Fees*

The second way in which investment advisors are typically compensated is by means of management and service fees. Rather than being earned at the time of sale, compensation is received on an on-going basis for the continued management of the investments. Taking the realtor example again, as the entirety of their work is completed before the sale is completed, it makes sense for the entirety of their compensation to be paid at that time.

However, in the case of an investment advisor, although initial research and portfolio construction occurs before an investment is initiated, a great deal of work goes into the on-going management, monitoring and rebalancing of your investment portfolio, and so on-going compensation becomes an important aspect of that relationship. This is typically paid as a percentage of the assets being monitored and managed, effectively aligning the interest of the investor with those of the advisor, who both want to see the investment perform well.

The fee percentage varies by advisory firm, the fund they recommend and the structure of that fund, but typically ranges from 0.25% to 1% of the total amount of dollars invested.

For example, a \$100,000 portfolio with a 1% management fee will result in \$1,000 per year being paid to the advisor's firm. Along with the commissions discussed above, an investment in the FEL (Front-End Loaded) version of a low-risk mutual fund might also pay 0.5% per year for the on-going management services on the investment. The exact same fund in the DSC (Deferred Sales Charge) version, would pay 0.25% to the advisor's firm, while holding onto the remaining 0.25% it would normally have paid out on that fund to recoup the 5% commission it paid at the time of sale.

In Canada, the majority of investment advisors receive this form of compensation from managed products 'bundled-in' with the products they recommend. That means that rather than being paid directly by the clients, the managed product administrator includes the advisor's compensation in the MER, charged daily, and then passes those dollars onto the advisor's firm on a monthly basis. In many cases, the service or management fee paid to the advisor is already included in the MER of the managed product, and these fees are paid out regardless of the level of service you are receiving.

It is important to note that in some cases, a fund will be offered in an unbundled or bundled version. Essentially, the unbundled version is the managed product investment only, without the advisor's compensation bundled-in. The bundled version pricing would be like looking at the price of an auto part including the price of service and installation, while the unbundled version would be for the part-only and you'd then be responsible for installing it. Clearly buying the part with the installation included is more expensive. For this reason, it is important that investors in managed products ensure that they are getting value from their advisor that is in-line with the bundled-in fees they are paying on these products.





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#### ***Services for Fees Rendered***

At Innova Wealth Builders, we believe that the key to providing better value to our clients is to provide all services pertaining to an individual's wealth management needs. By taking a bottom-up approach to our clients' financial lives and addressing all aspects of their financial profiles, from mortgages to insurance and income tax, we aim to ensure the maximum efficiency of every available dollar. Although this unlocks tremendous value for the client, it is also a great business model in that it increases the likelihood of those new-found dollars being invested with us.

#### ***How we do it***

It is our view that the on-going management fee compensation model is better suited to the advisor-client relationship than the commission model. For this reason, in most cases, new investments are placed in the Front-End Loaded version of managed products, but no percentage fee is levied, essentially turning the fund into a 'No-Load' fund. This means that the entirety of our compensation is not generated at the time of sale, but rather as a percentage of the investments we have together. Our incentive then becomes to provide you with holistic advice on all aspects of your financial profile to ensure that you continue to make the best decisions, in order to maximize and build your wealth and thus increase the savings we have invested together.

By having a financial interest in the success of our investment recommendations, we align our interests with those of our clients. The investor is content to see his investments growing in value, while our compensation is directly tied to the success of the investments we recommended. In this manner, trust in the advisor's recommendations can be achieved as the incentives lie in growing and protecting the investment values, rather than suggesting trades to generate commissions.

With regards to our investment methodology, modern portfolio theory shows that asset allocation is responsible for between 75%<sup>3</sup> and 90%<sup>4</sup> of portfolio variance and that security selection accounts for only 10% of the potential return.

For that reason, we've focused our return-maximization efforts on a strategy called Tactical Asset Allocation, the movement between asset classes instead of security selection, a topic we've thoroughly covered in previous newsletters and in discussions with clients and that is thoroughly explained in my graduate thesis (For those looking for some reading material to help put you to sleep, don't hesitate to ask!)

The use of managed product over individual securities is preferred for this strategy as it allows us to make tactical changes across our portfolio in a single day, without incurring transaction costs. Further, if our market analysis reveals that we want to underweight Canadian stocks in favour of US dividend payers, we can take advantage of a managed products years of market research, specialization and industry contacts with a single trade, thus allowing us to react to market movements with greater speed. Thanks to the tax efficient structure of some managed products, we can even convert interest income into capital gains and defer gains on trades using the capital class version of funds.

#### ***Getting your Money's Worth***

Interestingly, this is where the discussion on fees comes full circle. If our compensation is based on the total amount of invested dollars we have together, and management fees erode returns, we share your incentive to find managed products that offer the best value. At present, our target portfolio's all-in MER, including our compensation, comes in at 1.83% - some 20% below industry averages, despite our use of advanced active strategies such as hedging and options. For investors eligible for high net-worth pricing and hedge funds, this fee drops down further to 1.73% and becomes tax deductible, resulting in an after-tax MER of 0.9% on non-registered investments in our target portfolio for individuals in Ontario's top tax bracket. As discussed, that is but one aspect of the fund selection criteria, and as evidenced by the returns generated over the past 9 years for our clients, we hope that you continue to feel that you are getting good value for your hard-earned dollars.



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EQUITY  
Associates Inc.

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### *A Mercedes for the Price of a Kia*

Our stated mission is to optimize all aspects of our clients' financial lives. Our hope is that by aligning our interests with those of our clients', they will feel comfortable empowering us to manage this aspect of their lives so that they may focus their efforts elsewhere. Through selecting investments not only based on the fees relating to investing in them, but moreover the value we receive from these managed products, we strive to offer our clients a Mercedes-Benz for the price of Kia.

### *The Future of Innova Wealth Builders (InWB)*

Over the next few months, we hope to unveil new products, services, investment options and financial statements. J-F is currently taking additional studies that will open the doors to new investment options and introduce the potential for further fee reductions for our clients. Tanya has recently been licensed as a mortgage broker, which allows us to offer reduced-fee mortgage brokering for our clients. Cedric is working on a book-keeping service for our business-owner clients that will work in conjunction with our expanding tax preparation services.

Finally, we are looking forward to unveiling a new statement that will bring fee transparency to your accounts, essentially showing you exactly how much you are paying for the services you receive. It is an exciting time for Innova Wealth Builders as we continue to innovate new ways to help you build your wealth!

<sup>1</sup> All Mutual fund prices, fees or performance are taken from Morningstar.com

<sup>2</sup> IFIC : U.S. and Canadian Mutual Funds Costs to Advisor-Assisted Investors are Comparable - New Studies Show. (2.02% \* 1.08% for HST)

<https://www.ific.ca/en/news/march-6-2013-u-s-and-canadian-mutual-funds-costs-to-advisor-assisted-investors-are-comparable-new-studies-show/> <sup>3</sup>  
James X. Xiong, CFA, Roger G. Ibbotson, et al. The Equal Importance of Asset Allocation and Active Management. The Financial Analysts Journal, 66, 2, (2010).

<sup>4</sup> Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, Determinants of Portfolio Performance II: An Update, The Financial Analysts Journal, 47, 3 (1991).