ETF Fees Continue to Fall

Competition between fund providers continues to result in lower fees on exchange traded funds (ETFs).

A very good thing if you are a proponent of cost minimization when investing.

I read a short article that discusses this subject and makes a couple of useful side points.

"In the Trenches of the ETF Fee War" offers some thoughts that should be kept in mind when investing in ETFs.

Diminishing Returns on Reducing Fees

> *We've come to the point where the ETF industry's fee war is becoming inconsequential for investors*

The point here is that there is not much difference between many ETFs in the same peer group (e.g., large cap Australian equities). True, but be sure to make apples to apples comparison. Fees may not differ significantly within a fund category, but they will still vary between fund categories (e.g., mega cap U.S. equities versus small cap U.S. equities).

Further, that the minimal differences between offered funds is not worth shifting money from old to new. Again, true. Even over very long periods, 2 basis points difference in fees will not make or break you. That said, every penny in your pocket is preferable.

Again, compare apples to apples. The article notes:

> *the average ETF costs 0.65% today, compared to the 0.56% charges in 2010, according to Morningstar data. Apparently, the higher costs niche or specialty ETFs are pushing the average higher even as large providers are cutting costs on*

> *large, broad-based ETFs.*

You can invest in a S&P 500 index fund for less than 10 basis points per annum. iShares costs 0.07%. The difference between this fund and the 0.65% "average ETF cost" will add up over time. And as you get more exotic, the ETF costs will continue to rise. For example, the iShares MSCI India Small-Cap ETF (SMIN). It carries a 0.74% expense ratio.

For a few more thoughts on fees, please read "ETFs Over Funds: Investment Costs".

Need to Consider More than Price

> *investors should not base an ETF purchase on price alone, there are many other factors that play into the equation of an outperforming fund.*
>
> *Efficient trades, low bid-ask spreads and tax treatment are especially pertinent for total return.*

Yes, that is true. The smaller the fund, the more exotic the fund category, the more active the fund strategy, the less efficient the capital market, etc., the greater the cost to the fund.

Until you develop a substantial investment portfolio, I suggest you stick with the larger funds and passive index strategies. These will tend to have higher efficiency and (on average) less turnover than a smaller, more actively managed, fund.

Your Trading Habits are a Cost

> *Operating expenses are another area investors must consider. Every trade that is executed costs the investor, so for those who trade frequently, an ETF can be expensive.*

There are an increasing number of funds that are "transaction free" or "no-transaction fee". Availability and number differ between brokerage houses, so see what is offered where you trade. Or, if considering creating a brokerage account, factor this into your comparison.

If you use a general buy and hold strategy, your portfolio turnover will not be significant.

Where you may need to be careful is in using a dollar cost averaging approach to build your holdings. Dollar cost averaging is an excellent tool for small investors. But watch the transaction fees.

If you invest $100 each month and pay $10 in brokerage commissions, transaction fees will ruin your returns. Instead, accumulate capital in a cash account or low cost, no-load money market mutual fund. When you reach a critical mass – maybe 4, 6, or 12 months out – then invest in the chosen ETF.

Buy Index, Not Actively Managed, Funds

Invest in passively managed index funds, not actively managed mutual funds.

A constant theme of mine for individual investors.

Today, a short video courtesy of The Motley Fool.

> ***Buy Index Funds, Not Mutual Funds: Returns***
>
> *Uploaded by The Motley Fool on 2013-06-05.*

Keys to note in the video:

0:20 – note the big discrepancy in expense ratios between the Spider Index Fund (9 basis points) versus the other funds. Every cent you pay in additional fees negatively impacts your performance. And your ability to reinvest your returns for compound growth in the future.

0:20 – note the correlation between expense ratios and performance. Look at the 5 year return. A strong correlation between higher expense ratios and lower relative performance. That gets to my point about how difficult it is for active investment managers to consistently outperform their benchmarks over time. Smart investors stick with low cost index funds.

1:00 – the commentator discusses performance over the last month and three months. When considering investment alternatives, ignore short-term results. Luck or external events can impact short-term performance. Focus on mid to long-term results when researching investment products. Given the number of new offerings out there, three year results may suffice. But if you can assess five and ten year data, much better.

The commentator does not discuss, but when comparing investment options be certain to do apples to apples. In this video, they compare the S&P 500 to a variety of funds. To ensure you are comparing similar risk-return profiles, you want to check to see what benchmark each actively managed fund uses. If it is the S&P 500, then comparisons are probably reasonable. But if the benchmark is something else, then it is not fair to compare the fund to the S&P 500. In this case, the listed funds are primarily large cap U.S. equity funds, so S&P 500 is okay. But if a fund focussed on micro-cap technology stocks or Japanese equities, then using the S&P 500 as a benchmark is useless.

ETF Expense Ratios Between Countries

"I am considering buying an iShares S&P 500 tracker exchange traded fund. In the United Kingdom where I live, the annual total expense ratio is significantly higher than the exact same fund if I buy it on an American exchange. Why does an identical exchange traded fund (ETF), from the same provider, have a different expense ratios in different countries?"

That is a question recently posed by a reader. A very good question.

A few thoughts in response.

iShares S&P 500 Tracker

The questioner cited U.S. and U.K. versions of the iShares S&P 500 tracker index fund.

The U.S. listed S&P 500 ETF trades under the symbol IVV.

The U.K. listed S&P 500 ETF trades under the symbol IUSA.

Both ETFs track exactly the same index and come from the same ETF provider, iShares.

IVV, the U.S. listed ETF, carries an annual expense ratio of 0.07%. Extremely reasonable. Yet IUSA, the U.K. listed equivalent, has an annual expense ratio of 0.40%. Almost six times the identical U.S. ETF.

What gives?

Expense Ratios are Ratios

No, not being flippant. This is actually an important thing to remember.

ETFs, mutual funds, even individual companies, all incur costs to operate.

Some costs are variable. That is, the costs only occur in relation to some activity. Every trade you make, you pay a transaction fee. Every widget your factory produces has a specific cost component. Do not trade or manufacture that widget, no expense is incurred.

Some costs are fixed. If you manufacture widgets, you need a factory. You need the factory whether you produce one widget or a million. Same with funds. You need a fund accountant, marketing literature, etc., to operate. The smaller the fund, the less you can spread out the costs. To coin a phrase, let's call this "economies of scale."

IVV has assets under instrument (AUI) of USD 42 billion. At 0.07% expense ratio, its "costs" are USD 29.4 million. IUSA has only USD 12 billion AUI. At the higher expense ratio of 0.40%, its fund costs are USD 48 million. 63% greater than IVV expenses in hard dollars.

Higher, yes. But not at the same level as indicated by the enormous spreads between expense ratios (0.07% versus 0.40% or almost 6 times).

When comparing expense ratios between mutual funds or ETFs, always consider fund size.

The smaller the fund, the less fund costs can be spread out over more investors.

IUSA is More Costly in Absolute Terms

Why does U.K. listed IUSA incur greater costs than U.S. listed IVV?

Both invest in the same holdings, the S&P 500. Both appear to follow the same replication methods. So why does IVV spend USD 29.4 million each year to run the fund, while IUSA spends USD 48 million?

Punishment towards U.K. investors? An incentive for them to move to Canada or the U.S.?

Undoubtably. But there may be a few other reasons. And these may apply to any funds registered in different jurisdictions.

Regulatory Regimes

Different jurisdictions may have different reporting requirements and/or require fund companies to incur varying costs to stay legal. The greater the amount of regulations and laws, the higher the cost to the fund.

Transaction Costs

Actual transaction fees to maintain index holdings may differ between jurisdictions. Taxes may also play a role in costs.

Operating Costs

Marketing expenses, staffing costs, and all other associated expenses necessary to maintain a fund are impacted by where the fund is physically located and sold.

Exchange Rates

Although IUSA is USD denominated, there are still exchange issues. Just because the ETF is USD does not mean the fund accountant or marketer is paid a USD salary.

As well, there are costs involved in cross-currency transactions.

Never assume that a top rated ETF (or mutual fund) will have the same cost regime in all jurisdictions. Before buying a fund in your own country, do your due diligence.

Competitiveness

Maybe the largest factor in costs is competition between providers.

The greater the number of mutual fund and ETF providers, the greater the price pressure.

There are many fund providers in the U.S. As a result, competition is intense. For simple index funds, cost minimization is crucial for investors. If you compared two identical funds, you would always choose the lower cost option. At least I hope you would! To be successful in attracting investors, these providers know they must offer the lowest cost funds (and funds that accurately track the designated market).

Fund providers in competitive markets are constantly looking for ways to reduce costs. These include: finding easier (i.e., less expensive) indices to track; using temporary expense cuts to attract new money; using low cost funds as loss leaders and then providing complementary (more profitable) products and services.

If you live in a country with limited competition, expect to pay more for funds. Or consider the pros and cons of buying your funds on an exchange in another country.

Also, keep an eye on changes in your home market. For example, iShares appears to be expanding its global footprint. That may signify future ETF fee reductions in the United Kingdom and other European countries.

Lessons to be Learned?

Probably a few takeaways.

1. Total Fund Costs Are Spread Amongst All Fund Investors

Your share of annual fund expenses is directly related to the fund’s asset size. Ceteris paribus, if you want a low annual expense ratio, seek out extremely large funds.

As an aside, extremely large funds are essentially the market themselves. Good for passively managed index funds. Not good for actively managed funds.

If you want an active fund, I suggest you endure the higher expense ratio and find a small fund. One that can be agile and where relatively small investments in a particular investment can impact overall fund performance. Perhaps focus on active funds that target niche, neglected, or inefficient markets.

2. Different Jurisdictions Require Different Costs

Regulations, legal requirements, the cost of living, salaries, transaction costs – all of these things (and more) impact a fund’s cost structure in a specific jurisdiction. That means there will be cost differences between the same fund offered on different exchanges. Do your due diligence when investing. A fund that may be a good investment in the U.S. may not be as good an option in the U.K.

3. Consider Investing Via Foreign Exchanges

You may be able to arbitrage. What I mean is that if you are able to buy an investment product in another jurisdiction at a cheaper price, consider that. In our example above, IVV is a better deal than IUSA. Why not buy IVV and save some money on fees each year?

If you can purchase the same product cheaper elsewhere, definitely consider it. But be careful. There are many nuances to consider and many are country specific (so I cannot enumerate them all).

For example, perhaps your tax-deferred investment account has restrictions on foreign content. A fund purchased in your home country would qualify. The identical fund purchased on a foreign exchange would not. In Canada, many brokerage houses allow for purchases on Canadian and U.S. stock exchanges. But only a few online brokers allow for purchases on the Swiss or Hong Kong markets. Depending on your broker, you may have limitations on where you can access investments. Also, those brokers that do allow trading on foreign exchanges usually charge a premium for transaction fees.

Another issue to consider is taxes. Buying a fund on a foreign exchange may result in taxes withheld at the source. Many countries will have reciprocal tax agreements, so you will not be double taxed, but it increases paperwork. Or, your domestic issued fund may send you nice tax receipts each year to aid in your personal tax preparation. You probably will not get the same information from a foreign issued fund. Again, that may increase paperwork.

Bottom line, investing in a fund on a foreign exchange may be cheaper in annual fees. But you need to consider other relevant factors that can increase both real costs and aggravation.

4. Low Cost is Great, But the Fund Must Track the Index

Net performance versus the benchmark for an index fund is a function of cost structure and tracking error.

Yes, you want to minimize cost. But not at the expense of performance. You need to make sure that your fund accurately tracks its benchmark index.

Investopedia has a nice little article on ETF Tracking Errors, if you wish to learn a little more on tracking errors. I like the article, if for no other reason, it starts out, “Although rarely considered by the average investor, tracking errors …” And the last thing I want is for readers of this blog to be simply average investors.

5. Continued Globalization Aids Investors

As the world continues to shrink, fund companies will move into neglected markets (like the UK). That should result in lower costs to core products as well as a wider range of offerings. Also, brokerage houses will allow for better cross-border trading that will further improve investing efficiencies and effectiveness.

Or, for my U.K. readers, feel free to relocate to North America. Less rain and fog, our airports do not shut down at the first snowflake, and much better food options than bangers and mash.

[Tips to Diversify Your Portfolio]

Diversification is crucial for long-term investment success.

Proper diversification, that is.

Today, how to better diversify your investment portfolio.

A Quick Refresher on Diversification

We covered diversification a while back, so just a quick reminder on this important concept.

[What is portfolio diversification?]

[A little deeper look into portfolio diversification.]

[Portfolio diversification in action.]

[Portfolio diversification and asset correlations.]

Diversify with emerging markets.

Mutual fund holdings and diversification.

Efficient and effective portfolio diversification may be the main determinant of long-term investing success or failure. Please make certain you understand this crucial subject.

Investopedia provides "5 Tips For Diversifying Your Portfolio". We have covered these tips before, but it is a nice summary.

1. Spread the Wealth

Reduce your portfolio's non-systematic risk (i.e., the diversifiable risk) by spreading out your capital. Diversify within and between individual asset classes (e.g., equities, fixed income) and asset sub-classes (e.g., natural resource equities, junk bonds). Diversify across geographic regions (e.g., emerging, developed) and time (e.g., 5, 30 year bonds).

There are diminishing returns to diversifying. And the benefits of diversification are more a function of the correlation between the assets selected, not simply the number of investments you make.

2. Consider Index or Bond Funds

Cost effective. The funds are often well-diversified within the tracked index. And it is easy to create a diversified total portfolio with very few investments (though each fund will have a large number of holdings).

For example, consider the iShares S&P 500 index exchange traded fund (IVV). You buy one single investment product. Yet you receive the benefit of 500 companies representing a wide variety of the U.S. equity market. All for a minimal annual cost of 0.07%.

3. Keep Building

Fully agree that dollar cost averaging can aid in effective diversification.

Dollar cost averaging promotes investing discipline, a consistent approach, and portfolio quality. It is an excellent investing technique for small investors.

4. Know When to Get Out

I like a general buy and hold approach when investing in mutual and exchange traded funds. I do not think buy and hold forever works with non-diversified investments, like individual stocks or bonds.

One has to be aware of potential problems, but I think the advantages of buy and hold for funds win out for investors.

I like buy and hold. But that does necessarily mean buy and hold (forever, locked away in a drawer). Buy and hold, but review. As necessary, rebalance your actual asset allocation back in line with your target allocation. There are a few strategies available to rebalance.

5. Keep a Watchful Eye on Commissions

Yes, watch commissions on mutual funds. I recommend seldom (usually never) buying into any fund that charges a commission. There are too many good no-load funds out there.

Besides commission, keep an eye on all your investment related expenses.

Brokerage fees when buying or selling mutual funds, exchange traded funds, stocks, bonds, etc.

Annual expenses charged to an investment product. These can significantly impact investment returns for both mutual funds and exchange traded funds. They can also materially differ between investment products and offerings. So do proper due diligence prior to investing in any one product or fund.

Why? I cannot tell you which fund or asset class will outperform next year. But I can tell you with some confidence that lower costs will result in stronger performance over time.

ETFs Versus Mutual Funds

Exchange traded funds (ETFs) versus open-ended mutual funds.

In general, I prefer ETFs for investors.

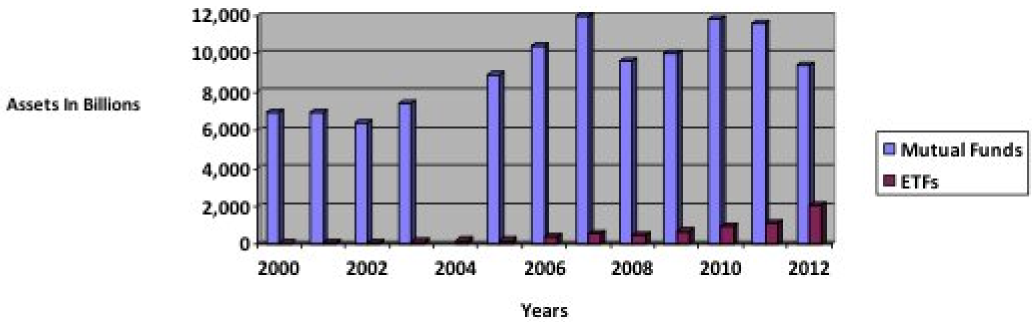
The exception tends to be for extremely small investors. It may be more cost-effective to pay higher annual expenses, but no transaction fees, with a no-load mutual fund, than to pay commissions on minimal ETF acquisitions. Also, many no-load mutual funds allow for very small purchases of funds and reinvestment of distributions.

Today, three graphs comparing the current state of ETFs with open-ended mutual funds.

If you read some of my previous posts – see Related Posts in the far right column – you know the reasons why I prefer ETFs for most investors.

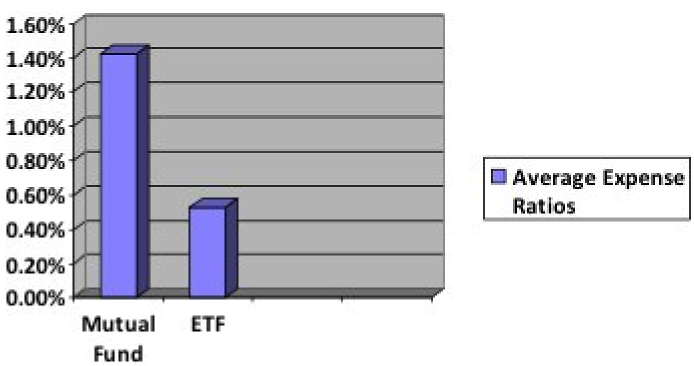
"3 Charts That Prove ETFs Are Here To Stay" nicely summarizes some of those reasons.

Total ETF Assets Vs. Total Mutual Fund Assets



Driven by lower expenses, lower taxes, intraday tradability as well as access to various non-traditional asset classes, more money managers and individual investors are making the switch over from mutual fund holdings into ETFs. Simply put, ETFs have seen growth, while mutual fund assets have started to dwindle.

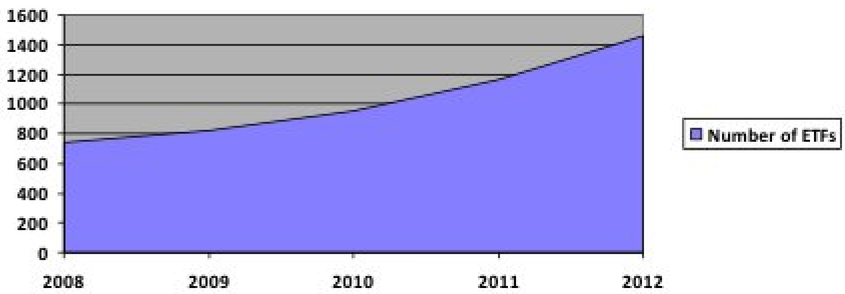
Average Annual Expense Ratio of ETFs Versus Mutual Funds



The difference in costs is truly striking as the average traditional mutual fund is more than one full percentage point costlier than the average ETF. These expenses grow when investors factor in some mutual funds' front-end sales loads, 90-day redemption fees and 12B-1 marketing fees.

The other points made in this section are very true. But while some mutual funds do have high thresholds, an increasing number of no-load mutual funds allow for reasonable initial purchase amounts (e.g., $1000) and very low subsequent acquisitions (e.g., $100).

The Total Number Of ETFs



> *Nearly every investment theme, asset class and strategy has been tackled by ETF sponsors. Adding up all the funds across the United States, Canada, Europe and Asia—the latter three regions' funds are available to some investors with global brokerage accounts—there are more than 4,700 different ETFs. This provides plenty of opportunities to diversify a portfolio.*

The multitude and variety of ETFs allows for investors to create well diversified portfolios on a cost-effective basis. A couple of cautions though.

One, there is a direct correlation between complexity (or exoticness) of an ETF and its annual expense ratio. While, on average, ETFs annual expenses are lower than mutual funds, there are some pricey ETFs out there.

Two, you can get pretty much everything with ETFs. But that may not always be a good thing. Be careful with ETFs that alter the basic risk-return profile. For example, leveraged ETFs can enhance your upside, but can also enhance your downside risk. And usually they will be more expensive than the identical non-leveraged ETF.

Also, ETFs (and mutual funds) are excellent vehicles to create diversified portfolios. Within a broad portfolio strategy, alternative asset or exotic ETFs can improve overall diversification. However, an individual ETF may have little to no diversification on its own. For example, if you load up on a futures-based corn ETF, that ETF itself will have poor diversification.

Signs of Portfolio Over-Diversification

A well diversified investment portfolio is a key requirement for long-term investing success.

Diversification is important. But sometimes too much diversification can negatively impact portfolio performance. It can be a fine line in getting it right.

Today, a look at indications your portfolio is overly diversified.

Portfolio Diversification

We have looked at the benefits of portfolio diversification in previous posts. Should you wish to refresh yourself on this important concept, please take a read of:

An Introduction to Diversification

A Little More on Diversification

Portfolio Diversification in Action

Diversification and Asset Correlations

Diversify With Emerging Markets

Pretty creative titles. What else to expect from an accountant/finance guy? At least I am not an actuary. As the saying goes, an actuary is simply an accountant without a sense of humour.

Bottom line, proper diversification is extremely important for investing success.

But too much diversification can hurt performance.

Indications You May Be Over-Diversified

Investopedia offers "Top 4 Signs Of Over-Diversification". The article has good observations.

1. Owning too many mutual funds within any single investment style category

> *Investing in more than one mutual fund within any style category adds investment costs, increases required investment due diligence, and generally reduces the rate of diversification achieved by holding multiple positions.*

For each investment category, find a single mutual or exchange traded fund that meets your investment criteria for that class. This should be fairly straightforward for passive investing. If you are investing with active fund managers, you may want to look at two or three funds to hedge the managers' performance.

Also, watch for too little diversification when buying multiple funds in the same investment style category. The pool of available investments within an investment class may be small, so you may end up with very similar holdings in two or more funds. Or, some investments span multiple investment style categories. You may just end up with Apple in every fund you own regardless of style category.

Watch the underlying holdings in any funds you research. Do not spread yourself too thin or pay for the same fund twice. And be careful with costs. Let your capital accumulate on your behalf. Not on making the fund company rich.

2. Excessive use of multi-manager investments

> *When considering multi-manager investment products, you should weigh their diversification benefits against their lack of customization, high costs and layers of diluted due diligence. Is it really to your benefit to have a financial advisor monitoring an investment manager that is in turn monitoring other investment managers?*

I am not a fan of fund of funds and/or multi-manager investment products. There are some investing aspects where it may be cost-effective to hire professional expertise (financial planner, active managers in specialized markets, etc.). But any individual investor should be able to put together a portfolio of funds on their own. Why pay someone to amalgamate a variety of readily available funds?

3. Owning an excessive number of individual stock positions

> *Too many individual stock positions can lead to enormous amounts of required due diligence, a complicated tax situation and performance that simply mimics a stock index, albeit at a higher cost.*

The greater the complexity of a fund, the greater the costs you will usually pay.

A problem with this is that outside of certain index funds (e.g., the SPDR Dow Jones Industrial Average (DIA) reflects the Dow’s 30 components), most funds will have significantly more holdings than the 20 to 30 normally cited for adequate diversification. Is holding 184 investments in the fund materially more cost effective than 227 holdings?

Or what about a fund that only has 60 investments but is constantly churning the portfolio? Is that better or worse than a fund with 300 investments that has very little turnover?

Me, I tend to focus more on two things. One, I look at the percentage of total fund assets in the top 20 or 30 holdings. That tells me something on the real concentration of assets. Two, I focus on the annual expense ratio for the fund. That tells me about management fees, transaction costs, administration expenses, etc., for the fund.

4. Owning privately held "non-traded" investments that are not fundamentally different from the publicly traded ones you already own

> *Non-publicly traded investment products are often promoted for their price stability and diversification benefits relative to their publicly traded peers. While these "alternative investments" can provide you with diversification, their investment risks may be understated by the complex and irregular methods used to value them. The value of many alternative investments, like private equity and non-publicly traded real estate, are based on estimates and appraisal values instead of daily public market transactions. This "mark-to-model" approach to valuation can artificially smooth an investment's return over time, a phenomenon known as "return smoothing."*

Most investors should be able to go through their lives without investing in these types of alternative investments.

I have owned some of these investments but tend not to recommend them to non-professional investors. Valuations can be problematic. Proper management is important. Cost structures tend to be relatively high. Also, liquidity can be an issue for investors wishing to divest. I suggest using caution when considering non-publicly traded investments.

Too much diversification may negatively impact your portfolio performance. Not necessarily from having too many investments. But in the increased costs associated with those additional funds and holdings.

Mutual Funds Lag Their Benchmarks

In the U.S., the Standard & Poor’s 500 stock index (S&P 500) is up 12.6% year to date 2012.

That is the good news. The bad?

Your mutual fund is likely not meeting or exceeding this benchmark.

Why the underperformance against investment benchmarks?

The Facts

From The Wall Street Journal’s, “It’s Not Your Fault Your Fund Can’t Keep Up”:

> *A Morningstar survey for The Wall Street Journal Sunday found that only eight of the 25 largest actively managed funds—all types, from bond funds to foreign—beat the S&P 500 for the quarter.*
>
> *That’s right in line with previous analyses. On average, fully two-thirds of mutual funds lag behind their respective benchmarks, according to Morningstar. (Such studies stacked bond funds against bond indices; and stock funds were compared to stock indices.)*

> *And over the long haul, according to fund guru John C. Bogle, virtually all fail.*

If you own a mutual fund, there is a strong probability that it will underperform its relevant benchmark. There are a few reasons why.

Individual Asset Selection Is Not Easy

Part of the problem is that active mutual fund managers historically, and on average, do not beat the markets with their picks.

Timing market movements and/or identifying the best individual assets is not simple. Even the professionals get it wrong a fair amount of time.

Larger Funds Become the Market

Even if the asset manager is a great individual asset selector, the larger the fund becomes, the less impact an individual selection makes on the overall portfolio.

The linked article mentions a few large funds: USD 59 billion large-cap American Funds Investment Co. of America Fund (AIVSX); USD 54 billion American Funds Washington Mutual (AWSHX); USD 37 billion Vanguard Windsor II fund (VWNFX).

At those sizes, even if they find the next great company, how much can they add to their portfolios? There are limits as to what one can buy.

Large funds need to buy large companies. Investing in a small company will result in too few shares to have any overall portfolio impact. Or buying too many shares and running afoul of securities regulations in regard to ownership levels.

If stuck investing in large cap companies, large funds essentially become the market themselves. An advantage of small funds – and often a reason why funds are capped – is being nimble.

Consider AIVSX. 4.45% of AIVSX's total fund holdings is Philip Morris (PM) stock as at December 31, 2011. So AIVSX owned about USD 2.63 billion of PM, which itself has a market cap of around USD 150 billion. AISVX could probably invest a few billion more without getting into problems. But that is because PM is a very large company. The same is true for their other big holdings – Microsoft, AT&T, Dow Chemical, Royal Dutch, Apple.

But are these stocks not simply the equity market itself?

What about investing in the best performing stocks of 2011?

According to The Street, the five best-performing S&P 500 stocks in 2011 were: Cabot Oil & Gas (COG); El Paso Corp. (EP); Intuitive Surgical (ISRG); Biogen Idec (BIIB); Mastercard (MA). The April 9, 2012 market caps of each were: COG, USD 6.5 billion; EP, USD 23 .2 billion; ISRG, USD 21.7 billion; BIIB, USD 30.0 billion; MA, USD 55.0 billion. With the possible exception of Mastercard, it would be difficult for AIVSX to acquire enough shares of these companies to have any real impact on the fund performance.

Fees Hurt Net Performance

I write about this a lot. Fees may be the biggest reason for underperformance.

You own a fund that beats its benchmark by 1%. Pretty good. Until you realize that you are paying a 2% management or total expense ratio each year.

You want to improve your performance, focus on fund fees. Stick with passively managed open ended index and exchange traded funds (ETF) to minimize costs.

For example, AIVSX has an annual expense ratio of 0.61%. Not bad for a mutual fund. Its top 10 holdings at December 31, 2011 were Philip Morris, Microsoft, AT&T, Dow Chemical, Royal Dutch, Apple, ConocoPhillips, Home Depot, Abbott Laboratories, JP Morgan. These stocks make up 27% of the fund, so a big impact on overall performance.

Yet consider the iShares Russell Top 200 Index Fund. Its top 10 holdings include Apple, Microsoft, AT&T, and JP Morgan. Significant overlap with AIVSX.

And the iShares ETF only charges 0.15%. Almost half a percent less than AIVSX.

Oh yeah, it is up 12.8% to March 31, 2012, versus AIVSX at 11%.

What to Do

The article provides some good advice for investors:

> *investors should look for funds with low expenses and pick fund managers with long, consistent track records of success. They should avoid newly established funds, or those with relatively inexperienced managers. Then, look for funds without wild year-to-year swings in investment return.*

As I elaborate in *Why Active Investing is not Optimal*, avoid the expensive active management approach. The payoff is usually not worth the price. Keep costs low and try to match the market as best you can. That means passively managed open ended index mutual and ETFs.

If you do consider active management, look at long-term fund management performance.

You want to see how the manager does over time and in both up and down markets. Remember that a fund may be in place for a long time, but management can change. What a prior manager did 5 years ago may not be relevant to what the current manager will do tomorrow. So study the manager and not simply the fund.

Next time I will have a few words on the last part of linked The Wall Street Journal article. Namely that you face a formidable investing foe: yourself.

Vanguard Investment Funds

I like Vanguard investment funds for long term individual investors.

Especially investors who follow a passive management style.

As I am not directly or indirectly compensated in any way by Vanguard I recommend them based solely on their merits.

That is not to say that other funds are poorer choices. I recommend a wide variety depending on a client's investment objectives, desires, and available offering in their home jurisdiction. I believe in a "best of breed" approach for clients, not what is best for my revenue. And within the "best of breed" options, Vanguard funds pop up with regularity.

Why is this so?

Vanguard's Passive Approach

I preach a passive investing style.

Hopefully in many previous posts, I have justified my faith in this approach. Active management tends not to outperform passive over time; active results in higher investor costs; good active funds grow and become the market; good managers may leave and new ones need to be assessed; or a manager's stock picking ability reverts to average over time.

Portfolio Construction

Morningstar offers a good summary of why Vanguard is often a strong company when choosing funds. This is because:

> *Vanguard has done an excellent job of driving down costs, choosing appropriate benchmarks, and replicating the performance of those benchmarks across its index lineup.*

There are three keys to passive investing.

Cost minimization is extremely important. If you cannot beat the market consistently, you need investments that keep costs as low as possible. And lower than other investment options. In conducting your research, you will often find Vanguard funds in the lowest total expense ratio quartile.

Investors want investments that meet their personal objectives and constraints. Therefore, it is important to know what asset categories the fund invests in. By indexing against transparent and appropriate benchmarks, investors can find suitable fund matches for their needs. Knowing the index being replicated also helps determine each investor's unique asset allocation calculations and in conducting periodic performance reviews.

Cost minimization is crucial if you cannot beat the market. But it is also critical to try and match the market as closely as is possible. So you need investments with minimal tracking error.

In each of these key areas, Morningstar and I agree that Vanguard does a good job.

Product Lineup

Another investment consideration for some investors concerns that family of funds offered. The family of funds is the product lineup for a fund company.

Often there are perceived advantages for investors in dealing solely with one fund company. For example, there may be a monthly minimum of $500 for contributions. If there is only one fund, you need to invest in that one alone. But if there are multiple funds offered you can typically spread your monthly minimum between multiple funds. There may be no transaction fees charged when you sell a fund and use the proceeds to purchase another fund within the family. Or it could even just be the administrative ease in that all investments are under one roof, with one statement to deal with each month.

Many fund companies offer large families of funds. Make certain that if you choose to put all your investment eggs in one basket that the product line is high quality across the board. And that the fund company itself has a history of strong client service, innovative products, and financial solidity.

I think Vanguard is one fund company that meets these criteria. As Morningstar says:

> *The firm's passive roster is packed with topnotch offerings. We have evaluated a good number of its index offerings and passive funds of funds thus far using the new Morningstar Analyst Rating, in fact, and these funds have received impressive ratings overall.*

And Vanguard continues to be innovative to meet customer needs by continuing to improve their offering.

> *Vanguard has made four important moves in 2011 that should make its passive lineup even more attractive to indexing fans.*

Availability

Vanguard is U.S. based and offer their most extensive product lines to U.S. residents. Vanguard does have some international companies that offer differing levels of investment products to residents of the specific country.

While currently with a limited international presence, Vanguard is slowly expanding its operations outside the U.S. For example, Vanguard will soon be offering Canadian domiciled and focussed ETFs.

You can purchase Vanguard's exchange traded funds (ETFs) pretty much anywhere worldwide. So if you live where you cannot invest in Vanguard mutual funds, you can still buy their ETFs. As I tend to generally prefer ETFs over mutual funds (due to ETF trading advantages and lower investment costs), this works well for me.

If you are looking for simplicity, excellent global equity diversification, and a low cost structure, consider the Vanguard Total World Stock ETF (VT). A single fund with relatively low fees, VT tracks global equity markets based on each country's market capitalization. The index holds about 2,800 stocks of companies in 47 countries and includes both developed and emerging markets. This well regarded ETF provides true global exposure at a reasonable cost.

As stated above, I receive no compensation from Vanguard. And there are other mutual and exchange traded companies that I also like and recommend. But whenever you are considering a mutual fund or ETF, always include Vanguard products in your analysis.

You will be happy you did.

Lower Costs Equals Stronger Performance

For most individual investors, I believe that a passively managed, well diversified investment portfolio is the best approach for long term success.

I do not believe that paying higher fees for active management brings superior results over the long run. Instead, minimize investment costs and stick to index funds for the majority of investments. Let portfolio returns compound in your investment account, not in the pocket of an investment advisor or financial institution.

I have written extensively as to why I believe in this strategy.

Today, a little more evidence that a passive approach outperforms an active one.

A Little Bit Technical

Vanguard reviewed data for various funds under two scenarios.

It gets a bit technical, so if you do not need to know the analysis feel free to skip ahead to the results below. And the quotations below come from the actual underlying research document, not the linked summary.

First, Vanguard reviewed a "Morningstar database of the returns of actively managed funds from 1990 through 2010" and "calculated alphas relative to the stock market's four common risk factors".

Note that "alpha" is a risk-adjusted return calculation. It represents the ability of the investment manager to add value to the portfolio through active management. The “four common risk factors” are market risk, small market cap minus big (SMB), high book-to-market ratio minus low (HML), momentum risk.

Vanguard then looked at the probability of funds remaining in the top-performing fund quartile over holding periods of 1, 3, 5, and 10 years. The researchers presented two sets of probabilities, one with survivorship bias and one without. The results without survivorship bias are more relevant to investors.

Second, Vanguard examined outperformance of U.S. equity mutual funds by expense ratio quartiles over 5, 10, 15, and 20 year periods ending December 31, 2010.

The researchers reviewed “the relationship between fund alphas and four readily observable fund characteristics”. These being the fund expense ratio, portfolio turnover, fund asset size, and fund age.

Vanguard’s Results

Active Management Does Not Consistently Produce Alpha

In assessing the probability of an actively managed fund remaining in the top performing quartile, Vanguard found that, when you exclude survivorship bias, there is less than a 16% probability of remaining in the top quartile over any of the 1, 3, 5, or 10 year periods.

Very interesting in that in a purely random distribution, there should be 25% of the top quartile performers in the same quartile in future periods.

This suggests that actively managed funds do not outperform their expected returns on a consistent basis.

Also, that while some funds may have achieved outperformance in previous periods, it may not be achievable in future returns.

As such, spending money on higher fees for active management will not result in better portfolio performance over time.

Expenses are Powerful Predictors of Performance

Fund expense ratios and portfolio turnover can significantly reduce potential alpha.

Vanguard found that "for every 1 percentage point increase in expenses, alpha declined by 0.78 percentage point." As well, "for every 1 percentage point increase in portfolio turnover, alpha declined by 0.22 percentage point".

As for actual performance, "over the 20-year period, 49% of the funds in the lowest-cost quartile beat the benchmark while a mere 16% of funds in the highest-cost quartile did so. Similar patterns were apparent in shorter time periods."

As "selecting active managers that consistently outperform their respective benchmarks is such a difficult task, focusing on low-cost index funds is a helpful and valuable quantitative measure."

My Thoughts

One, I should point out that Vanguard is in the business of offering low-cost index funds. So their researchers may have a vested interest in finding that low-cost index funds is the way to invest. However, the results are consistent with other studies I have encountered.

Two, as I have written before, it is questionable as to whether active management can consistently outperform a passive approach over time. Even if an actively managed fund has outperformed historically, there is a strong probability of underperformance in the future. This Vanguard data supports that contention.

Note as well that this same argument can be applied to investment analysts as well as fund managers. Unless you can jump from hot manager to hot manager (or analyst), keep it simple and invest in index funds.

Three, fund costs take a huge toll on fund performance. The Vanguard indicates that a fund's expense ratio is a predictor of future performance. When faced with two comparative funds, you are likely better off investing in the lower cost fund.

A large number of exchange traded and open-ended index mutual funds are available for many different markets and indices. Make certain that you compare cost structure in each before investing. There is a good probability that the lower cost fund in a specific market will outperform the higher one over time.

Money Making Mistakes

Some interesting examples of money making mistakes courtesy of CNNMoney.

Superficially, they each provide decent advice for individuals.

But they also provide deeper lessons for investors.

And an overall moral that applies to all examples.

Vacation Home as Investment

I think this one misses the mark to some extent.

Yes, physically owning real estate has additional issues versus purchasing stocks, bonds, or even real estate investment trusts (REITs). But I know many individuals who have shown a profit owning a vacation property.

The issue in this example has less to do with the specific investment and more to do with due diligence.

According to the cited investor, "… vacation rentals are a whole new beast that I didn't understand."

If you want to invest in any asset class, do your homework before shelling out your capital. Never invest in any asset that you do not understand. Otherwise, the odds of showing a positive return are low.

Too Much Money in Employer's Stock

A common problem for many investors. Especially those who work in companies with employee stock purchase plans.

Three lessons in this example.

First, the classic too many eggs in one basket investment principle.

Diversify, diversify, diversify. That way any adverse results for one investment will not have too great an impact on your overall portfolio.

Second, your employer is not just an investment.

Your company also provides your salary. If the company falls on hard times, you may be punished twice. Once on the investment side and possibly on the compensation side through pay cuts, lack of bonuses, or even being laid off.

Third, sentimentality is for suckers.

Take an objective, emotion-free approach to investing. Do not be greedy and take a rational view of investment risk and returns.

Trusted a Pro's Picks and Ignored Fund Fees

Hmmm, I may have previously written a few posts on these two subjects.

Always be careful when following the investment advice of anyone. Studies show that it is questionable whether professional asset managers can outperform the market on a consistent, long-term basis. .

And, as we have seen previously, fees can have a substantial negative impact on long-term portfolio performance.

These are two reasons why I tend to recommend low-cost, passively managed, index funds for most investors.

Too Risk Averse for Age

Age is one factor in determining the amount of risk one should assume. But it is not the only factor.

The level of risk one assumes should relate to one's overall personal circumstances. Phase of life-cycle, personal risk tolerance, financial situation, investment objectives, personal constraints, etc.

Short-Term Savings into Growth Stocks

Another point we have previously discussed.

You want to match your investment objectives to the most appropriate assets.

If you require liquid funds (i.e., cash) within the next six months, investing in venture capital or thinly traded equities is probably a mistake. Instead, terms deposits or money market funds are likely a better match for your needs.

Chased Hot Stocks

I hope you do not learn the same lessons as Mr. Resnick through an expensive trial and error process.

After experiencing losses, he is now "… much more of a buy and hold investor, and I'm more disciplined. I focus on diversification, stick with a long-term strategy, and keep fees low."

Sounds good to me.

Failed to Rebalance

We will cover portfolio rebalancing in the near future.

While you generally want to follow a buy and hold strategy, you should stick to your investment game plan and the resulting target asset allocation.

At times, this will necessitate rebalancing your portfolio to some degree.

Panicked When the Market Plunged

"I should have been patient and stayed in there."

Stick with your investment plan, assuming it is well thought out. Do not be lured by investment bubbles nor panic when markets go south.

I do not believe he has it correct now, sitting on the sidelines in a money market fund. Looks like this investor is still a little nervous.

The One Common Thread

In these eight money mistakes, there is one common theme.

I might call it a lack of common sense.

I do not think you need to be an investment expert to understand that you should not invest in things that you do not understand. Nor should you put too much of your wealth in any one asset. Or investing cash needed in six months into long-term asset classes. Or ….

Using some common sense will greatly help your investment success.

Most people possess some degree of common sense. But they get caught up in the investment moment. Hot stocks, vacation properties, shares in your company, etc., can all lead to emotional decision-making. And once emotions take over the investment process, your probability of success falls.

To ensure a rational and consistent approach, it helps to develop some investment skills. No need to become an expert, but enough to create a proper plan.

Also, this is where an Investment Policy Statement is key.

A very important tool if you want to develop a structured investment plan.

It will guide you in a systematic way towards achieving your investment goals.