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Mutual Fund Fees Affect Performance

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For many years now, the securities regulators across Canada have been actively promoting ways to ensure that investors are aware of the costs involved in their investment choices. Going forward, the regulators will likely be focusing on the mutual fund industry and how advisers are compensated.

On October 22nd, as part of this process, the Canadian Securities Administrators released a long awaited report on how mutual fund fees may affect performance and where investors' money is invested. The purpose of this report was to provide unbiased information on the topic so that the regulators can ascertain whether the mechanism by which mutual fund fees are paid to advisers needs to be changed. The study looked at over 18,000 different classes of funds from 2003 to 2014, which represented about $900 billion of mutual fund assets in Canada. As for the results of the study, well, it certainly appears that how advisers are paid does affect how they deal with clients. The report asked two main questions, "How does past performance affect fund flows?" and "Do fees and fund flows have any effect on future fund performance?" Here are the highlights:

How does past performance affect fund flows?

The study found, as expected, that funds that perform better attract more money. On average, a fund ranked at the bottom quartile of all funds for risk adjusted performance loses 0.02% of its assets in the next month, while a fund performing at the median gains 0.08% of new assets in the next month, and a top quartile fund gains 0.21% of new assets in the next month. That being said, a number of factors can dramatically change these results:

- **Affiliated Dealers**: Mutual funds sold through affiliated dealers are often not sensitive to past risk-adjusted performance.
- **Trailer Fees**: Mutual funds with trailer fees increased new flows regardless of past performance and, generally, the greater the trailer fee, the greater the level of net flows that has no relationship to past performance.
- **Fee-Based Accounts**: Mutual fund investments designed for fee-based accounts (e.g. F Class Funds) are much more sensitive to past performance. For example, a fund that moves from the top quartile to the bottom performance quartile experiences a drop in assets of 0.32% under fee based purchase options, but only 0.26% under front end purchase options, 0.19% under no load purchase options, and 0.13% under deferred sales charge purchase options, controlling for other things being equal.

These results only look at the flow of money to mutual funds, so there is no direct impact to investors. The information presented here does not indicate any specific issues but where there is smoke, there is usually a fire. The details do indicate that purchasing mutual funds from affiliated dealers which also pay trailer fees may not be the best option, and that funds with deferred sales charges may be the least beneficial option for investors. Do these activities translate into lower returns for the client? That is answered in the second section of the report.

Do fees and fund flows have any effect on future fund performance?

Ultimately, all fees are paid by investors so, not surprisingly, the study found that an increase in trailer fees corresponded to a decrease in performance while a decrease in trailer fees corresponded to an increase in performance. Over the study period, 2.5% of funds permanently increased their trailer fees which resulted in risk-adjusted returns dropping by 32.4% on average; conversely, 0.6% of funds permanently decreased their trailer fees which resulted in risk-adjusted returns increasing by 88.4% on average. Once again, some other interesting results were found:

- **Sensitivity to Past Performance**: Funds that have flows which are more sensitive to past performance tend to have better risk-adjusted performance on average.
- **Trailer Fees:** For stand-alone funds that cannot be purchased directly, an increase in trailer fees by 1% is associated with a reduction in future risk-adjusted returns of 1.4%.
- **Deferred Sales Charges**: For stand-alone funds that cannot be purchased directly, an increase in deferred sales charges by 1% is associated with a reduction in future risk-adjusted returns of 0.6%.
- **Affiliated Dealers**: Mutual funds that sell more through affiliated dealers tend to perform worse, experiencing reduction in future monthly risk-adjusted returns of 0.2% relative to those funds that did not receive any affiliated dealer flows.

It will be interesting to see how the regulators approach these results, but it is possible that they may decide that certain activities which negatively impact investors may be required to be changed, or they may simply require that more disclosure of fees and services rendered will be required so that investors are better informed.

The results in this section are very relevant to investors and, in some ways, simply confirm the obvious – that higher fees means lower return to investors. What is interesting is that trailer fees, deferred sales charges, and affiliated dealers are confirmed as lowering the risk-adjusted returns received by investors. The first section of the study found that these three items made the flow of money much more stable for the fund companies, so that may have reduced their incentive to achieve the best returns for investors. Those funds whose fund flows were most sensitive to past performance had a great incentive to perform well – if they did not the money would leave and the manager would get paid less.

From our perspective, there a few takeaways that investors should keep in mind when choosing their investment adviser:

- Is the adviser affiliated with a mutual fund company? If so, the adviser may be biased towards their affiliated funds, which this report has shown to negatively impact performance.
- Is the adviser recommending mutual funds with deferred sales charges? If so, performance may suffer as the options for moving investments around is more limited.
- What level of trailer fee does the mutual fund pay? From the report, higher trailer fees lead to lower performance.

Here at Alitis, we have been aware of these issues for years and many of the problems expressed in the report are the reasons why we started Alitis and why we created the Alitis Pools in the first place. Being independent, being able to purchase the most appropriate investment, and being able to shift investments as required all work together to enable us to provide the best investment products we can for our clients.

Over the next year, you will be hearing much more about fees and performance as new regulations come into force throughout the investment industry. As part of this, Alitis will be creating new reports on fees and performance to go along with our newly-updated statements. Please watch out for new announcements!

If you would like to read the full report, *A Dissection of Mutual Fund Fees, Flows and Performance*, you can find a copy at the British Columbia Security Commission's website by following this link: https://www.bcsc.bc.ca/uploadedFiles/News/News_Releases/Dissection of Mutual Fund Fees, Flows, and Performance, October 22, 2015.pdf