INVESTMENT COSTS THE TRUTH

COOPER PARRY WEALTH

A BIT OF BACKGROUND

At Cooper Parry Wealth we believe the traditional wealth management model is broken. It's focused on products, not what they can help you achieve.

Importantly, we feel like the industry serves the needs of those selling these products, rather than those investing in them.

We know you'll want to understand what to invest in. But will those decisions mean you can **spend more time with your family?** Will it stop you worrying and make it **easier to sleep at night?** Will it help you **enjoy the retirement you really want?** Will they give you the best chance at having a **successful investment experience?**

Over the years we've seen how the funds people choose to invest in, or are guided to invest in by professionals, often don't serve their long-term goals. **In fact, they do the opposite, by eating away at their wealth.**

It's why we've put this guide together, to help you unravel the truth about investment costs.

So, if you want to get to the bottom of what your investments are really costing you; look no further, you're in the right place…

Unravelling the murky world of investment costs

When most of us are focused on investment performance, the costs associated with your investments can often slip under the radar.

As high fees have gathered quite a bit of press attention over recent years, we wanted to unpack it all for you in this guide. So, here's what we're going to show you:

1 **There are hidden costs** (or at least 'hard to find' in many cases) - whether it's an ISA, pension fund or large portfolio, most people don't know exactly what they're paying.

2 **Costs matter** – small differences, even just 1%, may not sound much, but compounded over the long-term, they can destroy wealth.

3 **Increased fund costs don't lead to improved performance** – in most areas of life 'you get what you pay for' but actually, the opposite is true when it comes to investing.

Let's get started…

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PART 1:
THERE ARE HIDDEN COSTS

Before we delve into the subject of hidden costs, let's take a step back and talk about the different levels of investment costs that exist...

When you invest, costs exist at a number of different levels:

a **Advice costs** - these might be on a percentage or fixed fee basis.

b **Platform costs**[1] - typically when you buy a fund, a trading platform will be used to buy and hold your investments.

c **Investment costs** - the actual costs of the funds themselves (and **our focus in this guide**).

Over the years the umbrella term used to cover the costs mentioned in point c has changed from Annual Management Charge (AMC) to Total Expense Ratio (TER), and now to **Ongoing Charges Figure (OCF).**

The **OCF** is comprised of the fund manager's fees for running the portfolio, as well as other costs in relation to legal, administration, marketing and regulation. It represents the costs (as a percentage) deducted from the fund each year to cover the costs of managing it.

OCFs vary widely. From a **low-cost index tracking fund** that might have an **OCF** of 0.1% per year, to **higher-cost actively managed funds** that might cost over 2%[2] every year

Crucially, most investors think that the **OCF** is the full picture and that's all they're paying, but the reality **couldn't be further from the truth.**

So, what costs aren't included in the OCF?

Let's think about what a fund or fund manager does. A typical fund is made up of a number of different company shares. What the OCF doesn't include is:

- The costs for **buying and selling** the shares within that fund, known as the transaction costs
- **Stamp Duty costs** every time a share is purchased (UK funds).
- There's also the opportunity cost of holding high levels of cash, which some active fund managers choose to do as they wait for investment 'opportunities'. This creates what we call a **cash drag**[3]**.**

And so, the more 'active' a fund is (i.e. the more buying and selling that goes on within the fund), the higher the transaction costs, Stamp Duty costs and cash levels within the fund are likely to be.

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1. Also known as **custodian** or **wrap costs**
2. Based upon funds' 2024 Key Investor Information Documents, we found **over 35 UK domiciled equity funds** charging over 2% OCF (database of funds: Morningstar).
3. **Cash drag** is the lost investment return, due to not being invested in the correct investment asset e.g. company shares, with their higher expected return compared to cash.

What lies beneath?

A useful analogy is that **investment costs are like an iceberg**. Some costs are above the water and are disclosed to investors. But it's the hidden costs, below the water, that ultimately sank the Titanic!

Surely regulation exists to protect investors?

This is true. The financial services industry is heavily regulated and in 2018, legislation called MiFID II was introduced. It was designed to protect investors in a number of areas, including **full costs disclosure.**

Since then there's supposedly been an increased focus on transparency.

Prior to selling a fund, fund managers and advisers must provide investors with an estimate of additional transaction costs.

On an ongoing basis, a fund's actual transaction costs have to be disclosed for the previous year and reported to investors by investment platforms.

Although this is a good step in the right direction, this information is **hard to interpret** as there are a number of different ways in which fund managers can calculate transaction costs, whilst still being compliant with the regulations.

In addition, disclosure to investors of **cash holdings within a fund**, and the drag on investment return resulting from that, are still some way off.

Many advice firms and fund managers are **still only making the OCF readily available to investors**. The industry as a whole has struggled to settle on a way of disclosing full costs that is easy to understand and uniform across the board – which leaves investors with little hope of **getting to the bottom of it all**.

What's really left for you, after costs?

Let's look at some specific information for mainstream, actively managed funds available to UK investors.

Average Active Fund Costs[4]

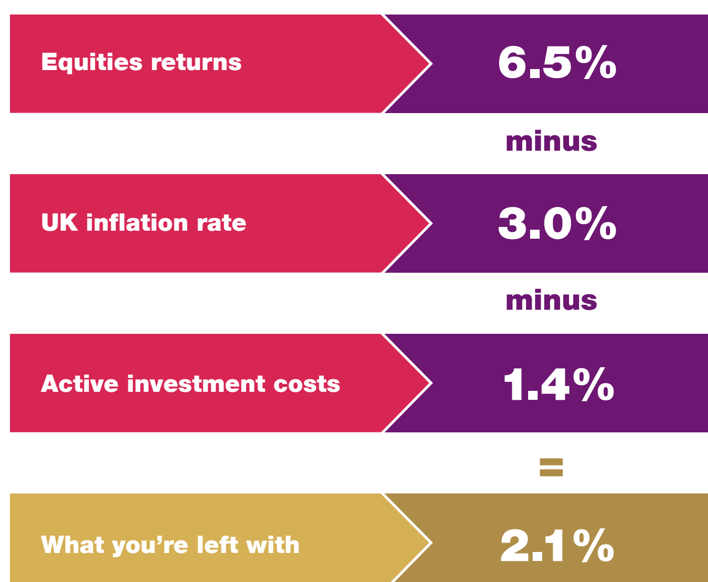
Geographic Area/Sector	Ongoing Charges Figure (OCF)	Transaction costs[a]	Cash Drag[b]	Total Ongoing Costs pa
UK	0.99%	0.21%	0.14%	1.34%
International	0.77%	0.24%	0.10%	1.11%
Emerging Markets	1.14%	0.42%	0.13%	1.69%
Property	1.23%	0.17%	0.21%	1.61%
Average active fund	**1.03%**	**0.26%**	**0.15%**	**1.44%**

a. The costs associated with buying & selling holdings within a fund.
b. This figure is based upon the average actual cash holding by funds in the geographical area/secgtor, multiplied by the difference between cash & equity returns

You can see that, although the average cost you as an investor see up front, the **OCF**, is 1.03%, **the real ongoing costs is more than a third[5] higher at 1.44%.**

The active fund manager takes a big slice of the pie

The very long-term expected return of equities is around **6.5%**[6]. If you take off long-term inflation of **3.0%**[7] this brings the real return down to **3.5%**. So, approaching half of the real returns, 1.4%, are then being given up in costs, as you can see below:



You could look at it like this: the fund management industry is **being paid handsomely for the risk that you are taking with your investments** – lining its pockets with approaching half of your long-term real returns.

In our experience, most investors **don't realise the full extent of the costs they're paying.**

4. Governance Update Issue 24, Albion, October 2022. Data is from Morningstar and is based upon UK domiciled funds adopting an active management style, broad market investment approach with equity allocation>90%. Average is not weighted.
5. Average Total Ongoing Costs at 1.44% are 39% higher than the OCF of 1.03%
6. Source: Albion Asset Class Assumptions October 2022. Expected returns are a 'best estimate' and are not guaranteed.
7. Actual inflation over 40 year period to 31 May 2024 has been 2.96% (UK Consumer Price Index, Retail Price Index before February 1988). Our long term inflation assumption is 3.0%.

PART 2:
COSTS MATTER

All too often investors simply don't understand the long-term impact of seemingly minimal costs on investment growth.

The industry has done a great job of teaching investors to be obsessed with investment returns - producing all sorts of graphs and tables to support their results, but they **rarely apply the same level of disclosure to what they're charging.**

Which types of funds have higher or lower costs?

There are two main types of investing – **active management** (typically higher cost) and **passive or index investing** (lower cost).

Active investing is a portfolio management strategy where the fund manager buys and sells shares (or other assets) with the aim of outperforming a benchmark or index. It often involves chopping and changing, as the fund manager moves money to different stocks with the aim of achieving outperformance.

Passive or Index investing involves buying all the shares in the market using highly automated processes. By definition there is much less buying & selling of shares.

It's worth noting that active funds will generally have a higher OCF (management fee), as well as higher transaction costs and higher cash holdings – **a triple whammy!** Our evidence-based investment approach means we don't use actively managed funds. We prefer index based fund. They are **highly effective** at capturing market returns for you and **highly efficient** because they are much easier to manage, and therefore lower cost.

Let's look at the same fund data as before to see a comparison between actively managed funds and those using an index approach[8].

Active vs Index - comparison of Equity Fund Costs

Geographic Area/Sector	Ongoing Charges Figure (OCF)	Transaction costs[a]	Cash Drag[b]	Total Ongoing Costs pa
Average active fund	1.03%	0.26%	0.15%	1.44%
Average index fund	0.30%	0.05%	0.05%	0.39%
Difference				**1.05%**

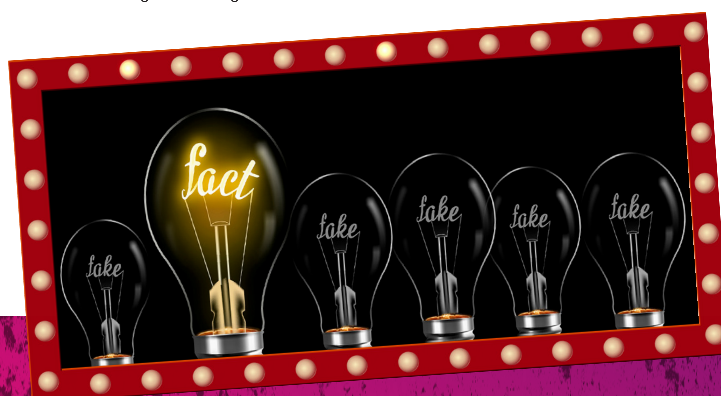
a. The costs associated with buying & selling holdings within a fund.
b. This figure is based upon the average actual cash holding by funds in the geographical area/secgtor, multiplied by the difference between cash & equity returns

You might think that **saving 1% in costs** doesn't sound like it would make much difference. After one year you would be right, there isn't a huge pounds and pence difference.

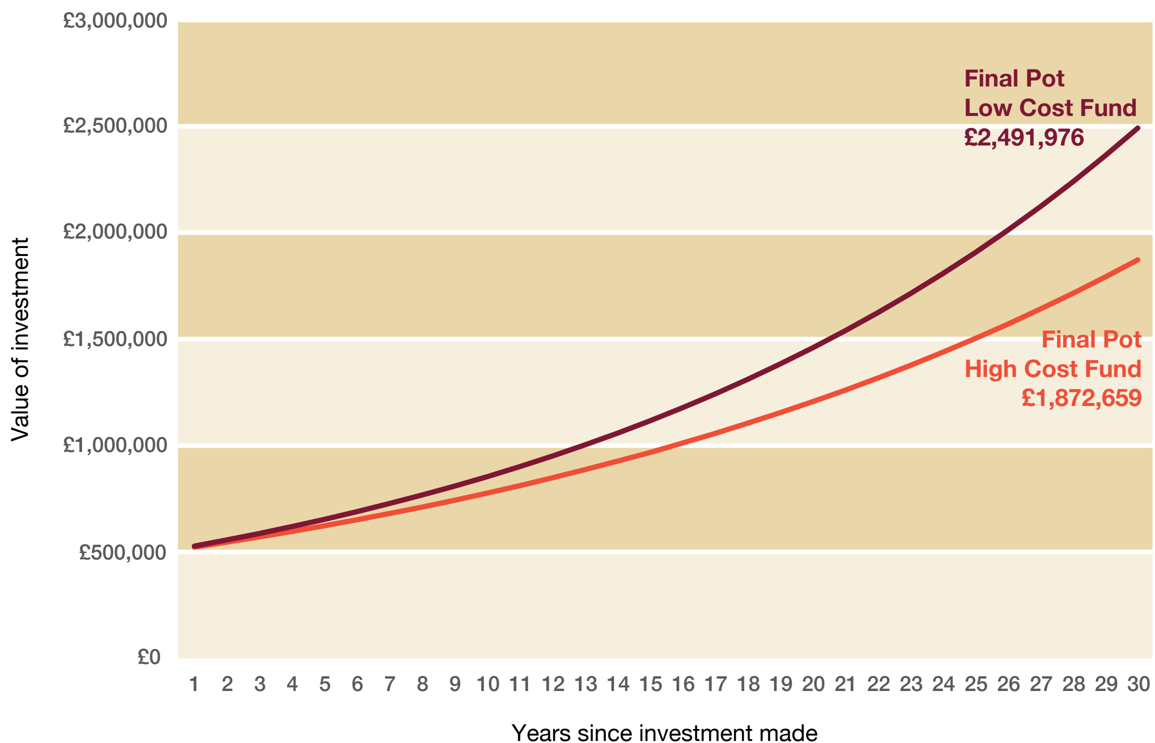
But, thanks to the effect of compounding the **difference over 30 years is huge.**

Take an initial investment of £500k and a gross annualised return of **6%** over a 30-year period. Let's look at the impact on returns with a **low-cost fund** and a **high-cost fund** where that **difference in cost is just 1%.**

8. Governance Update Issue 24, Albion, October 2022. Data is from Morningstar and is based upon UK domiciled funds adopting a broad market investment approach with equity allocation >90%. Average is not weighted.



Growth of £500k using a low cost fund vs a high cost fund[9]

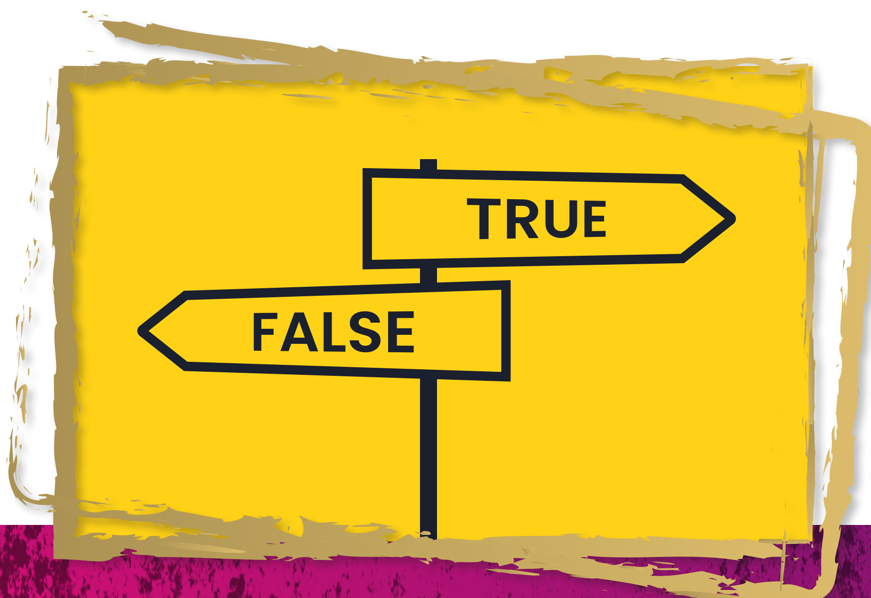


By year 30, that small 1% cost saving means **your pot ends up being a third bigger** and you have an **extra £619k to spend.**

30 years might sound like a long time, but if you're investing for your retirement or for the rest of your life, that's not an unrealistic time horizon.

This is really nothing to do with investing, this is a purely mathematical calculation. But that extra 1% in your pocket could leave you with a **life changing additional sum of money.**

9. Based upon the Albion fund research, we have assumed gross investment return of 6.0% and fund management costs of 1.5% for a high cost fund and 0.5% for a low cost fund, a difference of 1.0%



PART 3:
YOU DON'T GET WHAT YOU PAY FOR

So far, we've shown you...

1. There is **another layer of costs** - whether these are truly hidden or simply hard to find, they can be substantial.
2. That small differences in costs compounded over the long-term can **severely dent your wealth.**

However, we know what you might be thinking. There's a famous saying 'you get what you pay for', and in many areas of life this is no doubt true.

An expensive German sports car is generally seen as **higher quality and better performing,** than a low-cost alternative. Pay more for a designer Italian suit or dress and you're typically **buying better quality**. The latest flat screen, 4k HDR smart TV has a **better-quality picture** than a cheaper model. And so on.

So, the **same must be true of investing, right**? You don't mind paying extra for your investment management costs as you seek to capture a better investment return.

In this section we're going to prove this theory wrong.

In investing you don't get what you pay for because those higher costs come out of your portfolio. In addition, there's **evidence to prove that higher cost doesn't necessarily lead to higher returns.**

First piece of evidence

Here we have a study by Morningstar, a leading financial research company.

The study is called the **Active/Passive Barometer**[10] and you can find the latest version on their website.

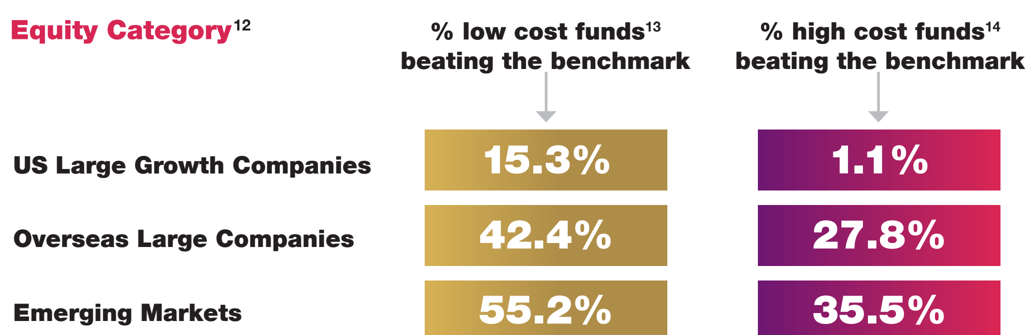
It measures the performance of actively managed funds versus passively managed funds within their respective categories.

It's unique in the way that it measures active managers' success compared to the performance of a composite of passive funds (the benchmark[11]), rather than to an index, which wouldn't include fees.

Year after year, this study shows the same trend across most time periods and across different fund types.

The findings are clear.

The **lowest cost 20% of funds do a far better job** of beating the benchmark than the more expensive funds.



Equity Category[12]	% low cost funds[13] beating the benchmark	% high cost funds[14] beating the benchmark
US Large Growth Companies	15.3%	1.1%
Overseas Large Companies	42.4%	27.8%
Emerging Markets	55.2%	35.5%

As you can see the evidence shows that, generally, **lower cost funds perform better than the higher cost funds.**

10. Morningstar's US Active/Passive Barometer, data to 31 December 2023. Data is for 10 year period.
11. The 'benchmark' reflects the actual, net of fees performance of investable passive funds.
12. Morningstar categories used: US Large Growth, Foreign Large Blend, Diversified Emerging Markets
13. Cheapest 20% of funds on Morningstar US data base for category.
14. Most expensive 20% of funds on Morningstar US data base for category.

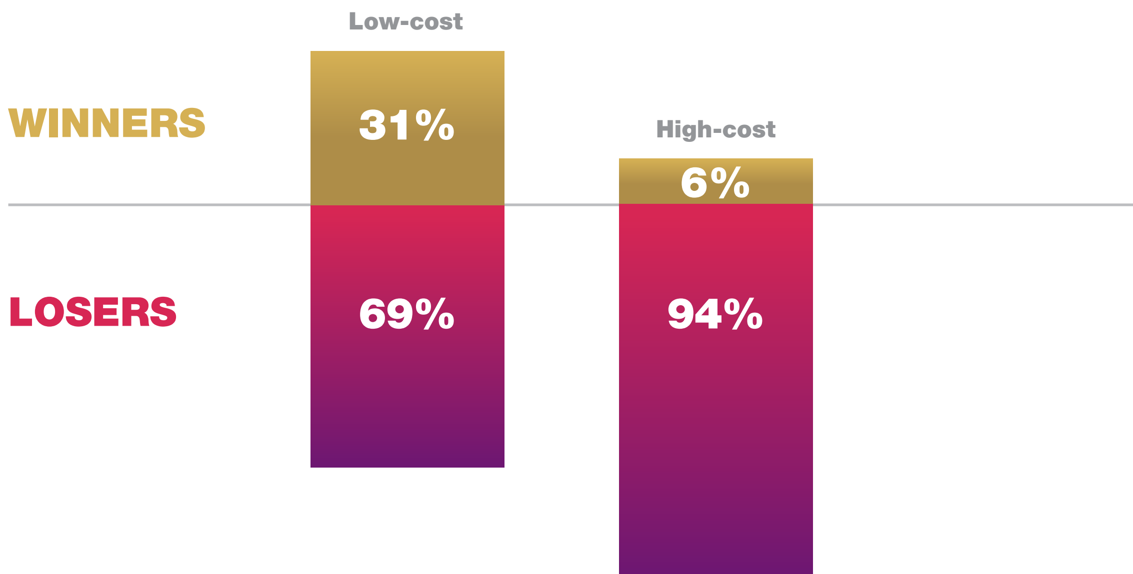
Second piece of evidence

Next up is a study by Dimensional Fund Advisers, an academic-led fund management group specialising in systematic, evidence-based investment strategies.

They produce an annual report, called the **Mutual Fund Landscape**, and it shows the performance over different time periods of various equity funds based on costs. The study divides the funds into four cost categories - low, medium low, medium high and high.

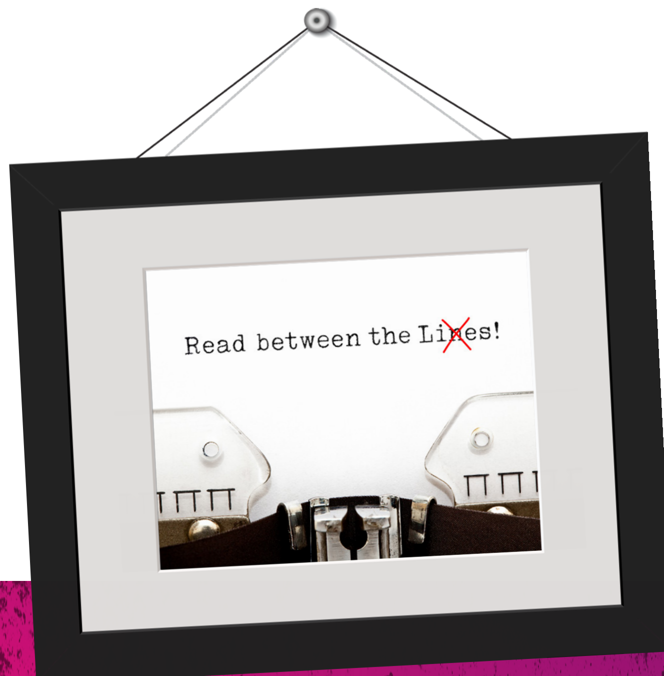
In the chart below winners are funds that survived and outperformed their benchmark over the period. Losers are funds that either didn't survive or didn't outperform their benchmark.

The Dimensional study shows a similar result every year. For the 20 years to the end of 2023[15], **31% of low-cost funds beat the index** and are therefore deemed winners. The situation is much worse for high-cost funds where only 6% are winners.



This evidence reinforces the Morningstar survey and proves that you have a better chance of achieving **higher investment returns by investing in low cost funds.**

15. The Fund Landscape 2024. A study of US domiciled funds, data to 31 December 2023.



CONCLUSION

We've explained the problem, you've seen the evidence, so what next?

We're here to help

Feeling uneasy? Sorry if we've taken the wind out of your sails. Hopefully we've now demonstrated the importance of understanding not only what you're paying, but why keeping costs to a minimum is really important to maintain the true value of your wealth.

You might be asking yourself how to get to the bottom of it all. Let us help.

If you'd like us to analyse your current portfolio Andy Sheena, Business Development Director is here to help.

Click here to get in touch with him or email andrew.sheena@cooperparry.com to get your review underway.

Introducing PortfolioScience™: Our low-cost, evidence-based investment approach

Cooper Parry Wealth manages £1.5 billion[16] of investment assets for successful individuals and families across the UK. Back in 2009, we made a decision to do things differently. To break the mould. To be the best at what we do. To help our clients make life count.

We scrapped the traditional model and created a new proposition. One that helps our clients achieve the things that matter most to them. What we've created is frighteningly simple, but it works.

What is PortfolioScience™?

It's our way of investing that's based on Nobel Prize winning research, academic evidence and most importantly, common sense. It's about doing a few simple things exceptionally well and it's built around our six principles of successful investing:

1 **At** Accept the stock market is tough to beat	2 **Ur** Understand risk and return are related	3 **Dp** Don't put all your eggs in one basket
4 **Fo** Focus on the investment mix	5 **Ky** Keep your costs low	6 **Cy** Control your emotions and think long-term

You can see that one of these principles is the subject of this guide, 'keep your costs low'. But you'll also see there are five other areas that are just as important when it comes to having a successful investment experience.

We've explained them in detail in our PortfolioScience guide which you can access here if you have questions about how the principles come together to support a successful investment experience, please get in touch using the details above.

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16. As at August 2024.

GET IN TOUCH

If you have any questions, or would like to discuss anything in more detail please contact Andy Sheena:

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Our teams of talent operate right across the UK.

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