A Bird's Eye View
Sparrows Newsletter

September 2016

Coming back from their holiday, the Johnson family was disappointed. Their summer house had been under renovation for the past 6 months, and although it was supposed to be ready three weeks ago, they hadn't been able to enjoy their traditional August break there. Instead, they had stayed at the five-star spa resort 10 miles down the road. They had often been there for dinner, or to enjoy the spa, and loved the place; so the whole family had been looking forward to enjoying their all-inclusive package. David, the father, was particularly relieved that he wouldn't have to get his credit card out during the entire stay.

It really started very well. The sun was shining when they landed. The hotel driver was waiting for them, and they rode with another couple to the hotel. David appreciated the free ride and tipped the driver. The rooms were superb, with amazing view over the lake and the still snowy mountains beyond. There was no minibar in the room, but David remembered reading that room service was included in the package, and called down for drinks. He thought this was a brilliant idea! That night they enjoyed an excellent "free" dinner, in spite of the customary poor service. This consistent failing was probably explained by the lack of competition in the region, thought David.

In the morning, David wanted to exercise at the gym, while Dana and the children went straight to the beach. When they met at lunch, Dana complained that she had been charged for the use of hotel towels and deck chairs. David, already upset that he too had been required to pay for the gym and to rent his towel, couldn't believe his ears.

They soon realised that almost everything other than the room, lunch and dinner was at extra cost. By the end of the two weeks, David had no idea how much this holiday had cost. He was shocked when he was told he had to pay for the drive from and to the airport (apparently a service provided by a third party), and for all the room service that had been ordered outside formal meal times. He felt cheated and called the agent who had arranged the booking to enquire why he had been so badly misled. Eventually, after a long and acrimonious argument, the agent disclosed that this hotel was paying him a commission three times higher than the norm.

David hated this feeling of being treated like a fool.

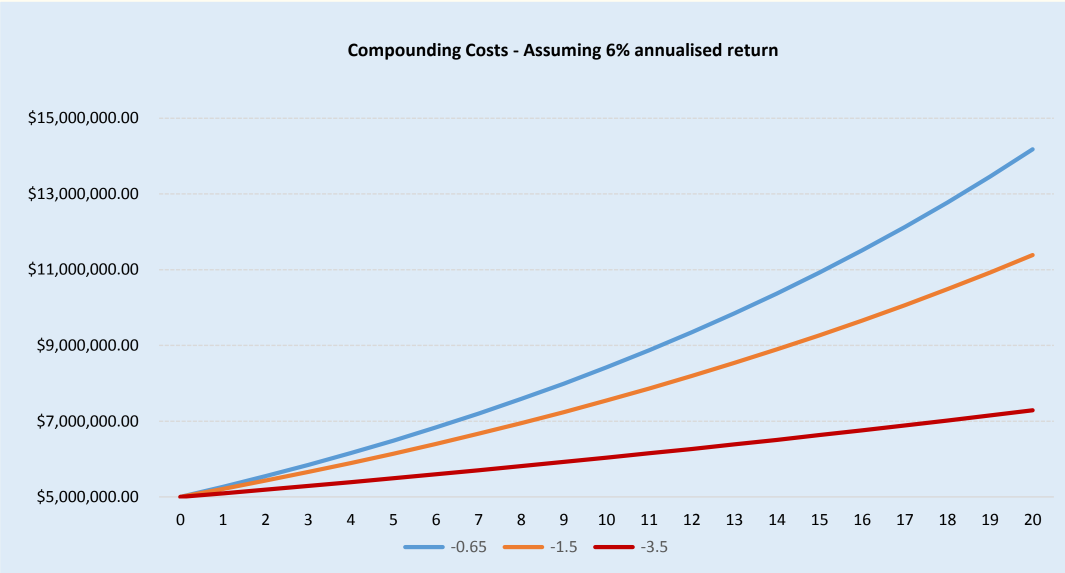
A week later, when he met with his portfolio manager, Mr. Goldmint, to review his investments, David was expecting good news. The equity markets in the US and UK have been successively hitting record highs over the past few months and he was confident that he had made substantial gains. At least that would make up for the unexpected holiday cost, he thought.

But, to his surprise, his portfolio had not delivered the expected returns. “Other markets have not been performing as well,” explained Mr. Goldmint. This was not the first time John had to listen to the so called “economic explanations of your returns” from his manager. Tired of hearing such excuses, John decided to dig deeper.

A friend referred John to another portfolio manager, Mr. Cashsavvy, who would be able to help him answer his questions. “It’s to do with the hidden fees. Fees and charges are what are eating into the return of your portfolio,” he said. David, slightly annoyed because he had already known fees are costly on a portfolio, replied “Yes I know that. There is a management fee for the manager and a further performance fee that is charged on top of that if my portfolio generates a positive return, which clearly is the case here! We have agreed to these fees and I’m happy to pay them. But surely there should be still a net profit after that?”

Mr Cashsavvy was not surprised by David’s reaction. He had dealt with such a situation many times before. “Yes. Those are the fees that are explained to you; they are known as Explicit Costs.” Now David was downright confused. “Hang on! Are you telling me that there’s another set of costs that I don’t know about?” Was the holiday nightmare being repeated?

“Of course,” said Mr Cashsavvy, “There are costs that the firm undertakes: marketing, administration, legal, research, custody and trading commissions. These costs are known as Implicit Costs. These can have a greater effect on your portfolio than explicit costs.” he explained. He pulled out a chart, showing how costs can affect the performance of an investment portfolio over time.



“If you take a look at the chart, you will notice that the cost that you incur on your initial investment has an exponential effect on your wealth. If you assume an annual performance of 6% per year on average, then whether Mr Goldmint and his affiliated providers charge you 3.5% a year or 0.65% a year makes a huge difference, as you can see between the red and the blue line! Over 20 years that is about $7 million on an initial $5 million investment!!”

“I don’t understand!” said David. “Mr Goldmint told me that even including his performance fees he would only be charging me around 1.5% per year in total; and yet my portfolio is not following the gold line here but the red line! How is that possible??”

“Look at it this way,” said Mr Cashsavvy. “Mr Goldmint is investing your money into funds, which themselves charge fees of around 0.8% per year. And he trades your portfolio frequently; in fact this year he has bought and sold funds to the exact value of your total portfolio. This 100% turnover generated a further 0.5% in transaction costs. On top of that, he has also invoiced you for his cost of accessing research, another 0.50% per year. And you obviously pay for the custody of your funds, another 0.20% per year.”

“Good grief!” shouted David. This was why his portfolio has not been producing the promised returns. He felt cheated as these costs had not been made clear and transparent to him. Infuriated, he told Mr Cashsavvy about his holiday and asked “Do you do this to your clients as well? Charge them all these hidden fees, without telling them?”

“No I do not, actually,” replied Mr Cashsavvy. “I work for a passive portfolio management firm, and all our fees are completely transparent and disclosed upfront to the client. We invest in low costs ETFs funds, we rarely trade on the portfolio to limit transactions costs, and our own management fees are also very attractive.”

“We are the blue line and we can save you that $7 million over the next 20 years, David!”

Fahd Rachidy

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