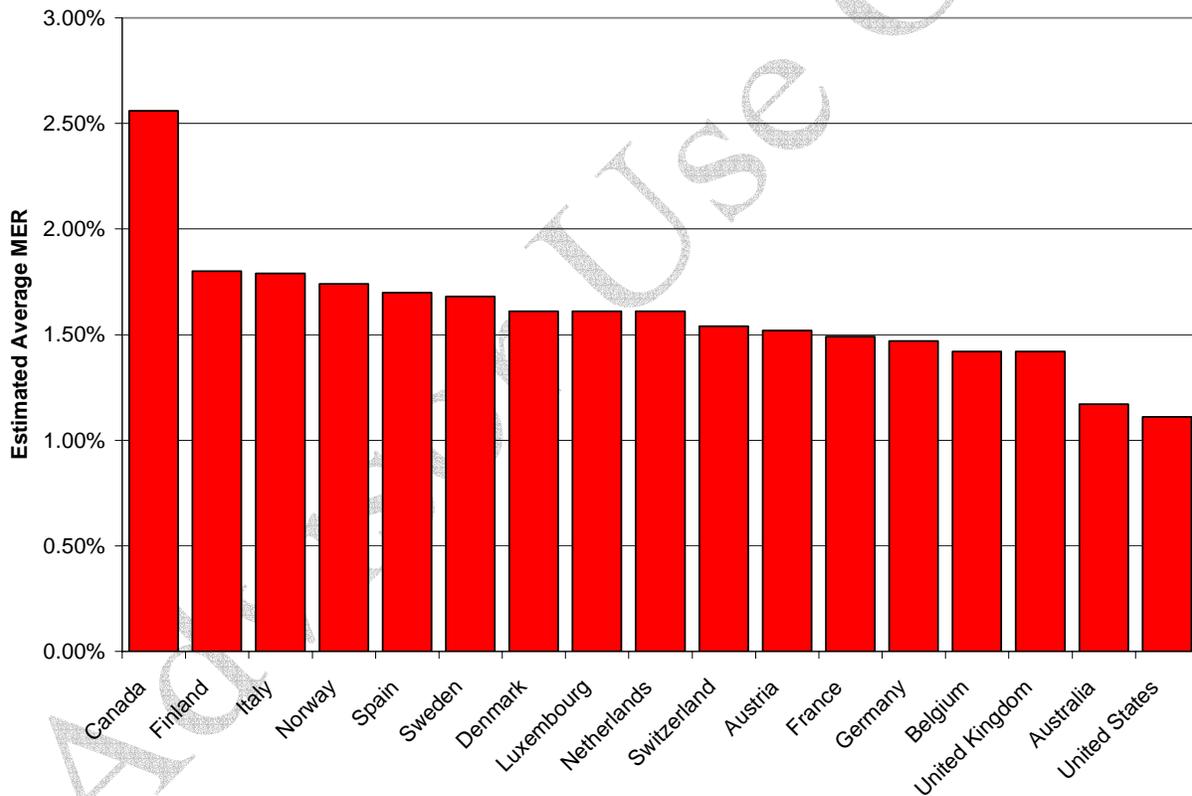


Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

If you ever want to see Personal Finance columnists from the various media outlets froth at the mouth, bring up the topic of mutual fund fees. They will climb on top of their pulpits and shout about the evils of the MER to any and all that would listen. While I poke fun at them, they do have an extremely valid point. Fund fees in Canada are high. In fact, according to a recent study released by Peter Tufano, Ajay Khorana, and Henri Servaes, Canada’s mutual fund fees are the highest in the world.

Average MER’s of Mutual Funds by Country (2002)



Source: Mutual Fund Fees Around the World by Ajay Khorana, Henri Servaes & Peter Tufano, May 1/07

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

IFIC and various industry groups have pointed out a number of perceived inaccuracies in the study, namely the various reporting standards across jurisdictions may result in the fees in other countries actually being higher than reported. Nevertheless, we do pay the highest mutual fund fees in the world and that doesn't appear to be changing any time soon.

Fees, like it or not, are part of investing process. There are two main contributors to fund fees in Canada:

- i.) **Management Fees** – This is usually the biggest portion of the fund cost and will range in the 1.75% to 2.0% range for Canadian Equity Funds. It typically will be higher for more complicated mandates and lower for fixed income type products. This fee pays for such things as investment management, marketing and administrative costs. Also included in the management fees are the trailing commissions that are paid to advisors, which will range from 0.50% to 1.0% depending on whether the fund was sold on a front end or back end basis.
- ii.) **Operating Expenses** – These costs actually refer to the costs of operating the funds, and will typically include such things as brokerage fees, audit fees and unit holder communications. Depending on the company and the size of the fund, these additional costs can range anywhere from 0.15% up to 0.50% or more.

In addition, some funds are moving towards adding yet another fee into the mix – a performance fee. With a performance fee, the fund manager will take a portion of any upside gains, with the balance being passed on to investors. We like performance fees as it tends to give the manager incentive to deliver strong performance for investors.

2

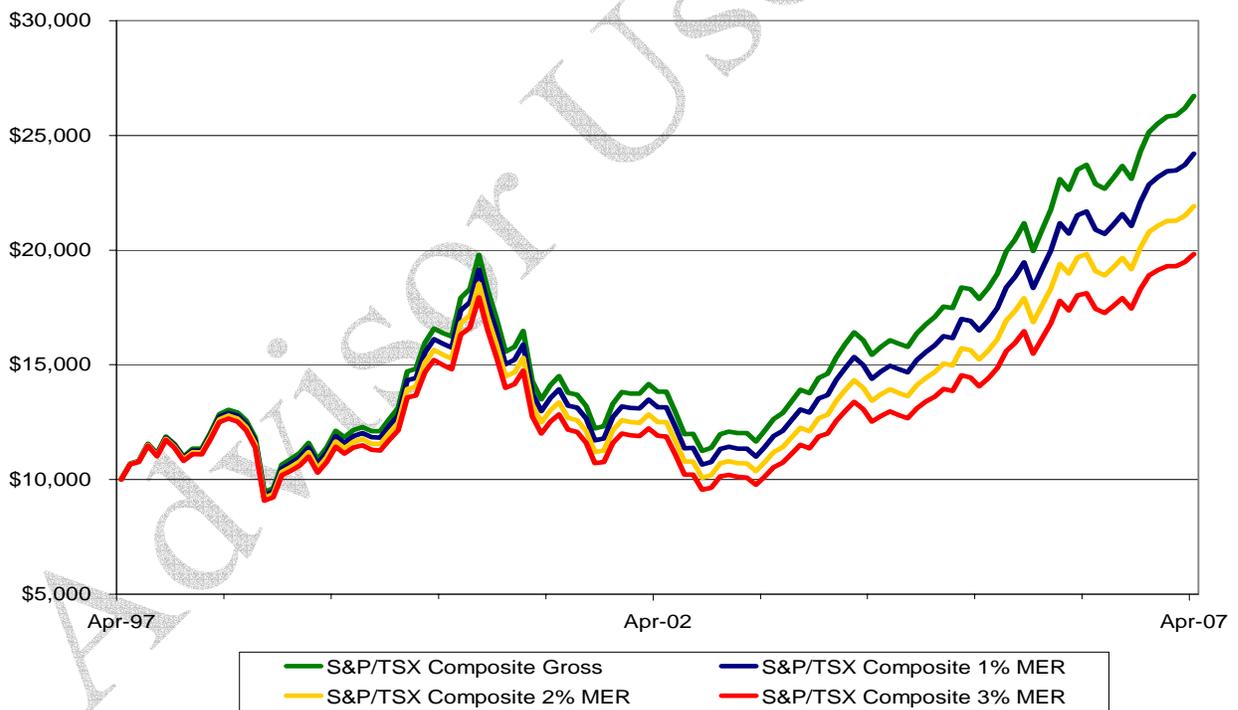
Paterson & Associates

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

However, in our view, if the manager wants to bring in a performance fee, then they should reduce the other fixed costs of the fund as a break for investors. For the most part, investors don't even realize that they are paying these fees, performance or otherwise, as they are deducted from the fund directly.

It is rather unfortunate that most investors are oblivious to fund fees. Very few realize the impact that they have on investment returns. For example, the chart below shows the actual growth of the S&P/TSX Composite Index for the past 10 years. For the sake of comparison, we have shown the actual return, and the returns where a 1%, 2% and 3% MER were deducted from the performance of the index.



For the 10 year period, a \$10,000 investment directly in the TSX Composite would have had an ending value of just under \$27,000. The 1% MER have ended with just over

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

\$24,000 while the 2% MER would have returned \$22,000 with the 3% MER coming home with just under \$20,000. In other words, for every 1% you pay in fees, over a 10 year period, you lose about a quarter of your original investment. Over time, that can really add up.

Another factor to consider when assessing fees on funds relates to the type of fund. For example, fixed income funds with their relatively conservative approach tend to be more impacted by fees than a more volatile equity fund. If we look at the range of returns for Canadian Fixed Income Funds, the best performing fund over a 3 year period returned 7.3% as of April 30, while the worst performing fund returned 2.0%, which is 5.3% differential. When looking at Canadian Equity funds during the same period, the best performing fund posted an impressive 28.9% 3-year return while the worst performing fund returned 3.1% for a differential of 25.8. Looking at these gaps, it becomes clear that the impact of fees will have a more significant impact on the fixed income funds where the return differential is already so narrow.

Even though fees are a necessary evil, advisors can take steps to help control or at least mitigate the fee on behalf of their clients. For starters, you can pay particular attention to the embedded costs of any fund you use and balance this with the quality of the investment products. Fees, as shown above, are something that needs to be monitored; however, cost should not be your sole factor in choosing a fund. If using active managers, one should pay attention to the manager's investment style and process, sell discipline, and historic track record, in addition to the level of fees.

When we analyze a fund using our quantitative model, we don't even consider fees - at least not directly. Our main reason for this is that our analysis is conducted using a return stream that is net of all fees. Therefore, while we don't directly account for the impact, it is indirectly addressed through the higher the level of fees a manager must

4

Paterson & Associates

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

contend with. The higher the level of fees, the higher the hurdle the manager must pass in order to pass along returns to the investors. That said, if we are looking at two investment products of similar risk reward profiles, then we tend to favour the lower fee product for the lower return hurdle going forward.

The second way to help minimize the fees your clients may pay is to switch to a fee-based platform for all or a portion of your practice. In a recent conversation with Certified Financial Planner and author of the book *To Fee or Not to Fee*, Marc Lamontagne, said that a fee-based approach is a great tool in servicing clients for a number of reasons. Under the traditional commission based system, a good portion of the advisors compensation comes from the embedded trailer fees. However, the problem is that those trailer fees are set by the company and result in a higher cost to the client. By employing a fee-based approach, the client will pay directly for the service, which effectively allows the advisor to un-bundle the compensation from the product cost. This serves two purposes. First, it allows advisors to consider other products that they wouldn't necessarily use with a commission based system such as the lower cost index funds available from providers such as Altamira. It also allows advisors to consider F-Class funds and funds from some of the more boutique operations such as PH&N and McLean Budden, who don't pay trailer fees to advisors.

The second advantage of employing the fee-based approach is that it allows for greater flexibility in pricing. The advisor is now fully in control of what they charge for the advice they provide their clients. For cost sensitive clients, the advisor can now compete with some of the lower cost alternatives that clients can now access. In the end, clients can receive better built portfolios at an all in cost that is less than what it would cost using a traditional mutual fund portfolio, with the compensation embedded in the management fees.

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

There is no doubt that the fees that investors pay for mutual funds in Canada are the highest in the world. Some companies have been quietly cutting fees, but to what extent leads us to believe that their actions leave a bit to be desired. Others have taken more public steps, such as capping MER's or implementing a fixed administrative fee, rather than the variable operating expenses. While this will help to provide some cost certainty going forward, there is, in our opinion, still some room for further cuts to be made.

Final Thoughts

As an advisor, you can take steps to help to mitigate the impact of fees your clients pay by paying attention to the fees in the underlying funds you use. However, a caveat is that fees should not be the only factor you use in selecting funds. Attention still must be paid to the manager, their style approach and risk reward profile. A good rule of thumb is that when considering two products of similar risk reward profile, lean towards the one with the lowest cost structure.

Another approach is to utilize a fee-based platform. By unbundling your compensation, you can offer your clients a broader range of investment products that are not profitable to you under the traditional commission model. This will also allow you greater control in setting your compensation as your clients will pay a fee solely for your services.

For more information on reducing costs or implementing a fee-based approach to your practice, do not hesitate to contact me directly.

Mutual Fund Fees – Are we Paying Too Much?

For Financial advisor use only

Disclosure

- This Report is for Financial Advisor Use only.
- This analysis is intended to be for informational purposes only. The information provided in this report is not intended to constitute legal, accounting, financial or tax advice. Many factors unknown to us may affect the applicability of any statement or comment found in this report to your particular circumstances.
- Any performance data given represents past performance and should not be considered indicative of future results. Principal value and investment return of stocks, bonds and mutual funds will fluctuate, and an investor's shares/units when redeemed will likely be worth more or less than the original investment. Stocks, bonds and mutual funds are not CDIC-insured, may lose value, and are not guaranteed by a bank or other financial institution. Portfolio statistics change over time.
- This analysis is based on information believed to be reliable. Every effort is made to ensure it's accuracy, however, we cannot be held responsible for any errors or omissions in the underlying data.
- The opinions, estimates and any projections contained in this report are subject to change without notice.