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Total Expense Ratios: quantifying and increasing the visibility of underlying fund costs

Fees are important, In fact, they are the main reason why actively managed funds on average underperform the market. Not only that, but because the average fund underperforms the market by the average fee it is critical for investors to understand the fees that they pay and the value they are getting for their money.

There are essentially three services that investors pay for, and three sets of fees they pay to invest in a unit trust. These are financial advice, investment management and administration. South African unit trusts already offer reasonably good disclosure of (arguably) the most important element of fees: the annual management fee charged by the Management Company for investment management and fund administration. Coupled with this, South African funds have always shown performance net of the investment management charge, allowing investors in the main to "compare apples with apples". What has not been disclosed to date have been the other costs of investing in a unit trust but this is about to change.

In April 2007, the collective investments industry will be introducing a new measure intended to enable investors to quantify and compare the ongoing underlying costs involved in the actual day to day running of a collective investment scheme or unit trust. This measure is known as a Total Expense Ratio or TER and it aims to provide further transparency and a way to quantify and compare the costs that are incurred within portfolios in addition to the annual management fee, such as stock brokerage, custody fees, trustee fees, audit fees and bank charges. Key costs that were not shown historically that the new TERs are most likely to highlight are brokerage (which increase the costs of funds that trade a lot) and the underlying costs in a 'fund of funds' structure. These costs should be currently disclosed in the annual financial reports of the relevant management company (for example Allan Gray Unit Trust Management Limited sends each unitholder an annual report in March every year), but in an effort to quantify these in a way that makes them comparable and more visible to investors prior to investment, the Association of Collective Investment Schemes (ACI) has initiated use and disclosure of the TER, in line with best practice in most global markets.

What is a TER?
A measure of a portfolio's assets that are paid as operating expenses. It is expressed as a percentage of the daily average value of the portfolio, which is calculated over a period of e.g. a financial year. The manager of a collective investment scheme calculates the TER and the approved auditors of the scheme verify the methodology used.

$$\textbf{Total expense ratio} = \frac{\textbf{Total Fund Expenses}}{\textbf{Average Market Value of Fund}}$$

As an example: The TER for the Allan Gray Optimal Fund for the year to 31 December 2006 is 1.84%. This includes all costs (including VAT) that the Fund incurs. This means that an investor would effectively have paid 1.84% of the average market value of his/her investment during the year for underlying portfolio costs. To use a numerical example, if the investor's average balance in the Allan Gray Optimal Fund was R100 000 then he/she would have effectively paid R1 840 in costs that were incurred in the Fund. Performance-based management fees are included in TERs with the objective of enabling investors to distinguish between costs that may be charged to the portfolio regardless of its performance and a performance fee that may vary significantly from one year to the next. Included in the new TER disclosure requirements is the requirement to disclose in a percentage format, the performance fee expense as a percentage of the average net asset value (NAV). In the above example, inclusive in the TER of 1.84%, is a performance fee of 0.49% of the net asset value of the fund. In the case of a 'fund of funds' structure, there are two different layers of expenses and TER should include both the costs of the top tier fund and the costs of the bottom tier funds.

What may not be included in a TER?
TERs normally exclude initial costs of entry to an investment such as initial fees (if applicable) and the initial and ongoing cost of financial advice. It is however important to compare apples with apples: some funds do include in their fee structure a 'built in' fee for advice which is not reported separately as it is 'funded' out of the annual management charge. This is often referred to as an 'all-in-fee' fund. These fees are not always reported and disclosed separately so investors don't always know what they are paying for financial advice as opposed to investment management. The result is that some annual management charges and TERs will include a bundled charge for financial advice and others will not, with the implication being that if investors want advice they will pay extra for it.

Where will this information be shown and made available?
From April 2007 TERs will be shown in appropriate pre-sales investment documentation such as Fund Fact sheets, fund lists, on our website, in annual unitholder communication and in our quarterly report.

In closing
When investing, costs, while important, are only a part of the fund selection decision. The really important factor is anticipated returns net of all costs. To take a view on this it is critical for an investor to understand the total costs as these are effectively the handicap the manager suffers before he is able to deliver enough to justify active investment management – and the higher the costs the less likely he is to overcome this handicap. All Allan Gray performance figures and values have always been and are quoted after the deduction of all costs incurred within the fund, but we hope that the additional disclosure of the TER will help investors better judge whether we are delivering value for the service we provide.

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