Fees are important

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When it comes to investing, having the right investment strategy is very important. After this, the focus should be on the implementation of the strategy and in particular the choice of investment manager(s), and the management fees. Low fees have an advantage.

There is no doubt that having a good manager is better than having a poor manager, but, unless you are confident you have a very good manager and they will be very good all of the time, focusing on reducing management fees to reasonable levels is likely to give a better investment outcome.

This article looks at the significance of fees in the context of KiwiSaver.

Important investment decisions

1. Right investment strategy
2. Efficient implementation (Low fees)
3. Regular review (but not too frequent)

Investing is about building wealth. Therefore long-term, the return that matters is the after-tax and after-fees average return. It is the average return on your money over the whole period of investment that is more important than the return in an individual year. Because it is the average that counts, the impact of even small fee differences each year, when compounded for several years, can be significant. This can be seen by looking at KiwiSaver.

Lower fees means higher returns, all else being equal. Higher returns means higher accumulated savings.

Under KiwiSaver, if one scheme charges fees that are 0.5% less a year, then another with an equivalent investment strategy, it results in increased savings of about $70,000 for an average employee over a savings period of 40 years. Is the extra $70,000 better to be in your pocket to spend in retirement, or the other manager's?

KiwiSaver example:

Salary of employee:	$50,000
Employee/employer contributions:	3% each
Pay growth:	3% p.a.
Return (after tax and fees):	- low fees scheme 5.5% p.a.
	- higher fees scheme 5.0% p.a.
Period to retirement:	40 years

Accumulation	
- low fees scheme	$666,000
- higher fees scheme	$596,000
Difference	$ 70,000

Our example fee difference is 0.5% a year. Often the fee differences can be more than 1% a year, making the difference in savings at retirement even more significant. The graph on page 3 shows the impact in dollars, of a range of fee differences. To test the impact of fee differences, check out the KiwiSaver fees calculators on www.sorted.co.nz.

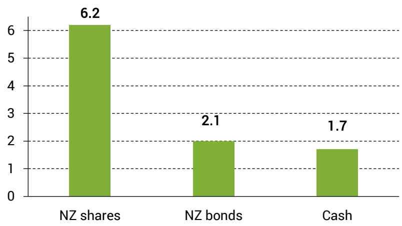
History shows that the providers that consistently charge low fees, have 5 main characteristics.

- they have a central philosophy of delivering value to the investor;
- helping members save is a core competency and business strategy. They are not distracted by other business activities;
- they adopt a passive, low turnover investment philosophy;
- they have minimal unquantified in-fund costs;
- they avoid complexity and avoid buying investments that are the latest fashion.

Low fees can also reduce risks

The expected average net returns to an investor are also linked to the level of investment risk taken. You can therefore use the presence of lower fees to reduce your level of investment risk, while getting the same net return. This is particularly important in the period leading up to retirement.

Average real returns in last 116 years



Source: Credit Suisse Global Investment Returns Yearbook 2016. Copyright @ 2015 Elroy, Dimson, Paul Marsh and Mike Staunton.

Over the last 116 years in NZ, the difference between the return from shares and return from bonds (before tax and before fees, are taken out) has averaged about 4.0% a year. Therefore by allocating 25% more to shares from bonds, the theoretical expected average return increases by about 1% a year. This is higher than what would actually be achieved, as from this will come tax and the fee differences between the cost of managing shares and bonds. Therefore, a lower fee manager can give you the same expected average net return as a higher fee manager, with less investment risk (i.e. less in shares).

Higher fee managers will claim that you get what you pay for and it is worthwhile paying higher fees, because you get a better manager and higher returns. In any year, some managers (about half) should do better than average and the others (about half) will do worse. In other years, it will be the reverse. This is the historical pattern that has been observed. Therefore, over the long-term it averages out and the differences, over time, between the average returns of two managers are typically explained by fee differences and strategy differences, and not skill differences.

For an investment manager to be a better manager and perform consistently above average, they need to have more of the investments that do well and fewer of the investments that don't do so well. In any year, there will always be some investments that perform above average and some that perform below average. So because different managers buy different investments, each year you would expect some managers to outperform the market i.e. you expect some managers to buy more of the good ones. But if one manager buys more of the good ones, another must buy fewer.

It must be remembered that if there is a "good" outcome for one investor, there must be a "poor" outcome for another; combined they must still equal the market average return.

When a manager does well in a year, they will tell you that it relates to their skill. In most cases however, it simply reflects the biases of the manager's decision making (style) relative to what happened in the market in that period, and will be reversed in a future period. Over the long-term the best skill, is the skill to keep fees low.

As investing is for the long-term, getting good performance in one year or for 3 years, does not guarantee good performance long-term. So rather than doing better some years and worse in others and paying higher fees, it is after often better to be in the middle each year and pay lower fees. Paying less in fees each year, can give a better long-term outcome.

Extra savings in KiwiSaver after 40 years for a given difference in fee levels