Fund fees – the charges that keep on taking

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Canada has some of the highest mutual fund fees in the world. But being mild-mannered Canadians, we just sit there and take it.

"Canadian investors do not pay much attention to fees. Canadian investors are comfortable with the fees because they don't know how low these fees should actually be," investment research firm Morningstar said in a report that gave the industry an F on fees and expenses – the lowest grade among 16 countries surveyed.

Today we'll look at where these fees go and how they affect an investor's returns. If you're one of those passive, procrastinating types who can't be bothered doing anything about the hefty fees you're paying, read on.

By the end of this column you'll realize that fees – even a few percentage points annually – are one of your worst enemies as an investor.

FEES? I'M PAYING FEES?

A typical investor in a Canadian equity fund pays 2 to 2.5 per cent in fees annually, or about double the fees of a U.S. fund, according to Morningstar. As stiff as our fees are, many investors aren't even aware that they're paying them.

That's because, although fees are disclosed in the fund's prospectus and on websites such as globefund.com, investors never actually see the money leaving their account; instead, fees gets deducted – quietly, painlessly and automatically – from the fund's assets.

"I think the average Joe who is going to the bank and buying a mutual fund does not realize that there is a fee that comes out of his return," says Constantine Kostarakis, a portfolio manager with Pfiffner Management Inc. in Montreal.

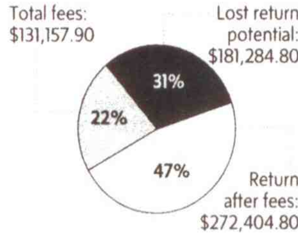
FOLLOW THE FEES

Let's look at a hypothetical example.

The FatCat Fundamental Value Fund has a management expense ratio (MER) of 2.5 per cent. The MER is the annual total of management fees and other expenses of the fund – such as legal, administration and promotional costs – expressed as a percentage of the fund's total assets.

The high cost of fees

$100,000 invested at 8 per cent annually would generate a profit of $584,847.52 after 25 years. But an investor who paid just 2.5 per cent in fees annually would make less than half of that.



THE GLOBE AND MAIL

The MER also includes the trailer fee, which is paid to the adviser or broker who sold the fund and which continues as long as the investor holds it. Trailers are "fairly specific to the Canadian market," according to Morningstar, and they're one reason mutual funds in this country are so expensive.

TRACKING THE TRAILER

Trailers – which are typically 0.5 to 1 per cent, but can be lower or higher – are perhaps the most controversial component of the MER. The fund industry defends trailer fees, saying they are designed to compensate advisers for the continuing advice they provide to clients.

Critics say trailers are more like a bribe to advisers – an inducement to steer clients into a particular fund and keep them there.

"Advisers direct client assets to funds that pay better trailers," Morningstar says. "And since the trailer is included in the MER, the result is that assets flow into higher-fee funds."

Even funds purchased though a discount broker – where no advice is given – are subject to trailer fees.

FEES EAT RETURNS

Now let's examine how that seemingly small 2.5-per-cent MER can make a huge difference over time. We'll use the Mutual Fund Fee Impact Calculator at Investored.ca.

Let's assume we have $100,000 to invest for a period of 25 years, and the stock market returns an average of 8 per cent annually. If we paid no fees at all and earned the market return, we'd end up making $584,847.52.

Now let's look at how the fictitious FatCat fund would have done.

Assuming a return of 5.5 per cent annually – the market return of 8 per cent minus the 2.5-per-cent MER – the $100,000 would generate a profit of just $272,404.80 – $312,442.72 less than in the no-fee example.

Where did all the money go? Well, $131,157.87 was lost directly to fees. The remaining $181,284.85 was "lost return potential." In other words, it's the return you would have made on the money that instead went to fees.

This is how compounding works in reverse, and it's the reason high fund fees have such a dramatic impact on performance, especially with a long investing horizon.

"It's decompounding that people really don't understand," says mutual fund critic Ken Kivenko, vice-chairman of the advisory committee with the Small Investor Protection Association.

"They see 2.1 per cent, 2.8 per cent, they think it's one year," Mr. Kivenko says.

"They don't understand that year in, year out, that fee gets pulled off returns."

HOW TO AVOID HIGH FEES

Do-it-yourself investors can slash their costs by choosing an exchange-traded fund such as the iShares CDN LargeCap 60 Index Fund, which has an MER of just 0.17 per cent. There are even actively managed mutual funds with low fees, such as the Mawer Canadian Equity Fund, with an MER of 1.2 per cent.

If you want to cut your investing costs, you have to drop the passive Canadian routine and take control of your portfolio, rather than letting a commission-collecting adviser make all your decisions.

"I believe you control your own destiny – or someone else will," Mr. Kivenko says.