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THE COST ADVANTAGES OF LOW COST INDEX TRACKING FUNDS OVER ACTIVE MANAGERS – or "Buffett is now as Sharpe as Bogle"

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Warren Buffett, the world's most famous investor, made the following observation in his letter to Berkshire Hathaway shareholders in February this year. In his instruction to the Trustee of the Warren Buffett estate, he has the following advice:

> *"Put 10% of the cash in short-term Government bonds and **90% into low-cost S&P 500 index funds**. I believe the Trusts' longer term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high fee asset managers."*

Mr Buffett's advice has two key messages: use low cost index funds to achieve the best long-term returns; and avoid high fee investment products.

William Sharpe, (the founder of the Sharpe ratio) who won the 1990 Nobel Prize for Economic Sciences, has published another Study in 2013, *"The Arithmetic of Investment Expenses."* He concludes:

> *"A person saving for retirement who chooses low-cost investments could have a standard of living throughout retirement more than 20% higher than that of a comparable investor in high-cost investments."*

John Bogle, the famous "father" of index investing and populising the use of index tracking funds through the Vanguard mutual fund company, has also published a recent Study, entitled *"The Arithmetic of "all-in" Investment Expenses"*, published in the Financial Analysts Journal (February 2014).

John Bogle believes that previous studies, such as William Sharpe's, have understated the damage on returns caused by costs. If "all-in" costs, including transaction costs, sales loads, (commissions) and cash drag are taken into account

> *"Compared with costly actively managed funds, over time, low cost index funds create extra wealth of **65%** for retirement plan investors."*

Whereas Sharpe calculated that the cost advantage of low cost index funds was 1,06% per annum, Bogle believes that this cost advantage actually comes to 2,21% per annum, once all hidden costs are taken into account. Mr Bogle finds that the Total Expense Ratio (TERs) used to calculate overall costs of investment products exclude:

- **Transaction Costs** – the stockbroking charges associated with buying and selling shares in the portfolio are not included in TERs (this is also the case in South Africa). Various studies in the US have indicated that the average brokerage charges incurred by active multi-asset funds account for around 1,44% per annum, well in excess of the 1,19% average reported total expense ratios for these funds. Since the 1960s, the average fund portfolio turnover of actively managed funds in the USA has leapt from 30% to 140% today. Despite lower stockbrokerage commissions and exchange trading costs, this "portfolio churn" adds significantly to the actual costs of actively managed portfolios.

  Index trackers, by contrast, seldom have to trade their portfolios as the index only rebalances periodically and then only a marginal percentage of index stocks are changed.

- **Cash Drag** – active funds typically carry cash in the range of 5% of total assets to facilitate daily trading in their units, whereas index funds are fully invested and do not have to hold cash as they trade independently on stockmarkets. As there is a long-term premium on the return to equity, relative to cash, this cash holding acts as a drag on performance and needs to be taken into account.

  Unit Trusts in South Africa also hold cost as part of the requirement to trade their units, so suffer from a similar cash drag.

- **Sales Costs** – the "distribution fees" or commissions paid by retail investors have fallen significantly in recent years in the USA. Up until the 1970s, funds typically charged an upfront "load" of 8%. If you held an investment for 8 years, the annualised load was 100 bps per year and, if the investment was held for 16 years, 0,50 bps per year.

  Since then, most funds have dropped the upfront fee and switched to an annual fee for sales commissions. This typically, in the USA, runs to about 1% per year.

  In South Africa, there has also been a move to replacing upfront fees with trailing commissions and fees. A 1% trailing fee paid to advisors is a typical sales load fee in South Africa, but can be higher.

  John Bogle, taking a conservative estimate, believes that these undisclosed charges, on average, lead to a **total cost increase of 2,21% per annum for actively managed funds relative to index tracker funds**.

  The impact of this cost advantage for index funds is shown in the Table below.

Total Wealth Accumulation by Retirement Plan Investors, Assuming a 7% Nominal Annual Return				
	Actively Managed Fund	**Index Fund**	**Index Enhancement**	
Gross annual return after all costs	7,00%	7,00%	-	
Net annual return	4,73%	6,94%	+2,21%	
Accumulation period				**% Increase**
After 10 years	$44,000	$50,000	$6,000	13%
After 20 years	130,000	164,500	34,500	27%
After 30 years	286,000	412,000	126,000	44%
After 40 years	561,000	927,000	366,000	65%
For investors earning US$30 000 annually with 3% annual growth in remuneration and contributing 10% of remuneration per annum.				
Source: The Arithmetic of "All-In" Investment Expenses – John Bogle, Financial Analysis Journal (Feb 2014).				

For a retirement fund investor in the US, a low cost index tracker product will deliver a 44% higher retirement pool after 30 years and 65% higher pool after 40 years, purely because of the cost benefits attached to the low cost passive tracker fund.

Is This Applicable to South Africa?

In South Africa, the Total Expense Ratios (TERs) reported by Collective Investment Schemes (including ETFs) also exclude brokerage charges, distribution fees, cash drags (not applicable to ETFs which are fully invested) and the sales load charged for advice given by FSPs. So the reported TER costs in South Africa also do not include the other "all-in" costs which are detailed in the US Studies by William Sharpe and John Bogle.

The extent of the "undisclosed fees" in the South African market is difficult to unravel, other than anecdotally, because of poor disclosure by most investment managers.

A recent Study by the SA National Treasury *"Charges in South Africa Retirement Funds"* (July 2013), found that the average charge for actively managed SA Retirement Annuity Funds was between 3,4% to 3,6% per annum. By comparison, the etfSA RA Fund that uses only low cost index funds in its portfolios' charges a total annual fee of 1,35% per annum.

The etfSA RA Fund, includes all actual costs and charges in its composite fee – these include TERs, brokerage and other transaction charges, account administration fees, benefits administration, sales and advice fees. The gap between the actively managed funds and etfSA RA Fund, is almost exactly the same (2,05% - 2,25%) as the gap between disclosed costs and the actual "all in" costs in the USA.

The SA Treasury Study reaches the same conclusion as the US Studies reported on in this article – a regular saver who reduces costs by 2% of assets each year, *"would receive a benefit 60% greater at retirement after 40 years, all else being equal."*

We will be reviewing the South African cost of retirement annuity funds in the near future, but what is applicable in the USA seems equally valid in South Africa – **reduce the costs of your retirement annuity products and you reap considerable benefits over time.**

For more information or detail, please contact Mike Brown, contact details below.

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