Fund management costs and performance

The return earned by an investor in an investment product is broadly determined by two factors: the return on the underlying assets, and the costs of investing. The higher the cost of investing, the lower the return, all else being equal.

There are three types of cost that impact fund performance:

1. The annual management charge (AMC)
2. Other costs charged to the fund, for example registration, audit and depositary fees, which together with the AMC, make up the Total Expense Ratio (TER)
3. Costs of investing the underlying portfolio: these will include stamp duty payable on transactions (generally the largest component), dealing costs and, potentially, market impact (though the effect of the latter will net to zero across the market as a whole)

The net performance of funds is after all these have been taken into account. It is however before any initial charge which may be levied.

This paper uses IMA data and Lipper Hindsight performance data to examine the relationship between the two.

UK index tracker funds

Index tracking funds lend themselves readily to an analysis of the impact of cost on investing, because of the existence of an external index which they are trying to match. Comparing the performance of a fund (net of costs) with the return on the index (the "tracking error" from a consumer perspective) enables one to estimate the cost of investing. (All figures and comparisons in this note assume dividends/distributions are re-invested.) As well as the three factors noted above, a fourth contributory factor to the tracking error will be the extent to which the portfolio may not replicate the index exactly.

Within the UK All Companies Sector, there are currently 39 index tracking funds, most of which aim to track either the FTSE 100 index or the FTSE All Share index. We compared the net performance of funds tracking these indices with the two indices themselves over the 5 and 10 year periods to September 2009, and the results are summarised in the following table.

Table 1: UK index trackers tracking error, 5 and 10 years

	Performance	Benchmark Total Return	Cumulative tracking error	Ave annual tracking error	Ave TER Oct 2009
FTSE 100 trackers 5 yrs	+28.6%	+35.1%	-4.79%	-0.98%	0.87%
FTSE 100 trackers 10 yrs	+9.2%	+18.4%	-7.78%	-0.81%	0.90%
All Share trackers 5 yrs	+33.4%	+38.4%	-3.60%	-0.73%	0.83%
All Share trackers 10 yrs	+21.6%	+28.5%	-5.33%	-0.55%	0.82%

Source: IMA, Lipper Hindsight, Financial Express

In other words, these funds delivered outcomes within 1% a year of the relevant index over the last ten years. The tracking error is higher for the last 5 years than the last 10. This reflects the impact of market volatility since the onset of the credit crunch in the summer of 2007; tracking errors increased notably during the period from August 2007 to March 2009.

It is also evident from this table that the TER is the principal component of the cost of investing. Indeed the total cost is typically slightly less than the TER. This may reflect a number of techniques that managers may use to improve returns at the margin.

Active funds

While the comparison with benchmark index can be done in the same way for actively managed funds, another factor enters the equation, which is the manager's stock selection. It is not therefore possible to say how much the return is reduced by trading costs. But it is possible to measure the net impact of stock selection and costs. The following table compares the average performance of the All Companies sector and the active and passive funds within it.

Table 2: 5 and 10 year net performance statistics[1]

	5 years	10 years
FTSE 100 index	+35.1%	+18.4%
FTSE All Share index	+38.4%	+28.5%
UK All Companies sector[2]	+30.5%	+27.7%
Active funds in UK All Companies sector[2,3]	+34.3%	+32.8%
FTSE 100 tracker funds[2,3]	+28.6%	+9.2%
FTSE All Share tracker funds[2,3]	+33.4%	+21.6%

Source: IMA, Lipper Hindsight

Thus, over the last ten years, the average UK All Companies fund performed broadly in line with the FTSE All Share total return and outperformed the FTSE 100 index by nearly 8%, or an average annual outperformance of 0.76%. The sector underperformed both indices over the last 5 years, suggesting that it would have outperformed significantly over the period 1999-2004. Over this 10 year period, the active funds outperformed the trackers (although it is less clear that they managed this over the last 5 years). This suggests that if the tracker funds were stripped out of the sector performance the average active fund, after costs, would have beaten both the FTSE 100 and FTSE All Share over the last ten years.

Many active funds have initial charges of typically 5%, which are not reflected in the performance statistics. The following table shows how many active funds outperformed the indices and outperformed by 5% over these periods.

Table 3: Proportion of active funds outperforming over 5 and 10 years[4]

Proportion of active funds outperforming:	5 years	10 years
FTSE 100	43%	60%
FTSE 100 + 5%	30%	50%
FTSE All Share	36%	43%
FTSE All Share + 5%	24%	34%

Thus, over the last ten years, 60% of active funds in the UK All Companies sector have outperformed the FTSE 100 total return and 43% the All Share. A half would have delivered the same return as the FTSE 100 or better, even if an initial 5% charge had been applied, and a third the All Share index.

[1] All figures include income re-invested
[2] Simple average return for all funds
[3] These figures are not adjusted for survivorship bias. IMA estimates that up to 0.5 per cent of headline annual performance for active funds, less for trackers, may be attributable to this effect. The sector performance is not subject to survivorship bias
[4] These figures do not take account of survivorship bias.

On average therefore, the performance of active funds would seem to stand comparison with the index. But performance varies widely: over the last 10 years the best performing UK All Companies fund more than trebled in value, while the worst performer lost over 20%. We therefore looked at the dispersions of performance among this group of active funds:

Table 4: Dispersion of active fund performance, 5 and 10 years[4]

		Annual average relative to:	
	Performance	**FTSE 100**	**FTSE All Share**
Top decile 5 yrs	+57.2%	+3.1%	+2.6%
Top decile 10 yrs	+64.1%	+3.3%	+2.5%
Bottom decile 5 yrs	+13.5%	-3.4%	-3.9%
Bottom decile 10 yrs	+0.4%	-1.6%	-2.4%

Over both periods the relative performance of the top decile was broadly similar: all the best ten per cent of funds appeared to outperform the FTSE 100 by 3% a year or more and the FTSE All Share by some 2½% a year or more. The bottom decile (ie that which is beaten by 90% of funds in the sample) was 1.6% a year below the FTSE 100 over ten years and 2.4% below the All Share; this compares with typical TERs in the range 1½-2%. Over 5 years however the relative performance of the bottom decile was worse, underperforming the FTSE 100 by 3.4% a year, some 1½-2% a year in excess of typical TERs.

[4] These figures do not take account of survivorship bias.