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CONFUSION ABOUT COSTS - UPDATED

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There is a considerable amount of uncertainty, if not outright obscurity and ambiguity, concerning the actual costs of various investment products in the South African market. Costs of course matter, because they can subtract considerably from overall investment performance, particularly over the life of a medium-to-long-term savings product.

Why then this incomprehensibility? Do providers of such investment vehicles look to deliberately confuse investors by resorting to ambiguity and lack of transparency? For the investor looking to commit savings, or a portion of their income to a regular debit order deductions into an investment product, the hidden nature of the true cost structure of many investment vehicles is a significant deterrent.

In order to bring some semblance of clarity to the actual extent of costs incurred, it helps to break down the fees paid for investment products into five distinct categories. Remember, there is a feeding chain of costs with such products, and the informed investor should take into account all of the cost components. These can be broken into:

- **Total Expense Ratios (TERs)** – measures the cost of running collective investment scheme portfolios (and can include performance fees).
- **Platform Fees** – these are specifically excluded from TERs and typically involve fees paid to a platform, often operated by a linked service provider (LISP), which enables investors to buy, sell and own unit trusts or ETFs.
- **Asset Management Fees** – unit trusts companies charge an asset management fee to investment platforms or LISPs for investors to use their funds.
- **Financial Advisor Commissions** – when investors utilise such financial intermediaries a commission is payable to such registered advisors as payment for their services.
- **Performance Fees** – many actively managed unit trusts now charge a "performance fee", when the portfolio outperforms its benchmark. Most ETFs only aim to match the benchmark index tracked and so do not impose such performance fees on their investors.

Looking at each of these in turn and comparing the implications for unit trusts and ETFs.

Total Expense Ratios (TERs)

TERs are a common form of measuring the costs of running Collective Investment Scheme (CIS) portfolios. A Standard Guideline has been drawn up by the Association of Savings & Investment SA (ASISA) for use by all registered Collective Investment Schemes (which includes ETFs).

The TER measures the expenses paid by a CIS fund in terms of the costs and services rendered in the management of the portfolio. These expenses are deducted by the fund manager from the value of the portfolio and therefore impact on the performance of the fund.

As the Table below shows, ETFs, here represented by the Satrix products, have Total Expense Ratios about one-third on average of those of comparable unit trusts that fall into the same category. This is a significant cost saving by the ETF industry and the promise by unit trusts that their performance makes up for this is not borne out by the facts. Over 70% of actively managed unit trusts typically fail over time to outperform a representative index benchmark. ETFs, of course, deliver the performance of the index, less the TER cost.

Average Annual Total Expense Ratios (TERs)	
	TER (basis points)
Domestic Equity - Financial	
Unit Trusts	1,51
Satrix FINI	0,45
Domestic Equity – Industrial	
Unit Trusts	1,51
Satrix INDI	0,45
Domestic Equity – Large Cap	
Unit Trusts	1,00
Satrix 40	0,45
Satrix Swix Top 40	0,45
Domestic Equity – Resources & Basic Industry	
Unit Trusts	1,64
Satrix RESI 20	0,45
Domestic Equity – Specialist Funds	
Unit Trusts	1,33
Satrix DIVI	0,45
Source: Association of Collective Investments (September 2009) (shows the average TERs for all unit trust in each category versus Satrix ETF products)	

Platform Fees
Most collective investment schemes are distributed (bought and sold) through investment platforms, typically registered as linked service providers (LISPs). ETFs differ in that they can be transacted, not only through the stockmarket utilising stockbroking companies, but ETFs can also be traded on LISP investment platforms, such as etfSA Investor Scheme.

LISPs and other platforms charge an annual fee – typically around 1,0 percent per annum for the services they provide. The administrators of such platforms offer investors an all-in service product that manages their investments, including debit order recurring transactions; the re-investment of dividends; quarterly or online statements; compliance reporting for FICA & FAIS purposes; and annual tax certificates, all covered by the annual management fee.

This platform fee is over and above the total expense ratio and is part of the overall cost paid by the investor.

Fund Management Fee
Also known as the asset management fee, these are annual charges levied by the manager of the unit trust to the investor (through the LISP or investment platform) to utilise his product. These fees typically range between 1,00% to 2,00% of the value of assets, levied annually.

ETFs do not charge this fee, which is a significant cost saving to investors.

Financial Advisor Commissions
Registered Financial Service Providers (FSPs) offer their advice and financial management services to investors. In practice, most unit trusts are sold through such FSPs and the financial advisor receives a commission, which can be upfront and/or ongoing (trailing fee). These financial advisor fees can be as high as 3,0% upfront and 2,0% per annum ongoing. Under pressure from more informed investors, financial intermediary fees are tending to gravitate to a total of between 1,0% to 2,0% per annum, with trailing fees replacing upfront fees, as the favoured form of reimbursing FSPs for their services. Of course, this means that the advisor earns fees over the life of the product.

Investors can buy ETFs directly, through stockbrokers or through platforms such as etfSA, without needing to utilise a financial advisor. However, where financial intermediaries are used, etfSA will pay a 1,0% per annum trailing commission to such FSPs registered on its platform.

Performance Fees
A growing portion of unit trust funds, available to retail investors, are now charging performance fees. These fees have some merit in that they only reward the manager of the actively managed fund if the fund's return beats the performance of the benchmark.

However, there are some disadvantages to the investor as well. These include:

- you might end up paying performance fees (which are typically calculated and imposed on historical long-term performance) without actually enjoying this performance yourself, if you are a new investor or a debit order investor in such funds;
- the benchmarks used as a hurdle rate before performance fees are applied can be inappropriate;
- underperformance is often not credited to the investor; and
- performance fees typically add to the total cost of the funds, as the manager can take between 10%-30% of the "outperformance" in extra fees.

By contrast, the majority of ETFs do not charge any performance fees, as they do not promise outperformance of the index. The lack of performance fees offers greater cost transparency, performance certainty and cost savings to the investor.

Comparative Fee and Cost Structures Unit Trusts vs Exchange Traded Funds (ETFs) (% of asset per annum)		
	Unit Trusts	**ETFs**
Total Expense Ratios (TERs)	1,5% to 2,5%	0,5%
Investment Platforms	1,0% to 2,0%	0,45% to 0,8%*
Asset Manager Fees	1,0% to 2,0%	n/a
Financial Advisor Commissions	1,0% to 5,0%	1,0%*+
Performance Fees	10%-30% of outperformance	n/a
Totals	**4,5% to 11,5%**	**0,95% to 2,3%**
Notes i) * Fees charged on etfSA platform. ii) +etfSA can be accessed directly by investors if Financial Advisors services not required. iii) These are representative charges ascertained from a sample of unit trust and ETF companies.		

Comparisons
As the table on comparative costs indicates, the total cost of transacting in unit trusts can be significantly higher than that of ETFs. Overall cost structures for unit trusts, transacted through an investment platform and utilising the services of a financial advisor, start from 4,5% per annum and can go to well over 10,0% per annum.

For ETFs, such comparable charges are a maximum of 0,95% to 2,3% per annum. Most investors do not use financial advisors for simple to understand ETF products, so in such cases the overall costs are reduced to some 1,3% per annum.

Once all the costs and fees in the feeding chain of service providers have been accommodated, the overall erosion in performance generated by such charges is significantly higher for unit trusts than ETFs. This must be kept in mind by current and prospective investors.