# Don't Pay the Manager More Than 15%

by Cemil Otar

It is hard enough for investors to pick the mutual fund that is right for them. But the problem is compounded when mutual fund companies take a chunk out of fund returns. There are several Canadian equity funds that charge more than 30% of gross return on investment (ROI) as management fees and expenses (MER). The best managers don't charge more than 15% of your ROI. Here is a formula that takes account of the amount of money your mutual fund company may be skimming off the top of your returns.

The fund manager takes management expenses (MER) from the gross return on the investment (ROI). The published ROI is usually the *net* ROI, with dividends reinvested. We can express this by:

$$\frac{MER}{MER+ROI} \geq 0.15$$

The average MER for a Canadian equity fund is about 2.1%. For example, for a fund with a net ROI of 4.2% (five year compound annualized) and a 2.1 % MER, the manager gets:

$$\frac{2.1\%}{(2.1\% + 4.2\%)} = 0.33$$

or 33.3% of gross ROI.

Let's look at where Canadians invest their money and how much of their ROI they pay to the manager.

I added all the assets of all the Canadian equity funds within each performance level, as of December 31, 1995. I included in my list 145 funds that had at least a five-year track record. The results are plotted in Figure 1.

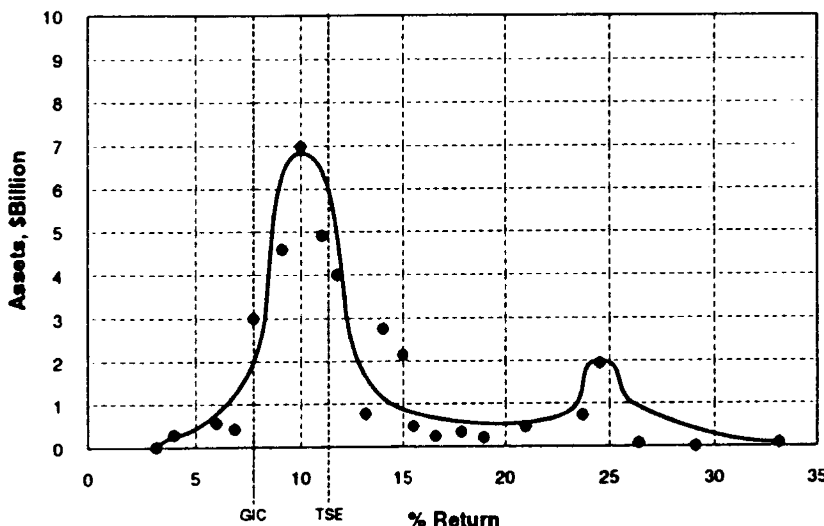


Fig. 1. Assets under management vs. 5-year annualized % return, Canadian equity funds, as of December 31, 1995, total of 145 funds.

We observe that the peak of the curve is to the left of the TSE 300 line ROI. The average managers' performance was about the same as TSE 300 (10.7%), but when they deducted their management expenses their ROI was worse than the TSE 300. Of all invested dollars, 53% ($17.9 billion) was placed in 86 funds that performed worse than TSE 300. Based on last year's assets, these funds kept about 18% of the gross ROI.

We can divide the funds into two groups: the Pariahs and the Champions.

## The Pariahs

The Pariahs include:

- Twenty-two funds, with $879 million invested in total, that returned less than 7.6% (average GIC). Based on last year's assets, the funds kept about 27% of the gross ROI.
- Seven funds, with $395 million invested, that returned less than 6.6% (average Canadian T-bill). Based on last year's assets the funds kept about 34% of the gross ROI.

If I put my money into one of these equity funds I would be investing in a fund that takes higher risks, earns less than the average GIC returns, and pays talented managers one third of the

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a bondholder's claim on assets is legally enforceable, while a preferred stockholder's is not. In the event of bankruptcy, preferred shareholders rank behind all other creditors, including employees, creditors, and holders of bonds and debentures.

Unlike a common stock, preferreds offer less of an opportunity to grow along with the company. Lower price volatility may be fine on the downside, but limits any potential capital gains.

Dividends are also not guaranteed. While a preferred has rights to receive dividends before the common shareholder, in years where earnings are low preferred shareholders may get nothing.

Volume on many preferreds is very low, with some not trading for days on end. This results in higher bid/ask spreads when the shares are bought and eventually when they are sold.

There are a startling array of preferreds. These include convertible preferreds (those that can be converted into common shares), cumulative and non-cumulative features (where unpaid dividends can accumulate), and callable or non-callable features (where the issuing company reserves the right to redeem preferred shares). Each preferred is a unique entity, which can limit their appeal on resale.

As with the market price of bonds, when interest rates rise the market price of preferreds will fall. Almost all preferreds are redeemable, or callable, by the company. This is good for the company, not the investor, since the company has the option to redeem. While dividends of common stocks are often increased, preferred dividends are fixed.

In summary, we continue to believe that investors are better off with investments in good-quality, dividend-paying common stocks that offer dividends as well as growth potential.

## Planning

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nies and brokers across Canada. Their representatives can recommend a broker for you to talk to and may be able to give you some general answers to your insurance questions.

The primary purposes for life insurance coverage are to protect your dependants' standard of living should you die prematurely and to cover the costs of your funeral expenses. For the most part, providing for your dependants is a function of paying off your existing debts and providing capital for your family to cover its expenses. As you grow older, your need for insurance protection will decrease. Your dependants will grow older and will be less dependent on you. In addition, through your disciplined investment program, you will slowly acquire a substantial buffer to cover any debts you might still have and provide an income for your dependants.

As an estate planning vehicle, life insurance should not constitute your primary means of saving for your estate. Insurance is a current service requiring current payments. However, there are certain types of insurance policies that do provide tax sheltered savings in addition to their protection. No tax is collectible from the disposition of policies that qualify as a registered pension fund or plan, an RRSP, an income averaging annuity contract, a deferred profit sharing plan, or an annuity purchased with RRSP proceeds received on a rollover basis by a spouse or dependent child. You will benefit by saving on a tax deferred basis through a pension or RRSP, and your beneficiaries will receive the benefits on a rollover basis. You should investigate these types of policies thoroughly before committing, keeping in mind that long-term tax savings benefits could be outweighed by the current cost of premiums.

## Don't Pay

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return.

Equity funds are bought because they might provide a better return than GICs in the long run. Funds with returns lower than GICs year after year do not fulfill these implied expectations. This is just like betting on a horse ridden by a jockey that weighs 200 pounds. It just has too much of a handicap; it will not win.

Figure 2 shows a list of funds that fall into this category.

### The Champions

The Champions are shown as a secondary peak to the right of the main peak in Figure 1. This is where the good stuff is. The Champions include:

- Six funds that returned better than 21.6%, double the TSE 300. They had $2.9 billion in

assets, and kept about 9.7% of the gross ROI.

- Thirteen funds that returned better than 16.2% ROI, one-and-a-half times the TSE 300. They had $4 billion in assets, and kept about 9.9% of the gross ROI.

Figure 3 shows a list of these champion funds *(see opposite page)*.

**Canadian Equity Funds, Fee <15% ROI**

| | 5 Yr. Ann Ret.% | Mer % | Load | MER as % of ROI |
|---|---|---|---|---|
| Admax CDN Select Growth | 3.0 | 2.6 | F or B | 46.7 |
| CIBC Canadian Equity | 4.2 | 2.3 | None | 34.9 |
| HRL Canadian | 4.2 | 1.8 | None | 29.4 |
| Top 50 Equity | 5.6 | 2.7 | Frnt | 32.9 |
| Metlife Mvp Equity | 5.8 | 2.0 | Defer | 25.6 |
| Trans-Canada Equity | 6.3 | 2.7 | FnDf | 30.0 |
| Canadian Investment | 6.7 | 2.3 | F or B | 25.1 |
| Green Line Blue Chip Eq. | 6.8 | 2.3 | None | 24.9 |
| Desjardins Environment | 6.8 | 2.0 | None | 22.7 |
| Westbury Cdn Life Eq Gth | 6.8 | 2.5 | Back | 26.9 |
| Chou RRSP | 6.9 | 1.3 | Fr&Bk | 16.0 |
| Atlas Cdn Large Cap Growth | 6.9 | 2.7 | None | 28.3 |
| NN Canadian Growth | 7.0 | 2.3 | Defer | 24.3 |
| Cdn Anaes Mutual Accum | 7.3 | 1.6 | None | 18.1 |
| Templeton Canadian Stock | 7.3 | 2.4 | F or B | 25.1 |
| Special Opportunities | 7.4 | 2.1 | Frnt | 22.4 |
| Mutual Canadian Indexfund | 7.4 | 2.0 | Frnt | 21.4 |
| Canadian Protected | 7.4 | 2.4 | Defer | 24.5 |
| Spectrum Cdn Equity d | 7.5 | 2.1 | F or B | 21.5 |
| NN Canadian 35 Index | 7.6 | 2.0 | Defer | 20.8 |

Fig. 2. Canadian equity funds with a history of five years or more, annualized ROI less than GICs and fund managers receiving more than 15% of ROI, as of December 31, 1995.

### Divergence of Performance and Promotion

One expects that over the long term, funds that perform substantially better will have more invested with them. This is because more people will start betting on the winners, and, through compound growth, the winners will see their investment rise and the losers will go home broke, thus shifting the curve to the right. What pulls the curve to the left? Effective promotion of the funds and the ignorance of investors. This happens when judgement is distorted and people get talked into betting on a sick horse because they trust the tipper.

A good performing fund may attract money into other funds in the same fund family. This is the same as going to the races and having one horse win, then betting on all the horses from the same farm, simply because they happen to be from the same stable as the champion horse. Several of Northern Dancer's barnmates became dog food.

There is also the ongoing chant that equity funds are long-term investments. This argument is used by field people most of-

**Portfolio Comparison**

**Bottom 10 funds ROI %: 5.7% per year, MER 2.38%**

| | Year 0[1] | Year 5 | Year 10 | Year 20 | Year 30 |
|---|---|---|---|---|---|
| Investor has, $ | 1,000 | 1,319 | 1,741 | 3,030 | 5,275 |
| Fund gets as MER, $ | | 137 | 318 | 872 | 1,836 |
| % ROI paid as MER | | 29.5% | 29.5% | 29.5% | 29.5% |

**Bottom 10 funds ROI %: 24.7% per year, MER 2.33%**

| | Year 0[1] | Year 5 | Year 10 | Year 20 | Year 30 |
|---|---|---|---|---|---|
| Investor has, $ | 1,000 | 3,015 | 9,092 | 82,666 | 751,612 |
| Fund gets as MER[2], $ | | 214 | 858 | 8,655 | 79,551 |
| % ROI paid as MER | | 9.9% | 9.9% | 9.9% | 9.9% |

Fig. 4. Comparison of two imaginary portfolios over the long term
[1] Net invested amount if fund is front load, sales charges paid extra
[2] calculation based on straight line appreciation of invested money, based on last 5 years ROI

## Canadian Equity Funds, ROI > 1.5*TSE300

| | 5 Yr. Ann Ret.% | Mer % | Load | MER as % of ROI |
|---|---|---|---|---|
| Marathon Equity | 32.9 | 2.5 | None | 7.1 |
| Multiple Opportunities | 28.8 | 3.5 | Frnt | 10.8 |
| ABC Fundamental Value | 26.6 | 2.0 | None | 7.0 |
| Altamira Equity | 24.6 | 2.3 | None | 8.6 |
| AIC Advantage | 23.5 | 2.7 | F or B | 10.3 |
| Dynamic Cdn Growth | 23.3 | 2.7 | Fr&Bk | 10.2 |
| United Canadian Growth | 21.4 | 2.4 | F or B | 10.0 |
| University Avenue Canadian | 19.6 | 2.5 | None | 11.5 |
| GBC Canadian Growth | 19.5 | 2.0 | None | 9.2 |
| BPI Canadian Small Comp | 18.9 | 2.8 | F or B | 12.9 |
| Altamira Special Growth | 18.2 | 1.8 | None | 9.0 |
| AGF Growth Equity A | 17.4 | 2.4 | Frnt | 12.3 |
| Sceptre Equity | 16.6 | 1.6 | None | 8.7 |

Fig. 3. Canadian equity funds with a history of 5 years or more, annualized ROI higher than one-and-a-half times the TSE 300, as of December 31, 1995.

ten as an excuse for bad performance. They claim that as long as you keep betting on this (wrong) horse, it may one day win the race. If your friend gives you a hot tip, and the horse wins sometimes and loses sometimes, he is betting on averages: tell your friend you don't want his tips anymore.

As for turf conditions, you must pick your winners according to turf. Some fund managers have a better sense of the economic environment than others; that is why their funds are on the right-hand portion of our curve.

Some people bet on long shots, hoping that bad horse will start winning. It may happen, but it's not likely. If a fund has been a pariah for the last five years it is highly unlikely that it will suddenly turn champion, except perhaps when a new winning management team is brought in.

Stick with the winners and the winners only. Most baby boomers have only 10 to 20 years of playtime left. When the race is over, make sure you can say "Most of my bets were on winning horses," and not "Oh well, it was fun while it lasted."

The long-term performance of two imaginary "Champion" and Pariah" portfolios are shown in Figure 4 *(see previous page)*.

Also interesting to note, 70% of funds in our "Pariah" list were load funds, as opposed to 46% in our "Champion" list. This does not mean that no-load funds perform better, but if the load fund is performing badly, people may be stuck in it longer.

The public can be protected if regulators place a cap limiting MER to 20% of gross ROI, say over a three-year period. Then the donkeys will have to get out of the race and leave the track to the thoroughbreds.

## Severance

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Depending on your total taxable income, you could lose as much as half of your settlement to taxes.

### What the Rules Allow:

- You are allowed to transfer from your severance package to your RRSP a maximum of $2,000 for each year of service with your employer prior to 1996,
- plus another $1,500 for each year of service before 1989 in which you were not a member of a pension plan or deferred profit sharing plan, or
- for years before 1989 in which you were a member but the benefits weren't vested to you.

This provision covers amounts received for wrongful dismissal, payments in recognition of long service, and accumulated sick leave. The payment of accumulated vacation pay does not qualify as a retiring allowance. Pension entitlements, whether received as a lump sum or periodically, are not eligible.

These transfers are in addition to and do not affect your yearly RRSP contribution limits. But take note: a large retiring allowance can trigger **Alternative Minimum Tax**, even when moved to an RRSP. It may be possible to avoid Alternative Minimum Tax by having your retiring allowance paid over more than one year. See your tax advisor or ask Revenue Canada for information on whether the Alternative Minimum Tax will affect you.