The Framework of the Story – Part 2: Fees

Now that you know that investing is going to be important for your future self, why *do it yourself*? There are people out there throwing themselves at you, eager to manage your money for you. Representatives at your local bank branch, planners with wealth management companies, and independent brokers are standing by to take your call now, with ads plastered over bus benches and on TV. Going with one of them would certainly save time, and avoid all the hassle of learning terminology you'll never use again and engaging with what looked *suspiciously* like math on the previous page.

But stop and ask yourself why there are so many people eager to free you of this burden. There's quite a bit of money to be made in it, and they make that money at your expense. The mutual funds you buy all have fees associated with them. These fees are hidden[3] – you don't get a bill for them every month, but they're there to be sure, disclosed in the funds' prospectus as a "management fee" or "management expense ratio" (**MER**). The average mutual fund fee in Canada is nearly 2.5% per year, part of which usually goes to the institution that runs the fund itself, and part of which is paid as a commission to whoever sold the fund to you.

Indeed, many would-be advisors are not strictly speaking working purely in your best interest: they get paid for putting you into certain products, and that commission may influence their recommendations,

[3] Changes to fee disclosures were made in July 2014, and more will be coming in 2015 and 2016 to make these fees less hidden.

particularly when it comes time to recommending that you switch around your investments. The standard-of-care in Canada is a "suitability requirement," which means that funds advisors recommend have to fit within what they know of a client's plans and risk tolerance. However, a bond fund that charges a 0.5% MER and one with the same holdings that charges 2.5% (kicking back 1% to the advisor as a commission) are equally suitable under that requirement in a legal sense, though perhaps you will agree that in a real sense that's not at all the case.

This commission is supposed to pay for their advice and assistance in helping you create a financial plan. However, many people you may see across the desk from you at a bank branch or investment firm are actually in a sales role and don't end up providing any help in overall guidance or long-term planning, or provide poor, self-serving advice. The conflict-of-interest where they only get paid if you invest in the mutual funds they have to sell means that they may recommend investing even if paying down your debt might be in your best interest instead.

Some fees are unavoidable in investing – you will never find a fund with a 0% MER – but it *is* possible to get a low-cost fund at around 0.5%, versus a more typical Canadian fund at nearly 2.5%. So let's say that the excess cost of a typical mutual fund is 2%. The math on that is pretty easy to do: for every $100 you have invested, you pay $2 a year in fees. Even for someone just a few years into saving for retirement with a few tens of thousands to invest that can represent hundreds of dollars a year lost to fees – and at that stage of your life, your time is probably not so valuable that you'd pay someone that much to avoid doing the work yourself; a few hundred extra may make a significant dent in your savings plan. Later on those fees can amount to thousands of dollars

each year when you have hundreds of thousands to invest.

Paying for people's time and expertise is not inherently wrong, but you have to be sure that you get value for the money that you pay, and sadly that is not the case in much of the financial industry in Canada. There is a large focus on investing and choosing funds when you sit in front of an “advisor” though this is where they add the least amount of value. Many people would be better served by discussing spending, saving, emergency plans, and charting a long-term course. The fact that the fees are hidden helps mask the fact that you may not be getting value: by not explicitly billing for advice or including it as a line item in your statement your brain can be fooled into thinking that your advisor is just a friend helping you out. In that context, less-than-optimal service is easily forgivable. But once you realize that an advisor is getting paid out of your returns – often quite handsomely – without sharing the risk, then you may demand the very best in planning service, and rightfully expect it.

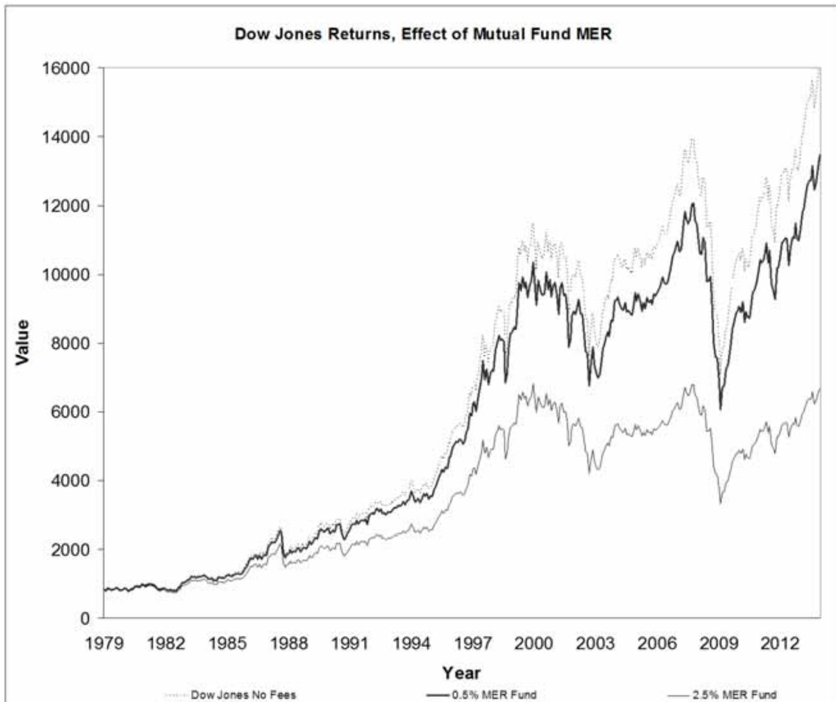
Taking a low-cost do-it-yourself approach to investing and paying – on a transparent flat or hourly rate – for help in crafting a long-term plan may be the best of both worlds. See “Getting Help” on page 184 for more on how to find professional help without the conflicts-of-interest presented by commission-based compensation.

How big an influence is this MER on your overall returns? After all, 2.5% doesn’t sound like much. Yet given enough time to compound – like the better part of your adult life until well into retirement – that constant drain has a big effect. Just look at the graph on the next page. Over 35 years, investing in a group of stocks[4] would

[4] In this case I’m using the Dow Jones Industrial Average (DJIA). This is a group of 30 large companies in the US. Rounded to nearest 10%, excluding dividends.

have given a return of over 1880%. Doing so through a low-cost mutual fund with a MER of 0.5% would have returned almost as much: 1560%. But a fund with a 2.5% MER would have only returned 720%. That seemingly harmless extra 2% per year drag ended up consuming almost half of the gains over the long term!

Or to put it yet another way, if you only expect your portfolio to return around 6-8% per year then taking 2% is like taking a quarter to a third of your returns. Now it sounds *properly* serious! Plus, even in a bad year on the market when you're losing money, the manager still takes their cut. So that is one good reason to become a do-it-yourselfer: to save on fees. Fees are something to keep in mind as you read the rest of the book and begin your investing career – and most importantly, **fees are one aspect of your investments you *can* control**.



The effect of fees on returns over the long term. Inspired by a figure from Michael Wiener. Here the returns for the DJIA and a simulated mutual fund with a 0.5% and 2.5% MER are compared. The 2.5% MER ends up costing almost a third of the total returns. www.michaeljamesonmoney.com/2009/12/mer-drag-on-returns-in-pictures.html

Fees are important! For mutual funds the fees are called the management expense ratio (MER) and are listed somewhere in the information sheets describing the fund. Canada has some of the highest MERs in the world, and these can dramatically reduce your long-term returns.