

WHITE PAPER

Fees 101

What is a reasonable fee to pay for an investment product or strategy? There are stock index funds available for only a few basis points, so why would anyone pay meaningfully more than that for any other fund? This paper attempts to offer a framework for thinking about what a fair fee to pay an investment manager is.

The first thing to understand about fees is that not every product should be priced the same way. One should be willing to pay more for certain investment products than for others.

An important question one should ask when thinking about what a fair price to pay is for an investment product is, “What would I have to pay to get similar exposure with any other products on the market?” Any time there is a close substitute, the lowest priced close substitute dictates what a competitive price is for a product. This applies to any industry. This is not just an investment concept.

Index Funds

If you are considering a fund that attempts to track the S&P 500 and wondering what a fair price to pay is, you should look at the expense ratio of other S&P 500 index funds. If you are considering an S&P 500 index fund with an expense ratio of 0.10% (Note: This is an annualized expense ratio. All expense ratios or relative performance quoted throughout the rest of this paper will be annualized even if I do not explicitly state whether or not that is the case.) and there is another S&P 500 index fund available with an expense ratio of 0.05%, you should ask, “Why should I pay an extra 0.05% for the same exposure?” Perhaps the fund with the 0.10% expense ratio is larger and more liquid. If that is the potential argument for why you should pay an extra 0.05% for the same exposure, you should look into trading cost differences in your specific situation to determine if trading costs will actually be 0.05% per year lower for you with the 0.10% expense ratio fund vs. the 0.05% expense ratio fund. If not, the 0.05% expense ratio fund is probably the better choice unless there is some other argument for why the 0.10% expense ratio fund is a better overall value.



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If you then found a global stock index fund with an expense ratio of 0.15%, it would not be appropriate to compare that fund to the 0.05% expense ratio S&P 500 index fund. This is a bad comparison because the S&P 500 is just the large capitalization portion of the US stock market, which is most, but not all, of the US stock market. The total US stock market is a little over half of the market capitalization of the global stock market, so the S&P 500 is not similar exposure to the global stock market. In order to determine what a reasonable price to pay for global stock index exposure would be, you would want to find other global stock index funds and make the same kind of comparison we just made with the S&P 500 index funds.

Index, Smart Beta, and Active Management

Staying with stock examples, consider that there are three basic types of stock funds. There are index funds, smart beta funds, and actively managed funds. Index funds are generally the cheapest because they simply take market capitalization weighted exposure and require minimal effort to manage. Smart beta funds are the next least expensive of these three because they attempt to deviate from capitalization weights by systematically overweighting or underweighting a large group of stocks with certain characteristics. Because there is more effort involved in determining what market capitalization weights are and what deviations from those weights should be based upon the desired characteristics than in simply determining market capitalization weights, the expense ratios of these funds tend to be a little higher than the expense ratios of index funds. Actively managed funds involve portfolio managers and analysts deeply understanding as much as possible about their universe of stocks and making decisions about which stocks within that universe they like the best. This is a very labor intensive process that demands higher fees than simply market capitalization weighting (index funds) or systematically weighting based upon a single or a few characteristics (smart beta).

Index funds do serve as a nice benchmark for smart beta and actively managed funds, both of which have higher fees than index funds though. Investors in smart beta and actively managed funds should question whether or not the fees they pay above and beyond what they would pay for an index fund within the same asset class can be justified. Are the allocation deviations in the smart beta or actively managed funds vs. the index funds significant enough to justify the extra fees? After all, the asset allocation all three are offering is the same.

For smart beta funds, the fee hurdles over what one would pay for an index fund are typically modest. There is also the benefit of transparency in how one is deviating from market capitalization weights. Since these funds overweight certain characteristics (e.g. value or small cap), you as an investor know what you are getting. You can also typically find indices that reflect these kinds of tilts, and these indices will often have longer histories than the typical fund. Having a longer time series of historical data helps one in making empirical assessments of whether or not the relevant characteristic is associated with higher expected returns that may justify the higher fees. There are likely academic papers discussing the characteristics most smart beta funds are

using as well, so you can understand what the theory for why this characteristic should be associated with higher returns would be.

With active managers, the fee hurdle tends to be higher than what smart beta fund fee hurdles are. Investors who prefer this type of approach tend to think assessing a stock's return prospects involves more than simply classifying a stock based upon a single or a few characteristics. One useful approach to putting into perspective how likely it is that an active manager will outperform an index fund net of fees is to look at the fee hurdle (active manager fee less the index fund fee) and the active manager's active share vs. the index. Active share measures how much of a fund's allocation does NOT overlap with the benchmark. For example, if 90% of an actively managed fund's allocation overlapped with the benchmark, the active share would be 10%. If that actively managed fund had an expense ratio of 1.00% while the index fund had an expense ratio of 0.10%, the fee hurdle would be 0.90%. The actively managed fund would need to outperform gross of fees by 0.90% to match the performance of the index fund in this case. Furthermore, the 0.90% of outperformance must come from only 10% of the allocation since the other 90% of the allocation is exactly the same as the index fund's allocation. That means the 10% allocation that is different must experience 9% ($0.90\% / 10\% = 9\%$) per year outperformance just to get the actively managed fund to the same return net of fees as the index fund. If the fee hurdle is the same but the active share is much higher (meaning there is less overlap in allocation with the index fund), the outperformance of the portion of the allocation that is different from the index does not require as much outperformance. This is a useful framework for thinking about how realistic outperformance vs. an index fund could be for an active manager. Once you have gone through this process, the next step would be understanding how compelling the argument is for why the portion of the allocation for the active manager that is different from the index fund should outperform.

Alternatives

When we think about fees to pay for alternatives, we can apply the same framework. Just like it does not make sense to compare the expense ratio of an S&P 500 index fund to a global stock index fund, it makes even less sense to compare the expense ratio of an S&P 500 index fund to that of an alternative fund whose correlation with stocks is close to zero. Keep in mind that the correlation between global stocks and US large capitalization stocks (S&P 500) is a strong positive correlation, so while global stocks and US large capitalization stocks are not the same, they are at least somewhat similar. This means the fee spread of one over the other should not be but so high. With an alternative investment that is completely uncorrelated with stocks though, there really is no comparison with the S&P 500 index fund to even be made. The investment exposure is totally un-related, thus the comparison is totally irrelevant. For the alternative fund, a better comparison to make would be with another alternative fund that is utilizing the same strategy (or better yet, the whole universe of funds utilizing that strategy).

It is also important to think about the amount of exposure the investment is providing. For example, assume you are considering two trend following funds that are identical except that one has a 15% volatility target and the other has a 10% volatility target. Assume the 15% volatility target fund has an expense ratio of 1.70% while the 10% volatility target fund has an expense ratio of 1.30%. Initially, it is tempting to think the 1.30% expense ratio fund is cheaper, but this is actually not true. If you invested \$150 in the 10% volatility target fund, you would pay \$1.95 in expenses ($1.95 = 150 \times 0.013$). In order to get the same level of exposure to the trend following strategy with the 15% volatility target fund, you would only need to invest \$100 since this fund uses more leverage (i.e. it has larger positions). In this case, you only pay \$1.70 in expenses ($1.70 = 100 \times 0.017$). The same concept could be applied to stocks if one stock fund was fully invested while the other stock fund had $2/3^{\text{rd}}$ s of its capital allocated to stocks and the other $1/3^{\text{rd}}$ in cash. If you wanted the same amount of stock exposure utilizing both funds, you would need to invest more dollars in the fund that is only $2/3^{\text{rd}}$ s invested. This means the fund that is only $2/3^{\text{rd}}$ s invested should have $2/3^{\text{rd}}$ s the expense ratio of the first fund.

Advisory Relationships

In an advisory relationship, it is common for an advisor to manage a client's assets and also provide other services such as financial planning, estate planning, and tax planning. When considering how much is a reasonable amount to pay an advisor, a client should consider the value of all of the services the advisor is offering in addition to the investment management. Typically when one invests in various products, such as mutual funds or ETFs, the other services an advisor typically offers are not also included. Therefore, comparing an advisor's fee to an expense ratio for a mutual fund or ETF is not an apples to apples comparison.

Conclusion

To summarize, fees do matter in investment performance, but it is always important to consider what you are getting for the fee you are paying. Comparing the fees on two different types of investment exposures does not make sense. Having plenty of other products that are good substitutes tends to reduce the fees one should be willing and able to pay for a certain kind of exposure. White Oaks always takes these concepts into consideration when we evaluate third party managers we use.