Brief history of investing in Canada

Prior to the creation and popularity of mutual funds, retail investors had a choice. You hire a financial advisor, better known as a stock broker at the time, or invest in GICs at your bank. Those who hired a financial advisor were substantially wealthier than average. Their portfolios were invested in stocks and bonds. Mutual and pooled investments were in their infancy of development. Proper diversification principles meant that the client would purchase a basket of stocks and bonds individually. The stock broker got paid per transaction. This worked for the wealthy but the average saver had little access to stocks and bonds and were stuck with GIC investment products.

The creation of mutual funds and the invention of the deferred sales charge option changed this. Clients with limited means could now invest in one or two mutual funds and obtain complete diversified access to equity markets. The invention of the deferred sales charge option meant that smaller clients were profitable to the stock broker. For a refresher on the DSC option, the fund company pays the advisor 5% of the value of the purchase. The fund company recoups the payment by ensuring the client remains invested for 8 years. If the client redeems out of the fund company before the end of the 8-year period, there is a sizeable charge to the client. For example, if a client invested $25,000 in a fund, the advisor and advisor's firm shared $1,250 up front and ongoing smaller trailer revenue. The DSC option meant that middle class clients were profitable for the advisor. A new clientele opened up for financial advisors.

Pooled funds (a mutual fund is a pooled fund) allowed the smaller investor access to stock and bond markets and allowed the advisor to earn reasonable revenue from middle class clients.

Realizing how profitable mutual funds are to their business, advisors quickly began offering mutual funds to all clients. Mutual fund companies quickly began marketing their funds to financial advisors.

Financial advisors transitioned their business from investment picking to financial planning. The fund manager was performing the investment picking task. The financial advisor's business transitioned from "I like investment A over investment B because the P/E is lower and the cash flow is higher" to "I think you should invest in an RRSP instead of a non-registered account. If you do so, and save $10,000 per year, you will be able to retire at 60".

Everyone was happy. Financial advisors were getting rich, clients had access to higher earning equity and bond markets compared to GIC returns, and fund management companies were booming. Well, not all were happy. Banks were slow to offer mutual funds to their clientele and many clients moved from bank GICs to independent financial advisors and invested in mutual funds. Banks eventually succumbed and now offer all sorts of pooled funds and hold a large market share of the investment management industry.

Then came along research that proved that fund management companies and professional fund managers were not creating value. Few could consistently outperform their benchmarks after-cost. As posted on the Active vs. Passive tab 93% of large cap (big companies) actively managed U.S. investment funds underperformed the S&P 500 index over a 15-year period. The link between high total cost and underperformance became clear.

The passive investment management industry was born. John Bogle, a passionate advocate for low-cost passive management, created the investment management company Vanguard in the early 1970s. TIPS, an ETF that replicated the returns of the Canadian market, was created in the early 1990's. The passive investment management industry has grown steadily since.

We are not far from this period now. Still, though, if you want financial planning advice you likely have to accept investing in high cost actively managed pooled funds. Few advisors offer passively managed ETFs or index mutual funds to their clientele. They are not nearly as lucrative to the investment management industry as the actively managed pooled fund.

How do you pay, what do you pay, and what are you paying for?

How Do You Pay

When we purchase a good or a service we typically pay a transaction fee. If I buy a TV I pay a one-time fee. If I pay someone to clean my home's eavestroughs, I pay a one-time fee. I know the price in advance and pay the fee for the work done or product purchased. This is not so with financial advisory.

Pooled funds come with a Management Expense Ratio. Management Expense Ratio is cost to the fund investor. If a fund has a 2% MER, the fund manager is removing 1/365 x 2% out of the fund each day. It is a 2% annual fee charged daily. Fixed income funds typically come with a lower fee because there is less investment research to perform.

Two percentage points of anything sounds small. This is not the case with investing. The pre-cost return is also small. If investments within the fund average a 7% return, a 2-percentage point charge results in a post-cost return of 5%. Cost at 2 percentage points reduced growth of the fund by 29%. Or, post-cost return is 71% of pre-cost return. This adds up to an enormous reduction in account value over the long-term. The difference in portfolio value with a 2 percentage-point return difference.

This ignores all other potential cost such as DSC charges and account fees and trading costs.

What Do You Pay

An example helps. Let's say you hold $100,000 in a fund with a 2% MER. The fund delivers a 7% pre-cost return and a 5% post-cost return to investors per year for 5 years. I will ignore trading expenses for the moment. (Trading expenses are incurred when the fund manager makes a trade. The more the fund manager trades, the greater the relevance of trading expense. Passively managed products have trading expenses but because they are managed passively they don't trade much. (If a company in an index gets removed from the index, passively managed products that track the index must sell the company out of the portfolio.))

At the end of:

Year	**Value**	**Cost Paid**
1.	$105,000	$2,000
2.	$110,250	$2,100
3.	$115,763	$2,205
4.	$121,551	$2,315
5.	$127,629	$2,431

At the end of the 5th year you have $127,629 invested in the fund and have paid $11,051 in fee. You have not seen a charge on a bill or invoice. If cost was 0% per year you would have $140,225 in your account. Total cost to you is $140,225 – 127,629 = $12,626. The difference of $12,626 - $11,051 = $1,575 is the fees paid not compounding in your account over the 5-year period. Your account is 8.98% less valuable because of the cost paid and the cost not compounding in your account. Over the long term this adds up to a substantial difference in portfolio value.

Most ignore this. They look at their statement and are pleased that their account has grown to $127,629. The financial service industry takes advantage of this.

What Are You Paying For

You are buying two services. You are buying the day to day management of your savings through the fund manager and you are buying the financial planning services of the financial advisor or planner. As an approximation, the fund manager's company keeps 45% of the MER as company revenue and the fund management company sends 45% of the MER to the financial advisor's firm. The remaining 10% is allocated to fund expenses such as accounting fees, statements, etc. In year 1 of the above example, the fund management company keeps $900 and sends $900 to the financial advisor's firm to be shared between the firm and financial advisor. In year 2 the amounts increase to $945 each and so on. This goes on for as long as you have money invested in the fund.

After reading the Active vs. Passive tab you should understand that the active fund manager is not adding value.

The financial advisor or planner, if skilled at their profession, is likely adding value. The question is are they adding enough value to justify the cost?

I Should Explain The Deferred Sales Charge Sales Option

Deferred sales charge, and versions of it, are popular with independent financial advisors. Approximately 5% of the value of a fund purchase is sent from the mutual fund company to the financial advisor's firm. The client does not pay this. 100% of the client's money is invested in the fund. The fund management company finances the 5%. They recoup their money by sending less to the financial advisor's firm on an ongoing basis for typically the first 7 or 8 years. If the client redeems this specific chunk of money out of the fund management company (the client can switch between the fund management company's funds) within the first 7 or 8 years, the client pays a hefty redemption fee. If the client redeems after this period, there is no fee. The fund company has recouped its 5% payment. This fee can be avoided if you don't redeem. The unwelcome news is that you are somewhat committing your money to the firm for 7 or 8 years. Life can get in the way of this commitment. Many people end up paying a hefty DSC charge.

Why does this exist? Without DSC, a $100,000 client fund purchase results in annual revenue to the financial advisor's firm of approximately $900 plus growth per year. This is shared between the financial advisor and the financial advisor's firm. Successful advisors get more, unsuccessful advisors or new advisors get less. Let's say the advisor gets half, or $450. An advisor needs a whole bunch of $100,000 accounts to make a living. $100,000 accounts are not that easy to come by. With the deferred sales charge sales option, the financial advisor's firm gets approximately $5,000 up front and lower ongoing revenue for the first 7 or 8 years. If a new advisor gets 20 $100,000 accounts per year and negotiates the DSC sales option with each client, they will earn $50,000 of revenue per year with a 50 /50 split with the firm. The industry is slowly moving away from the DSC sales option.

How To Find Your Cost Factor

Grab your statement and search the internet for the exact name of the investment on your statement. Try to find the Fund Fact. Here is how the Ontario Securities Commission describes a fund fact: https://www.getsmarteraboutmoney.ca/tools/fund-facts-interactive-sample/ In this example total cost is MER + TER = 2.3% found near the bottom of fund fact. It is law for each fund to maintain and present a Fund Fact.

If you hold more than one fund your total cost factor will be a weighted average of the total cost of each fund. Lets say you hold $50,000 in fund A with a cost of 2.10% and $25,000 in fund B with a cost of 1.85%, then total portfolio cost is 2.02%.

Are You Getting Value Commensurate With Cost?

A two percentage-point cost factor is taking an enormous amount of wealth from you in the long-term. We see that with the above linked spreadsheet. Even a one percentage point cost factor is difficult to justify. Are you getting that much value? Is it not worth a few hours to learn and a few hours per year to maintain your accounts to slash your high cost factor? This is especially true if you are an employee earning T4 income. There is not much financial planning complexity when earning T4 income.

Over a 40 year period, a two percentage-point cost factor off of a pre-cost return of 7% reduces a one-time, lump-sum investment by over half.

Over a 40 year period, a two percentage-point cost factor off of a pre-cost return of 7% reduces a systematic annual savings (ex $10,000 per year for 40 years) by over a third.

- Mutual funds or pooled funds have embedded expenses that the client pays on an ongoing basis. These fees can add up to more than 2 percentage points in many cases.
- "Embedded" means you never see a charge. You pay through a reduced return. To explain through an example, if your embedded fee is 2%, your return will be two percentage points lower per year. Stated differently, if your mutual fund returned 5% to you, it would've returned 7% if the embedded fee was 0%. If your mutual fund returned negative 5%, it would've returned negative 3% if the embedded fee was 0%. This adds up to great portfolio value differences over the long term. This is an ongoing unavoidable fee with mutual funds or pooled funds.
- 2 percentage points sounds small but 2 percentage points on a 6 percentage point growth removes 1/3 of your growth. This is money extracted and not compounding for you. You can see the long-term ramification of a 2% embedded cost on 7% pre-cost growth here.
- The fund company collects the fee and shares it with the advisor's firm which shares it with the advisor on an ongoing basis.
- Mutual funds can have a separate sales fee. A sales fee is an upfront fee paid to the advisor's firm by either you or the fund company.
- Front end sales charge is a charge you pay. If your front end charge is 1% and you are investing $10,000, $100 is sent to the advisor's firm to be shared with the advisor and $9,900 is invested in your account. You are instantly $100 in the red.
- Deferred sales charges or low load sales charges are popular sales options. With the DSC sales option, the fund company sends the advisors firm approximately 5% of the purchase amount. The fund company pays this 5%. The fund company recoups the payment by sending the advisor's firm less on an ongoing basis. If you redeem your investment out of the fund company within a certain time period, typically 7 or 8 years, you pay a redemption fee that can be as high as 6%. You can redeem fee free once the 7 or 8 year period ends.
- There is also a fee for service option typically reserved for larger portfolios. The fee is extracted from your account or bank account. You can at least see the fee with this option.
- Make sure you know what you are paying.

You more than likely do not pay the traditional way. The traditional way is to pay for work done. When you meet with an accountant, a lawyer, a golf professional or many others, they typically charge for work done or time spent with you. This is not the case with a financial advisor or financial planner. They charge or get paid a percentage of your assets year after year and may get an upfront payment as well.

Remember, when you sit down with an advisor or planner there are four main parties involved: you, the advisor or planner, the advisor or planner's firm, and the product provider. All need to be paid and it is you doing the paying.

Let's look at a how a financial planner or financial advisor gets paid if they invest your money in mutual funds or pooled funds. I'll pick on Royal Bank. Royal Bank has some of the lowest fees for actively managed products so good on them for that.

RBC Canadian Equity Fund has a management expense ratio of 1.97% as per the current fund fact. http://funds.rbcgam.com/pdf/fund-facts/funds/rbf269_e.pdf This means that you pay 1.97% of the amount of money you have invested in the fund. If you have $100,000 invested in the fund, you are paying in the neighborhood of $1,970 per year. Note that you pay daily and the per day calculation is 1 / 365 days x 1.97% x $100,000. RBC Asset Management charges 1.60%. RBC Asset Management sends approximately half of this, or .8%, to the advisor's firm and the advisor's firm shares this with the financial advisor. If the financial advisor gets half, they get .4% or approximately $400. per year. If the fund goes up you pay 1.97% on a higher amount and vice versa if the fund drops in value. This is an ongoing fee.

The difference between 1.97% cost to you and the 1.6% management fee is legal fees, statement distribution fees, accounting fees, director fees, gst, hst, pst and other fees. These are the other parties that get paid. The relevant cost to you is 1.97% plus trading fees. I won't get into trading fees but on the fund fact you can see that trading fees were 7 basis points. Trading fees are separate from the costs captured in the MER. Total cost is the MER plus trading fees. For RBC Canadian Equity the total cost is 2.04%. Yikes!

Here is a mutual fund fee calculator from the Ontario Securities Commission:
https://www.getsmarteraboutmoney.ca/calculators/mutual-fund-fee/

There are a lot of hands in the pie and they need to be paid. I should say in defense of the financial service sector, the regulators have not done much to bring down these costs. They pile regulation upon regulation on the industry and this raises cost. Compliance departments have been growing steadily over the last 20 years. The compliance department does good work but they come with a cost and I am not sure the cost / benefit ratio is in their favour.

There can also be sales charges. There is the initial sales charge that few use anymore. If an advisor charges a 1% sales charge, 1% of your initial purchase is removed and sent to the financial advisor's firm to be shared with the advisor. A $100,000 purchase would result in $1,000 sent to the financial advisor's firm and $99,000 invested.

Deferred sales charge, and versions of it, are popular with independent financial advisors. Approximately 5% of your initial fund purchase is sent from the mutual fund company to the financial advisor's firm. You do not pay this. All of you initial purchase is invested in your account. The mutual fund company is financing this. They recoup their money by sending less to the financial advisor's firm on an ongoing basis for typically the first 7 or 8 years. If you redeem money in this time period you are charged a heavy redemption fee. If you redeem after this period you are not charged a redemption fee. This fee can be avoided if you don't redeem. The bad news is that you are somewhat committing your money to the firm for 7 or 8 years. Life can get in the way of this commitment.

Why does this exist? In the above example, a $100,000 purchase results in annual revenue to the financial advisor of $400. A new or struggling advisor needs a whole bunch of $100,000 accounts to make a living. $100,000 are not that easy to come by. With deferred sales charge revenue, the financial advisor's firm gets approximately $5,000 up front and lower ongoing revenue for the first 7 or 8 years. If a new advisor gets 20 $100,000 accounts and negotiates DSC sales option with the client year they will earn $50,000 of revenue with a 50 /50 split with the firm.

Low load sales charge is a lighter version of DSC.

How to determine your cost factor

Let's say I have $50,000 invested in RBC Select Growth and $24,000 in RBC Canadian Equity. The fund facts tell me that RBC Select Growth has an MER of 2.04% and a Trading Expense Ratio (TER) of .12% for a total cost ratio of 2.16%. RBC Canadian Equity has an MER of 1.97% and a TER of .07% for a total cost ratio of 2.04%.

$50,000 x 2.16% = $1,080

$24,000 x 2.04% = $490

Total cost is approximately $1,570 per year. $1,570 / $74,000 = 2.12% = portfolio cost ratio. This portfolio is growing 2.12 percentage points slower after-cost than pre-cost annually. I am ignoring any DSC charges.

Is it worth it?

If you knew that you could get a similar portfolio managed passively for under 15 basis points would you be interested? 15 basis point charge on $74,000 results in an annual cost of $111.0. This is $1,459 less expensive year after year. The $1,459 remains in your portfolio and compounds over time. This is almost two full percentage points less expensive. You can see the long-term ramification of a 2% MER on 7% pre-cost growth here.

Back to the poker game analogy

Remember that investing is a positive sum game but a zero-sum game around the after-cost market return. It isn't wise to rely on the active manager to overcome the fee drag and outperform the market long term. They may for a few years but you are asking them to earn a long-term average substantially above the after-cost market return simply to match the return of low-cost, passively managed portfolio. In the poker game analogy, the three non-gamblers earned 6.85% and the 7 gamblers played in a zero-sum game around 5%. The gamblers had to be long term outperformers by 1.85 percentage points just to match the return of the non-gamblers. This is not easy to do.

Why does active management persist?

Even with high active management fees, it is still a positive-sum environment. A 2% charge on 7% growth still earns you 5%. Too many people are content with the 5% and are unaware that fees remove a significant portion of their portfolio growth.

Random paragraphs

Most financial advisors or planners suggest their clients invest their savings into pooled funds. A mutual fund is a pooled fund. The manager of the pooled fund is making investment decisions based on the objectives of the fund. If the fund is mandated to invest in Canadian equity the fund manager is making daily decisions of which Canadian equity investments to purchase and own or sell and disown. For example, the fund manager could say I like the prospects of TD Bank and have soured on Scotiabank. The fund manager would sell some or all shares of Scotiabank and purchase shares of TD Bank. The goal of the fund manager is to deliver outstanding performance to fund investors.