Flaws with funds

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When we see bank fees eroding our bank balances we become understandably annoyed. Why should financial institutions charge so much for looking after our money?

Bank fees, at least, are revealed on our statements, but in terms of what we pay to the financial sector they are no more than the small tip of a very large iceberg. As measured by annual GDP Australia's financial sector is a $46 billion industry – twice the size of our entire agricultural sector. Or, to bring these figures into perspective, we pay around $6000 a household for the services of the financial sector.[1]

Most of this $6000, of course, is incurred by businesses rather than households, and is passed through to us in the prices of goods and services. But one cost which we bear very directly is for the services of the managed funds industry, which, perhaps, has been the major beneficiary of two policy initiatives of the 1980s – financial market deregulation and compulsory superannuation.

As competition has squeezed returns in traditional banking markets, with a falling spread between lending and borrowing rates, and as the flow of funds into superannuation has opened up new opportunities, established firms in the financial sector have moved into funds management. The largest firms in the industry are the four big banks (including the Colonial First State subsidiary of the Commonwealth Bank, which dominated the headlines in relation to Chris Cuffe's $33 million payout), life insurance offices (including AMP, which has had its share of media publicity), and international financial groups (such as Merrill Lynch and Credit Suisse).

Their funds-management assets are mainly superannuation funds, including superannuation holdings of life insurance offices. The other and rapidly-growing market is in public unit trusts – managed funds outside the superannuation sector ("other" in the table below).

Table 1 – Assets of managed funds industry (March 2003)

Sources of funds	$billion	Percent	Annual growth rate 1988-2003
Life office statutory funds	164	26	7.6%
Specialist superannuation funds	290	47	12.9%
Cash management trusts	28	5	17.9%
Other managed funds	142	23	12.2%
	624	100	11.1%

Source: RBA

1 ABS stats. 2001-02 GDP of "Finance and Insurance" sector $46 272 million, 2000-01 prices. "Agriculture, forestry and fishing" $22 763 million. Households – $7 315 million.

Most, but not all, superannuation assets are held by the managed funds industry. Around a third of superannuation assets are invested directly[2] – in some cases by large corporate or industry funds and in other cases by wealthy individuals with self-managed "DIY" funds (although most people with a "DIY" fund use the services of a fund manager).

Performance

In the financial exuberance of the 1990s, there was little concern about the performance of financial markets. From 1995 to 1999 many asset classes – even fixed interest assets – were showing double digit returns. High returns tended to mask the effect of fees. If a fund could earn ten percent on its investments and take a fee of one percent, then investors would still be very happy with a return of nine percent. Even if the fee were disclosed investors would be reasonably content.

But the sharp downturn on financial returns in 2000-01 exposed the pernicious effect of fees. The table below, relating to retail superannuation funds (which are structurally similar to the products non-superannuation investors purchase), shows the effect of fees on returns in recent years.[3]

These expenses, revealed in Australian Prudential Regulatory Authority data, relate to expenses incurred in the funds themselves. They do not include, for example, fees associated with providing advice, which, for retail investors, generally involves the imposition of a trailing commission. That is, a commission based on the value of the funds under management, for as long as the investment is held, even if there is no ongoing advice. Nor do they include fees added by master trusts – intermediaries which allocate funds between fund managers. A recent study by the Reserve Bank, which confirms other studies on fees, has found that the total fees on retail funds are typically between 1.0 and 2.5 percent – considerably higher than the basic fees shown in Table 2.

Table 2 – Superannuation fund performance – retail superannuation funds

	Invest-ment income $m	Operating expenses $m	Average assets $m	Return on assets before expenses	Expenses as % of assets	Return on assets after expenses
1998-99	8 581	1 252	104 706	8.2%	1.2%	7.0%
1999-00	11 656	1 255	128 930	9.0%	1.0%	8.1%
2000-01	7 136	1 254	147 245	4.8%	0.9%	4.0%
2001-02	-5 610	1 527	169 797	-3.3%	0.9%	-4.2%
2002-03 (to March)	-5 573	1 117	174 263	-4.3%	0.9%	-5.1%

Source: APRA. (2002-03 pecentage returns annualized by a scale factor of 4/3)

2 APRA Mar 2003.

3 Taken from Dec 2002 and Mar 2003 APRA spreadsheets – cols 1-3 by addition/averaging, 4-6 by calculation.

A fee of one or two percent of capital may not sound much, but, because of the effect of compounding, it has a leveraged effect on reducing ultimate returns. The table below illustrates this effect.

Table 3 – Effect of capital fees on an investment of $1 000 over 30 years

	Final accumulation		
Rate of return before fees	Zero fee	One percent fee	Two percent fee
4%	3 243	2 427	1 811
5%	4 322	3 243	2 427
6%	5 743	4 322	3 243

What is a reasonable rate of return over the long term is a matter of conjecture, but it is a fairly sure bet that the high returns of the 1990s will not be seen again for a long time. (Indeed, many of the high profits of the 1990s have been found to be works of creative fiction.) They resulted from a unique conjunction of events – including a technology stock bubble, lax accounting and supervisory standards, once-off productivity gains from information technologies, and delayed effects of financial market deregulation in the 1980s. In the long term it is unreasonable to expect real returns (that is, the return after inflation) on a mixed portfolio of investments to exceed five or six percent. A two percent fee taken off a fund earning six percent is essentially one third of that fund's earning.

It is not only the level of fees which is problematic, however; rather it is the whole structure of fees which results in poor performance. To understand this, it is useful, perhaps, to examine why people invest in managed funds in the first place.

Incentives to invest

In theory at least, there are two reasons for placing our investments with a fund manager, both to do with scale economies. One is to take advantage of the fund manager's knowledge. Even those individuals who have a good understanding of finance and investment lack the time and access to information which would allow them to make sound judgements. Fund managers, with the benefit of research staff, have much more access to market information than any individual can hope to gain. Another reason is to benefit from diversification of investment, diversification being the usual method by which investors hedge against risk. On average, Australian households have about $125 000 of assets (not including home equity, but including about $55 000 of superannuation assets)[4]. That's too little to buy a diversified portfolio of investments, without incurring high transaction fees.

A third reason is policy-related, for much of Australians' savings are tied up in compulsory superannuation – and that proportion is likely to grow. While the superannuation industry grizzles about taxes, it is still in a highly privileged position vis-a-vis personal savings made from post-tax income.

[4] FPA/Natsem 2002 *Levels, patterns and trends of Australian household saving*

Managed funds, however, have not provided the benefits investors may have hoped for. High fees have not bought superior performance. Research in US financial markets shows that over the period 1982 and 2002, the annual return on the 500 equities which made up the Standard Poors Index averaged 12.9 percent, while the average pre-fee return of managed funds was only 9.6 percent. (That is, the average return enjoyed by investors who kept their money in one managed fund.)

While the funds' performance was poor, individual investors in managed funds did even worse; their average return was only 2.7 percent – close to standing still in real (after inflation) terms.[5] While switching fees and management fees account for some of the difference, the main reason individual investors did so badly was that they tended to switch funds at the wrong times; they would switch out of particular funds after a period of poor returns, into funds which had shown a run of good returns. As anyone who reads the financial press knows, funds which have had a run of good performance are prolific advertisers. But in financial markets past performance is rarely a guide to the future; runs of good luck do not last. Statisticians know this phenomenon as "regression to the mean". If, as many economists believe, capital markets are reasonably efficient in finding correct prices over the long run, then no fund manager can consistently beat the index; at best they can hope that their runs of bad luck more or less offset their runs of good luck.

There is less research available for Australian performance, but what is available tends to confirm US research. Vanguard Investments, a funds-management firm which specializes in index funds, has pointed out that over the period 1995 to 2000, in all classes of assets, Australian retail managed funds have performed more poorly than their corresponding indices.[6]

The conclusion from such research is that investors seeking sound returns through managed funds should seek out an index fund – that is a fund which tracks an appropriate index, such as the ASX 200. They can virtually be guaranteed a higher return over the long run, for the fees charged by index fund investors are about 0.5 percent lower than those charged by active managers.[7]

This does not necessarily imply incompetence among the fund managers. The reasons for poor performance relate mainly to the set of incentives built into their performance measures and fee structures.

Herd behaviour

The measures by which investors, advisers and the financial press judge fund managers tend to emphasise short-term performance, and they encourage herd behaviour (another way of saying there are rewards from staying close to the behaviour of other fund managers). Even

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5 Economist 5 July 03

6 Vanguard website personalinvestor.com.au/vanguard

7 RBA Feb 2003.

when a fund manager believes a stock is over-priced and is rising too quickly, if he believes other fund managers will hold or buy the stock, he will do likewise. When performance is judged on short-term returns the market does not look kindly on those who abandon a bull run too early. Similarly, if fund manager believes a stock is under-valued, and is falling too quickly, he will not necessarily buy if he thinks others will not be buying.

John Maynard Keynes described such herd behaviour in terms of newspaper beauty contests run by British newspapers the 1930s. Contestants were asked to judge not on their own perceptions of beauty, but on the basis of what other contestants might choose. Neither the market nor internal management systems reward those who hold out against the herd, particularly if such behaviour requires a fund manager to take short term losses with the reasonable expectation of long term gains. Fund managers' research departments, even if they are staffed by competent, incorruptible and hard-working experts, may as well not exist.

Another reason returns converge on the index is that large firms in the funds-management industry, because of their own market strength, tend to determine the index. They cannot behave like the small contrarian investor who benefits from going against the herd, because they are the leaders of the herd. Many small investors seek large funds managers in a belief that there it is wise to "get with the strength".

What really brings performance down is use of an asset-based fee structure. By definition such fees are not performance-based. As Table XX shows, fees in the retail funds management industry have remained remarkably steady, while performance has been highly volatile. Fees based on a percentage of assets are attractive in the industry because they give reasonably secure returns for fund managers. If a fund's returns in one year fall from ten percent to zero, then the fund manger's income falls by only ten percent, while the investor's falls by 100 percent. These incentives result in competition for market share rather than performance, and market share responds, unreasonably, to posted short-term performance which encourages investors to switch funds.

The irony of such a structure is that it effectively transfers risk back to the individual investor, while protecting the main players in the market from risk themselves – but one of the very purposes of financial markets is to provide small investors with intermediaries to cushion against risk. In Australia's situation the fund managers are further assured of an easy and low-risk ride because of a steady inflow of superannuation funds, which nearly always offset investment losses and the (so far) small outlays on pension claims. With a $360 billion national payroll[8], a nine percent superannuation levy is guaranteed to bring in at least $32 billion a year, before extra employer contributions and salary-sacrifice contributions, both of which receive favourable tax treatment, are taken into account. (Contributions this year will be in the order of $50 billion.)

For now this industry can prosper on cash flow; it is a long time before significant superannuation payouts have to be made, and, because these payouts are accumulation accounts with no firm dollar amount obligation (as is the case with certain classes of long-tail insurance liabilities), the industry is virtually free of all financial risk. It's similar to HIH, but without the burdensome worry of accumulating liabilities.

8 National accounts

In the non-superannuation component of the industry the poor performance of fund managers may be causing even more distortions in financial markets. Investors are reasonably free to switch their investments not only between funds, often at the wrong time, but into and out of the industry altogether. Many investors, disillusioned by the poor performance of managed funds have sought the false security of real-estate.

Conversely, some who have had their fingers burnt in direct share investment have sought refuge in managed funds. It is notable, for example, that direct share ownership in Australia is falling. In 2000, following a number of privatizations and de-mutualizations 5.7 million Australians were direct share owners; by 2002 that figure had fallen by 0.3 million, with the strongest falls among younger and middle-aged investors. Over the following two years the number investing through managed funds had risen by 0.4 million.[9]

The vision of a nation of mum and dad shareholders has not been realized; opportunities for investment in high quality growth assets are still practically closed to those of modest means. A short period of "people's capitalism" in the late nineties, when more than 40 percent of adult Australians had direct shareholdings, has given way to the more usual situation of direct shareholding being confined to wealthier and older households.

Towards an investment policy

There is no one solution to these problems. More choice of superannuation, as proposed by the Commonwealth, is likely to aggravate the problems of short-term and risk-averse behaviour. Higher superannuation contributions, through tax breaks, top-ups for low-income earners, or higher mandated contributions, will only reward a poorly-performing industry. Proposals to give low-income households funds to buy shares have some merit at first sight, but it is hard to imagine how they might accumulate a portfolio large enough to justify the transaction costs involved and diversified enough to ameliorate risk.

Regulatory reform to require more informative disclosure of fees – both their structure and effects on ultimate accumulations – would help by bringing more price competition into the managed funds market. This would benefit all employees subject to compulsory superannuation, and it would help others make more prudent decisions in relation to personal investments and salary sacrifices to superannuation.

But the main policy need is for a more coherent set of policies relating to investment. Successive Commonwealth governments have been rightly concerned with making saving more attractive, but they have forgotten that saving, in itself, yields no benefits if it is not directed to productive investment. If people's savings are eroded by the fees and charges of the financial sector, or if those savings simply contribute to asset price inflation, as happened to stocks in the 1990s and is now happening in housing, they bring no long-term benefits to the individual investors or to the community.

Investors, particularly individual investors, face a set of incentives which make it difficult for them to develop a well-balanced portfolio. The Ralph "reforms", which have reduced capital-

[9] ASX Share Ownership Survey 2002.

gains taxation but have also removed indexation of capital gains, have encouraged high-risk and short-term speculative investments over capital-stable investments. At the same time, investments in interest-bearing securities continue to be penalized by imposition of taxation on full the full amount of nominal interest, even though part of that interest is simply an adjustment for inflation. It is understandable therefore, particularly when by the same distorted logic those who borrow to invest can claim all nominal interest as a tax deduction, that many have borrowed heavily to invest in real-estate. That's the real injustice in "negative gearing"; borrowers can effectively gain two tax deductions for their capital investment, once through depreciation, and again through the inflationary component of their interest payments, while the real value of that debt diminishes.

It is not as if Australia lacks opportunities for quality investment. Once we realize that the 1990s party is over and that the double-digit asset returns of the period were illusory, and when our cities are festooned with "to let" signs, we may be able to make more sober judgements about long-investments, particularly in the public sector, where there is an ever-accumulating backlog of needed public investment in environmental protection and restoration, surface transport, communication and human capital. Governments have gone as far as they can go in involving the private sector in infrastructure provision. In fact they have gone too far in many cases, such as power distribution and generation, toll roads and water supply. In their obsessions to reduce reported debt, they have forgotten that there are many investments which, while returning high community benefits, are unattractive to private investors.[10]

In short, there is an excellent opportunity for governments, state and federal, to re-introduce public sector bonds to finance infrastructure. Ideally, these would be inflation-indexed, and would provide a low but secure real return, for those wishing to balance their portfolios and to contribute to restoration of the nation's common wealth.

Providing such avenues for direct investment will bring some needed competitive discipline to the funds management industry. And they will surely yield much more individual and community benefits than a bundle of OneTel scrip or a vacant apartment in the Melbourne CBD.

[10] There is a long article coming in the next edition of Dissent which fleshes out these arguments with heaps of data. This should be published by around August 10.