Advertorial

The cost **advantage** of **low expenses**

Investors are waking up to the fact that among other factors, the cost of investing has a big influence on their investment returns.

It is prudent to understand the link between investing costs and returns. Simply put, the high costs of investing will eat into our returns. On the flipside, with lower costs and fees, we will take a shorter time to recoup our investing costs which translates into potentially higher returns.

So it is worth our while to pay attention to the underlying costs and fees that come with an investment.

The good news is that cost is a factor that is within our control, in that we can make an informed decision and select investments that come with lower costs.

Low-yielding investment environment

It is even more pertinent to lower our investment costs in today's low-yielding investment environment. A GIC report[1] stated that the long-term (20-year) returns in the coming years are likely to be significantly lower than what we have seen since 1980. Low returns are likely over the next 10 to 20 years, due to high starting valuations, historically low interest rates expected to rise over time, modest and uncertain fundamental growth outlook.

Financial experts are expecting a difficult investment environment with modest growth prospects, greater uncertainty and a high degree of volatility in the macroeconomy and markets. All these point to lower investment returns, so all the more reason for investors to control the cost factor.

How investing costs add up

Every cent counts in giving investors better odds of returns. Add the compounding effect, and the opportunity cost of losing the potential capital growth that the investing cost alone might have had for future years becomes bigger.

Let's assume you invested a sum of $100,000. If the investment earns 6 per cent a year for the next 20 years and had no fees or costs, you would end up with $220,713.55 in earnings.

But if you had paid an annual investing fee of 2 per cent, after 20 years your investment will generate earnings of only $119,112.31. This means the 2 per cent that went into investing costs every year would wipe out about 46 per cent of your earnings[2], compared to the returns you would have received had there been no fees or costs payable.

Reducing fees for CPFIS products

Mindful of the impact of costs on investment returns, the Government announced in March that it will lower the costs of investing in retirement funds under the Central Provident Fund Investment Scheme (CPFIS). Doing so would help to enhance investment returns of CPFIS products.

The sales charge and wrap fee imposed under the CPFIS would be cut in two phases. Come October 1 next year, the sales charges for new purchases of CPFIS products will be removed, while the cap on annual wrap fees will be lowered to 0.4 per cent per annum (p.a.). The latter covers advisory services and the costs of maintaining the account.

For this round of review of the CPFIS, the total expense ratio (TER) remains at a maximum of 1.75 per cent p.a. for funds that invest in equities[3].

What is TER?

The TER or the expense ratio is a measure of the recurring costs associated with managing and operating a fund, such as a unit trust.

Recurring fees and charges payable by a fund include annual management fees, trustee fees, legal fees, auditor fees and other operating expenses like custodian fees, printing and distribution fees, and amortised expenses.

However, they do not include some expenses such as brokerage and transaction costs, tax deducted at source or arising from income received and front or back end loads.

Typically, the TER of a unit trust would range between 1 per cent and 2.5 per cent p.a. of the fund's net asset value.

That means for every $1,000 invested in a fund, an investor could pay up to $25 in fees and charges every year.

Mr Gerard Lee, Chief Executive Officer of Lion Global Investors (LGI), said: "Returns of a fund are dependent on the skill of a manager, market direction (up or down) and TER. Research has shown that a low TER is likely to lead to better returns over the long-term. Unlike skill and market direction, TER can be determined upfront. So before you buy into a fund, be sure to know what TER is."

How TER influences returns

Research from investment management firm Morningstar showed that expense ratios are a predictor of future fund returns. It said that using expense ratios to choose funds helped in every asset class and in every quintile from 2010 to 2015.

For example, in US equity funds, the cheapest quintile had a total-return success rate of 62 per cent compared with 48 per cent for the second-cheapest quintile, then 39 per cent for the middle quintile, 30 per cent for the second-priciest quintile, and 20 per cent for the priciest quintile[4].

So, the cheaper the quintile, the better your chances. All told, cheapest-quintile funds were three times as likely to succeed as the priciest quintile, said Morningstar.

It goes to show that the TER has a big impact on investment returns. A higher TER will ultimately reduce your return on investment.

If the TER can be reduced, the cost savings can be huge and generate better investment returns over time.

Actively-managed funds tend to have higher TER than passively-managed funds. Managers of active funds typically seek to beat the index's performance through stock picking and market timing. On the other hand, low-cost investments are usually passive in that they seek to replicate the performance of an index, such as the Straits Times Index. Managers of such funds usually employ a buy-and-hold approach to investing.

Taking advantage of funds with lower TER

Over time, the TER could well be one of the most important determinants of a better outcome for investor returns and load-adjusted returns. The latter is derived from subtracting sales charges and/or redemption fees from the investment returns.

As such, it is important that investors take note of a fund's TER when they invest.

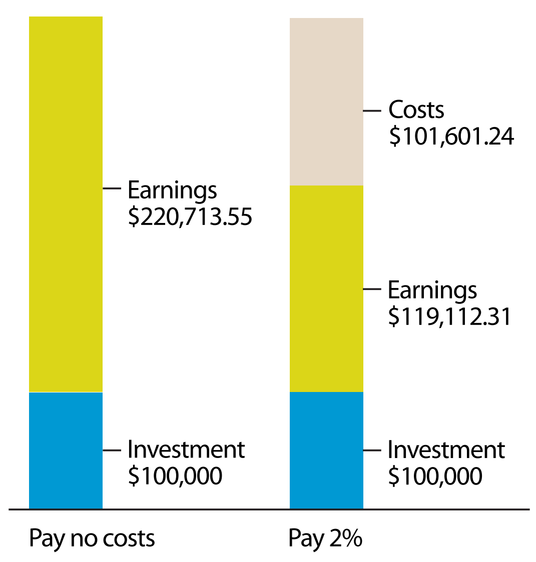
[1] https://www.businesstimes.com.sg/government-econmy/gics-annualised-real-rate-of-return-over-20-years-dips-to-4

[2] Earnings refer to the value of investment in excess of the initial investment sum of $100,000, after deducting any cost of investment, assuming zero sales charge.

[3] https://www.cpf.gov.sg/members/News/news-categories-info/news-releases/2235. The TER cap for CPFIS funds currently ranges from 0.35% p.a. (money market funds) to 1.75% p.a. (equity funds).

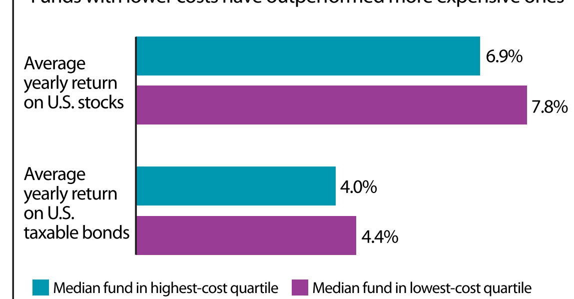
[4] http://www.morningstar.com/articles/752485/fund-fees-prdict-future-success-or-failure.html

How they compare



Lets assume there is an investment amount of $100,000. If it achieves 6% a year for the next 20 years and had no costs or fees, you would end up with earnings of $220,713.55. If you paid 2% a year in costs, after 20 years your earnings would be $119,112.31. The 2% you paid each year would wipe out almost 46% of the total earnings in the scenario where no cost is payable. Source: SPH Content Lab.

Funds with lower costs have outperformed more expensive ones



This illustration compares the annualised returns (for the 10 years ending December 31, 2014) of the median funds in two groups: the 25% of funds that had the lowest expense ratios as of year-end 2014 and the 25% that had the highest, based on Morningstar data. Returns are net of expenses, excluding loads and taxes. Both actively managed and index funds are included, as are all share classes with at least 10 years of returns. Past performance is not necessarily indicative of future performance. Source: Vanguard calculations using data from Morningstar.