BloomsburyWealth®

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Clear and transparent: The cost of managing your portfolio

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We have sought for many years to be as transparent as possible about the costs to which investors' portfolios are subject because cost is one of the few things over which they have any influence. While it is true that the costs charged by third parties are set by those third parties, in a free market the investor can choose whether or not to engage with them and if their perception of the costs is unfavourable, they can walk away and place their business elsewhere.

Unfortunately the world of investment management is, while not as opaque as that of life assurance (there are still providers whose charging structures resemble those which were around in the 1980s and which hardly anyone I knew then understood), less than the model of clarity than we might wish.

While this may not be a deliberate attempt to hoodwink unsuspecting investors, in part the problem is that there are so many parties involved in the chain between manufacturer and investor that it can be difficult to see where your money is going and every pound that you pay to someone else is one that is not available to spend on your

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own objectives (which is, after all, the reason why you invest in the first place).

For this reason, since at least 2005 we have been calculating, to the best of our ability, the costs of both our own portfolio models and those elements of clients' portfolios which we do not manage and because we recognise that many of us find pictures easier to understand than tables of numbers, providing charts which break down the costs between the main elements for which we are able to estimate them.

Despite our attempts to provide greater clarity it would appear from feedback we have received that the chart can come across as confusing. We have acted on the feedback and produced a revised version of the chart along with an explanation of the numbers behind the chart.

Even if you are happy with the costs that you pay for your Bloomsbury portfolio, it may still be worth reading on because the principles apply to all portfolios and we think that it is helpful to know what you are paying in order for you to assess whether you feel that it represents good value to you.

Bloomsbury currently identifies four elements to the total cost, namely costs attributable to the underlying assets (generally funds) in which it invests, the cost of the fund managers trading within those funds, the cost of maintaining secure records of the holdings attributable to each client account and what Bloomsbury charges for ongoing financial planning and portfolio management. We will now consider each of these in turn.

Underlying asset costs

With one or two exceptions for specific reasons related to the regulations imposed by overseas tax authorities on a particular structure, all of the assets held inside Bloomsbury portfolios (other than cash) are held via pooled funds. This provides far greater diversification than would be available if client portfolios were to hold individual stocks (some of the funds have exposure to more than 3,000 companies) as well as far less tax administration for dividends (funds generally make only two or four distributions each year) and greater control over the timing and amount of any capital gains tax liabilities as it is only when a holding in the fund itself is sold that a potentially taxable gain arises.

There is a cost for this, the largest of which comes in the form of an annual management charge (AMC). For the individual funds that Bloomsbury uses, this currently varies between 0.15% (i.e. 15p per £100) and 0.55% (55p per £100). Bucking the usual trend within the fund management industry, some of the funds that we use have actually reduced their management fees over the period since they launched in 2004 as their size has increased.

However, there is more to fund charges than the AMC, as the fund also incurs other costs which are charged to it. These typically include fees for directors, the depositary, the custodian, advisers to the fund, providers of valuation, accounting, shareholder services such as transfer agents, registration, regulator dues, audit, legal and other professional services, distribution and marketing. The good thing is that most of these are either fixed (so do not increase at the same rate as the fund grows) or small percentages. Nevertheless they do all add up and every pound spent on charges is one not available to you for your goals.

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The AMC and these additional costs are together referred to as the ongoing charges figure (OCF). They were previously referred to as a total expense ratio (TER), which was something of a misnomer as it was neither a total nor a ratio.

To illustrate the impact of these additional costs, they increase the 0.15% and 0.55% AMCs mentioned above to 0.27% (27p per £100) and 0.69% (69p per £100) respectively.

The fund-specific costs may be charged to either income or capital – the former is most common but particularly for bond funds with a focus on providing income, costs may be charged to capital, which helps to maintain a higher headline yield figure but gradually erodes the capital from which the income is derived. For investors who pay tax on their income but who may not use their CGT exemption regularly, this may not be the most efficient way to produce cashflow from a portfolio. Either way, these charges are deducted from the fund before the unit price is calculated each day so that any performance figures always take account of them.

Since funds are obliged to publish OCFs every year, we multiply the published figure for each fund by the percentage holding of that fund in each Bloomsbury portfolio model and then by the value of the investor's portfolio to determine the cost in cash terms of each fund for each investor. Adding together those figures for each fund gives the total OCF for the portfolio. So for a portfolio of £100,000 which has 30% in a fund with an OCF of 0.5%, the estimated cost of that fund would amount to:

£100,000 x 30% x 0.5%
= £150 each year

Specifically excluded from the OCF (and the TER) are assorted other costs, such as entry or exit charges (we always look to avoid funds which levy these), performance fees (likewise, as they tend to represent a better deal for the manager than the investors), interest on borrowings, brokerage and other dealing charges and payments due to holding derivative positions.

Portfolio turnover costs

Any portfolio which is not just created and then forgotten about will require ongoing management, if only to reinvest income that it generates and rebalance it periodically to avoid overconcentration in a few securities.

Every time the manager carries out a purchase or sale transaction, there will be costs generated, which may be in the form of dealing commissions, a spread between the price at which they buy and sell, stamp duty or other costs. Although institutions are able to trade at much lower costs than private investors due to the number and size of their transactions, there is still an impact and the less liquid the securities being traded, the higher the dealing commissions and the wider the spreads are likely to be.

Depending on the structure of the local market, trading overseas securities may also carry higher costs than domestic ones.

Several academic studies have been carried out into the 'round' trip' costs of trades and the consensus[1] seems to be that around 1% is a typical aggregate figure for selling one equity security and buying another. This means, very conveniently for the mathematically challenged among us, that a portfolio which turns over 100%

[1] Orton, I (1999), 'Just why are portfolios turned over so often?', Financial Times, 16th October 1999

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of its holdings each year experiences an annual cost 'drag' of around 1%. High credit quality bonds are much cheaper to trade and we therefore disregard the trading costs for these.

The other factor in determining the impact of transactions is clearly how much of it goes on in a year, which is identified by the portfolio turnover ratio, which is a percentage figure intended to show the proportion of the portfolio which was traded in a year. However, interpreting this ratio is not helped by the fact that there are two methods of calculating it and one of them (which is more commonly used on this side of the Atlantic) can result in a negative number, which is of no use at all for this purpose.

The methodology used by the US Securities and Exchange Commission (SEC) is rather more helpful in that it disregards transactions due to inflows and outflows (when the manager is obliged to trade) so that it only reflects those which result from voluntary ones; however, this is less widely used in Europe other than by management groups with a US origin. Where a fund is constantly growing, it may be possible to take the cash for outflows to exiting investors from new inflows and thus avoid the need to trade assets at all, which serves to limit the need for transactions.

There are specialist companies which calculate portfolio turnover (it requires a very tedious trawl through each fund's report and accounts followed by some maths) but the market coverage is limited and the cost is high, no doubt partly because demand is low.

Although there were moves in recent years to require all funds to publish this data, these plans appear to have been dropped (quite possibly in the face of opposition from management groups, many of which seem oddly reticent to make it widely available) and therefore it is necessary to use either the data from those companies which do publish or to make estimates based on what data is available.

From a study in 2006[2], we know that at that time, the turnover for the median (i.e. half were lower and half were higher) UK-based equity fund was around 59% using the SEC calculation basis. Index-tracking funds, in which transactions tend to be less frequent than for actively managed ones, typically have a turnover of around 20%.

Combining the round trip cost and the turnover figures by multiplying them together affords an estimated annual cost of around 0.59% for a typical equity fund and around 0.2% for a typical index fund. We can then estimate the cost impact on a portfolio by multiplying this figure for each fund by the percentage of the model in each holding and the portfolio size. So for a portfolio of £100,000 which has 30% in an index fund with 20% turnover, the estimated turnover cost for that fund would amount to:

£100,000 x 30% x 20% x 1%
= £60 each year

These turnover costs are not explicit in the way that annual management charges or the OCR are, in that there is rarely a published figure (in any event it varies according to the amount of turnover in an accounting period and the cost of each trade) and they are not paid to a single organisation but they manifest themselves in a lower return than would otherwise be the case. All else being equal therefore, just to match that of a typical index fund with annual turnover of 20%, a highly active fund with, for example, an annual turnover of 200% needs to generate an additional

[2] Lipper Fitzrovia (2006), Benchmarking UK portfolio turnover 4th edition, Lipper

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1.8% (2% less 0.2%) of return every year. This is certainly possible but as explained in Bloomsbury's 'Guide to investing', the task of identifying in advance which funds those will be is far from being a simple one.

Custody costs

In order to make it practical to manage portfolios which often comprise several accounts, each of which contains multiple assets, it is necessary to hold those assets via a third party custody service. The custodian maintains records of what is in each account and to whom the account belongs, along with the history of transactions. It also ensures that income generated by the portfolio is attributed correctly and, if required, distributed to the investor.

Fortunately the cost of this service is explicit and simple – for assets at Pershing, where the majority of Bloomsbury's clients' investments are, the charge is 0.2% of the assets in each account, so for an account worth £100,000, this would amount to £200 each year. The fee is deducted from the portfolio monthly and we ensure that sufficient cash is held to meet them.

Wrapper costs

Although most assets within Bloomsbury's managed portfolios are held in accounts with no additional charges (general investment accounts and individual savings accounts), where more specialist products are required to ensure that the assets within the underlying account are treated correctly from a taxation perspective, there may be additional charges levied by the provider of that product wrapper. The most common wrappers that Bloomsbury uses are self-invested personal pension schemes (SIPPS) and offshore portfolio bonds (OPBs), although occasionally others may be employed where appropriate.

Experience indicates that since the only functions of the providers in such circumstances are the administrative ones of providing a wrapper which meets the legal requirements and carrying out any associated reporting, which are not necessarily any more onerous for a £10m portfolio than for a £10,000 one, it is more rational to utilise those whose fees are fixed (or at worst, tiered) irrespective of the size of the account rather than being based on a percentage of the account value. Although the fixed charges commonly increase each year in line with price inflation, the impact of the wrapper costs tends to reduce over time as long as the account value increases at a faster rate.

Taking the same £100,000 portfolio and assuming that it were invested in a typical SIPPS, the SIPPS wrapper's ongoing cost might be around £200 plus VAT, which would amount to £240 at current rates. The fees are either deducted directly from cash held in the wrapper but outside the investment account, or invoiced, in which case Bloomsbury arranges for them to be paid from the cash held in the relevant investment account for this purpose.

The costs of these wrappers have not previously been included in charts showing the cost of portfolios managed by Bloomsbury but as all costs are now shown in cash rather than percentage terms, it is more practical to do so and therefore we are looking to do this in the near future.

Planning and management costs

There are the fees that you pay to the firm or firms which manage your portfolio; for Bloomsbury clients on the Wealth Management Service Basis A charging structure, they also include ongoing financial planning advice in relation to your goals and your personal circumstances (for the Wealth Management Service Basis B charging structure

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and for the Financial Planning Service, aimed at clients whose principal need is for planning and who may not yet have substantial assets to manage, planning is covered by a separate annual fee).

These are the only fees which Bloomsbury receives itself and are deducted monthly from the cash balance on each investment account, for which we ensure that there is sufficient cash to meet them when they are due.

Conclusion

As Vanguard founder John Bogle pointed out, in investing:

"You get what you don't pay for"

so controlling the costs that you pay is an area to which we direct considerable attention. Over the years several of the funds held within our portfolio models have been replaced when lower cost alternatives became available and as the costs of existing holdings fall, our clients benefit from that too. For clients on the Wealth Management Service Basis A charging structure, our own ongoing fees also reduce after three years and we review our fixed fees regularly according to the historic and expected levels of work applicable, with some of those also having reduced in recent months, subject to the need to remain profitable so that we can continue to invest in further improvements to our services.

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For further information please get in touch with your usual Bloomsbury Wealth contact, telephone 0204 502 4560 and ask for a member of the wealth team or alternatively e-mail:

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