STANDARD & POOR'S

Setting the Standard

Fund Services

Worth the extra cost?

In order to make their investment decisions, investors must define their timeframe of investment and ask themselves how much risk they are ready to take for how much return. But investors do not always place enough emphasis on management fees as a component of their decision. However, good performances are difficult to guarantee, and will certainly be affected by paying high charges as the table below demonstrates.

Paying high charges for funds with similar investment objectives and levels of volatility has not always been justified by good performance. On the contrary, funds with the lowest charges have shown the best performances recently. For example, the Pearl UK Smaller Companies fund, which charges the highest fees in its sector (annual and entry fees of 1.5 and 6%), has been ranked in the bottom 25% performing funds in its sector over the 1, 3 and 5-year total returns.

This dramatically contrasts with the Standard Life UK Smaller Companies fund, which has been assigned with a Standard & Poor's Fund Management Rating of AA , and which charges almost half that of the Pearl fund, but has been consistently performing in the first quartile of the sector over the same time periods. In this case, through paying 2.5 percentage points less up front, an investor would have gained 31.32% over the last 5 years, compared with losses of 50.38% sustained by the Pearl fund.

Examples where high charges have not paid off

	Annual Charge	Entry Fee	1-yr	Quartile Ranking	3-yr	Quartile Ranking	5-yr	Quartile Ranking	3-yr Volatility	S&P Fund Ratings	Min Initial Invest (£)
Fixed Income GBP											
Eagle Star Income	1.25	6	-4.58	4	8.82	4	18.98	4	1.28		1,000.00
L&G Fixed Interest	0.5	0	4.14	1	21.24	1	36.33	1	1.16	AA/S3	500
Equity Japan											
Abbey Japan	1.13	6	-30.03	3	-47.85	2	-25.93	2	6.65		1,000.00
L&G Japanese	1.5	0	-25.45	1	-39.04	1	0.45	1	6.22	AA	500
Smllr Companies UK											
Pearl UK Smaller Companies	1.5	6	-42.78	4	-55.75	4	-50.38	4	8.62		1,000.00
Std Lf UK Smaller Cos Rtl	1.5	3.5	-19.21	1	-4.25	1	31.32	1	7.16	AA	500

Calculation offer to bid, net income re-invested, GBP - Data up to 28/11/02

Worth the extra cost?

Standard & Poor's has produced a survey to demonstrate just how dramatic the differences in costs between unit trusts sectors can be. We looked at two main charges applicable to unit trusts and OEICs: the initial charge and the annual management charge.

The initial charge is normally imposed when buying units or shares. This means that if, for example, you have £1,000 to invest and the initial charge is 5%, you are actually only investing £950 into the fund. Also known as the front-end load, this charge covers management costs such as administration, commission, regulation, and advertising. Managers sometimes reduce their standard initial charge in order to help promote their funds. Initial charges range from 0 to 7.5% , both extremes being quite common with institutional funds. The initial charge is often reduced or even eliminated if you buy through a discount broker or an Internet fund supermarket.

The second main charge is the annual management fee, meant to cover ongoing fund management costs and administration. It ranges from 0 to 2.25% but for the 80% of unit trusts, it is between 1 and 1.5%.

In an attempt to compare the differences in levels of charges among unit trust sectors, we have looked at the average Fitzrovia total expense ratio (TER) , which measures the internal costs of the fund management process. Not surprisingly, we found a strong correlation between the level of front end and annual management charges imposed onto the investor and the expense ratio: the higher the Fitzrovia TER, the higher the charges.

However, we also have found that there is often no correlation between fees, volatility and historic returns. In theory, the riskiest sectors, which offer the best likelihood of returns, could potentially justify the highest fees. And this is certainly true if we look at broad sector categories: equity sectors tend to be riskier and have higher management fees than fixed income sectors. The table below illustrates this point: it looks at unit trust average performances and charges by main area of investment using Standard & Poor's fund classifications. With equity markets being at their gloomiest, the average equity unit trust has lost 26% over the last three years, with a volatility of 6.45, while charging higher front end and annual management fees than fixed income funds which have had an average three-year return that is considerably higher.

Money market funds charge more than four times less than fixed income funds while being more than nine times less volatile. They have had the best performance over the last one and three years, understandably given recent market conditions, by far outperforming bank deposit and building society rates. The latter, represented by the S&P UK Savings 2500 index, have provided an average return of 1.21 last year, free of charge.

Worth the extra cost?

The riskiest areas of investment charge the highest fees

UK Unit Trusts/OEICs by main area of investment

	1-yr Return %	Fund Count	**3-yr Return %**	**5yr Return %**	**3yr Volatility**	Average Annual Charge	Average Front End Load	**Average Total Charge**
Equity	-23.31	1108	-25.94	-10.76	6.45	1.31	4.15	5.46
Fixed Income	-4.49	197	9.63	22.89	1.63	0.98	3.14	4.12
Money Market	2.04	40	10.92	21.76	0.17	0.54	0.42	0.96
UK Savings 2500	1.21		5.56	11.83	0.04	-	-	-

data up to 21/10/ 02

Calculation basis: Offer-Bid, net income re-invested, GBP

The results are not good news for investors who have been willing to opt for rather risky investments that bear high charges. But has this strategy been rewarded in any other areas of investment over the last few years?

Looking at the unit trusts sectors using S&P classifications, extra cost and risk has paid off for specialised funds investing in the following areas: healthcare, commodity and natural resources, gold & precious metals, and finance.

Healthcare funds are the most volatile sector (with an average volatility of 15.86, even higher than global TMT funds' average of 14.34) and bear the some of the highest charges. However the extra cost and risk have largely paid off longer term: despite having lost 39% over the last year, Healthcare funds have performed very well over the last three years, with Healthcare Global and USA funds returning respectively 52% and 32%.

The only other area of investment that has been profitable to investors taking on more risk at extra cost has been European Emerging Markets, the fourth most expensive sector with average total charges of 6.83%. This has proven to be the best performing sector over the last year with returns of 8.4%, a reflection of the exceptional performance of East European and Russian stocks .

Those last few years have been indeed dreadful for all other equity markets, and the burden of extra cost has not been rewarded for any other sectors. One avenue that investors could explore in markets like these are floor funds. These funds apply a fixed percentage to establish as the maximum allowable depreciation in the initial capital at any time – the Floor. As the portfolio value increases, the floor moves up with the percentage cushion remaining. The floor is only meant to move up.

The average costs involved with these funds are among the highest, with a total cost of respectively 6.26% and 5.7% for funds investing in global and UK securities.

Such high charges seem to be justified if we look at the Fitzrovia Total expense ratio: while global floor funds bear the 12th highest Fitzrovia TER of all sectors, such funds have a very low volatility. However the extra cost has not been justified by good returns: the sector has performed badly, losing on average 13% over the past 3 years.

Worth the extra cost?

Asset Allocation UK Defensive Funds, which principally invest in UK equity, fixed interest and money market securities but with no more than 30% in equities, have shown a low volatility of 2.74 but charge an average 5.43%.

Despite their limited exposure to equities, these funds charge much more than many equity funds investing in volatile markets such as Asia, Japan and even global emerging markets. Funds in the latter sector, which invest in excess of 70% in emerging market equities, exhibit on average a three-year risk of 8.16 but charge only 5.21%, significantly less than asset allocation UK defensive funds. What is even more surprising here is that global emerging market funds appear to involve higher Fitzrovia TERs than those of UK defensive funds, leading us to expect higher front end or annual management charges.

The mixed results tell us that investors should look at all the charges before making their investment decisions as they can have a major impact on the net return of unit trust investments. Although initial and annual charges are the most visible ones, there are other charges to look out for: front-end charges can be scrapped in favour of exit charges, which try to encourage investors to keep their money invested longer.

Before making investment decisions, investors should:

- Neither look at fund performances nor charges alone, but look at charges in relation to performances and level of volatility.
- Try to compare funds with their true peers on the basis of their investment objectives, which is crucial when comparing funds. Standard & Poor's sector classifications have been devised with the objective of allowing investors to compare like funds with like.
- Although sector averages are a useful tool, as proven in this article, it is only one dimension of comparison. Investors should investigate the full spectrum of charges and performances between peers.
- Finally, investors should also be aware that charges do change over time. A schedule of fees, charges and maximum commissions should be available on request from the management group.

Geoff Hawksworth, Managing Director Europe at Standard & Poor's, says that the period of lower returns that we are experiencing today will certainly make investors place more emphasis upon costs, as we are already seeing more awareness from investors about risk control. He adds that the industry will be encouraged to offer more "niche" products to a broader audience in order to justify value-added fees: fund of funds, hedge funds, guaranteed funds, alternative investment and passive funds (index trackers).