ProSolution
PRIVATE CLIENTS

Sack the investment experts. You're paying for poor performance!

Who's deciding how your superannuation is invested? How much are you paying them? How have they doing? Have you checked?

Consulting actuaries Rice Warner, concluded that Australians are paying "the experts" on average 1.12% p.a. of their super balance to invest their money (in 2013). Based on these findings, I estimate that our average client will pay their super fund's investment manager/s over $400,000 in fees over their lifetime! In fact, from the reviews I have conducted recently, many people will pay more than double this amount – a staggering $800,000! So what are you getting for your money? It is your responsibility to find out.

Research suggests you can slash your investment fees by almost one quarter of this amount (i.e. $70,000 using the above example) whilst at the same time giving yourself a 96% chance of getting a higher investment return. I'll tell you how in this blog.

Last month, I wrote about a blog about superannuation fees which received an amazing response. Since posting this blog we have reviewed 16 clients' super funds and the average saving we have identified is a staggering $159,892! We can review yours – but more than this later. By the way, I'm not the only person harping on about this important issue - the government has been warned and action is needed.

They need to sell you this story… but it is nothing but slick marketing!

Everyone likes an "insider's tip" don't they? Something that gives them the edge over everyone else. So if I told you that I have this awesome investment methodology that allows me to make money in the stock market and it can't fail, you might be interested, right? Most people would be and this is how the financial services industry has successfully marketed itself for many decades. I mean it is a great story to tell isn't it; "pay me a fee and I'll make you lots of money. I am the expert so that's why you have to pay me fees. I can invest your money better than you can."

However, this story is nothing more than a marketing tactic. Let me tell you why.

Generally, there are two ways to invest money being *active* and *passive*. Active funds management is probably what you are familiar with. Active fund managers try to beat the market by deciding what stocks to invest in. They typically take two approaches being *value* and/or *growth*. A *value* approach means that they will buy stock that they think are undervalued in the hope that the market will eventually value them correctly (in their opinion anyway). A *growth* approach involves investing in companies which, in the investment manager's opinion, have great growth prospects and they hope that will reflect in their future share price growth. Active fund managers typically charge in the range of 1% and 2.5% p.a. in fees.

The second type of management is called *passive* (or index). This approach is based on the philosophy that you can't beat the market (because the participants are highly skilled and the market is efficient). Instead, you should invest in an index such as the ASX200 (being the top 200 companies on the ASX) for example. An index fund such as an ASX200 fund for example, will invest in the top 200 companies weighted by their market capitalisation. For example, CBA makes up 9.68% of the index so 9.68% of your money is invested in CBA. Index funds charge in the range of 0.20% and 0.60% p.a. in fees.

> *Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship.*
> **Warren Buffett – 2013 letter to shareholders** (read a very important 400-word extract here)

These two methodologies head to head

So how have *active* fund managers performed compared to *passive*? The short answer is; poorly! There is a huge body of research evidence that demonstrates that active fund managers cannot outperform the market in the long run. That is, they might be able to beat the market in year 1 and possibly year 2 but year 3 for example is a very bad year. So the question becomes; firstly, how do you know which fund managers will outperform this year and which won't. Secondly, when you do pick a winner, when do you know to jump off the wagon (i.e. before they underperform the market)? This is the "marketing story" that many financial planners' business models reply upon i.e. that the financial planner has some sort of crystal ball and knows which fund managers will perform well this year. They don't. Virtually no one does.

I am not saying that no one can beat the market. There are a select few fund managers that have actually beat the market over the long term (Warren Buffett, Ray Dailo, David Swensen to name a few) – but they are the top 0.0001% investors in the world. We don't have a chance when we invest in the same market as these guys. Actively investing in the share market is like playing poker against the World Series of Poker champion… you stand a very slim a chance.

Click here for a summary of research that has been conducted.

> *"The goal of the nonprofessional should not be to pick winners – neither he nor his "helpers" can do that – but should rather be to own a cross section of businesses that in aggregate are bound to do well. A low-cost S&P 500 index fund will achieve this goal."*
> **Warren Buffett – 2013 letter to shareholders**

There some additional benefits of passive investing

In addition to higher longer term investment returns there are some additional benefits passive management provides compared to active management being:

- **Less tax** – one of the issues with buying and selling shares or switching between managed funds is that it gives rise to income and/or capital gains tax. Each time you buy and sell, if you make a profit, you'll have to pay tax meaning you have less to reinvest. This hampers impact of the eighth wonder of the world – as described in this blog post.

- **Lower fees** – arguably you do not need to pay your financial advisor high fees when you invest in passive funds because it eliminates the fund manager risk (i.e. you don't need to pay for advice about which fund manager you should invest with). Also, when your fund manager buys and sells shares you pay brokerage. When you sell out of a managed fund there are exit costs (called the buy-sell premium). Lower turnover results in lower fees.

It is inefficient to turnover your investments because of the tax and fee consequences. There is far less turnover in a passive fund because the managers don't buy and sell stocks based on their "opinion". An index fund buys the stocks that represent the index and the only time they buy and sell is when a stock enters or leaves the index (which is typically immaterial) or to rebalance. There are also "optimised" index fund managers alternatives which reduce turnover even further. The fact is that there's significantly lower tax and fees as a result of lower turnover in passively managed investments.

And more investors are working this out…

About 30 years ago you had to go to a financial advisor or stock broker to learn about various investment strategies and their benefits. Not today. There's an enormous amount of information just one Google search away. This has helped more and more people "wise onto" the marketing tricks that the financial services industry has relied upon to generate huge profits. As such, there has been an enormous amount of money shift out of active investments into passive in investments driven by both individual investors and large institutions.

Research house Morningstar, estimated that during the 2014 year, approximately $USD79 billion of investment funds exited actively managed US equities (i.e. this is the net deficit after taking into account new investments less withdrawals) whereas approximately $USD139 billion flowed into passively managed funds.

Morningstar, aggregating data on mutual funds and exchange-traded funds (ETFs), suggests passive investing is now the default choice for American investors, attracting an astonishing 68% of the past 12 months of investor inflows in 2014.

That is very compelling evidence.

This trend will continue because more people have worked out that they are better off regaining control over their investments – have you?

Case study: $860k more super: the cost of high fees and lower performance

John is 40 years of age. His superannuation balance is $220,000. His super is currently invested with AMP in an actively managed 'growth' investment option. His Fund charges an investment fee of 1.80% p.a. John's employer contributes 9.5% of his salary which equates to $14,000 p.a. John is considering switching his super into a low cost fund and investing it into passively managed investments.

I have compared two options. Firstly, John could stay with AMP and pay 1.80% p.a. in fees and earn a return of 6% p.a. Alternatively, John could switch to a lower cost alternative and pay just 0.20% p.a. in investment fees. Given its passively managed and based on the research, I have assumed that the return is 2% higher compared to AMP - 1% extra to account for passive versus active management investment returns plus a further 1% to account for lower tax and transaction fees and no advisor fees.

I have projected that if John stays with AMP his super balance by age 65 will be $1.175 million after he has paid $260k in fees. However, if John switches to a low cost passively managed super fund per the assumptions above, his super balance at age 65 is projected to be $2.04 million – **some $860k or 74% higher.**

Of course I cannot guarantee that if you invest in a low-cost passive fund that your super fund's after tax and fees return will be 2% p.a. higher than any active fund. I don't have a crystal ball. No one does. However, the research suggests that it will be higher and this is a simple case study to demonstrate that a small change in fees, taxes and returns altogether make a massive difference.

Get advice before you take action

Of course the information in the blog is general in nature and I cannot take into account each reader's individual circumstances. Therefore, you must get personal advice before you consider switching your super as there are many things to consider apart from how your balance is invested (e.g. additional benefits, insurance, etc.).

If you like we can help you with this important decision as it could make a massive difference to your retirement funds. **We invite you to accept our offer to review your existing super fund/s on a complimentary basis.** We'll look under the bonnet and identify what your fund is charging and (if possible) what your returns have been compared to the market (or index). If you would like us to do this, **simply email Kristy Dishon today and she will get started** with helping you make some smart superannuation decisions.

If this high level analysis suggests we can save you a lot of money we will need to prepare more detailed advice and if we do this, a fee may apply – but allow us the opportunity to demonstrate value first – before we get that far. It costs you nothing to take a closer look.