Sanlam Wealth

Understanding fund fees
(in particular transaction costs) under MiFID II and PRIIPs

AT A GLANCE

Two pieces of EU legislation came into force at the start of 2018 – MiFID II (the second Market in Financial Instruments Directive) and PRIIPs (the Packaged Retail and Insurance-based Investment Products).

They were brought in to make the cost of investing in products such as investment funds completely transparent and comparable. Together, they require the disclosure of all costs and charges involved in investing in an investment fund. Note 'a cost' is not necessarily 'a charge'.

Notably, this means that the **transaction costs and additional costs** involved in buying and selling the underlying securities inside a fund must be disclosed.

These costs are NOT new costs. They have always been fully reflected in a funds returns. However, this is simply the first time they have had to be separately shown as part of the overall cost of investing in a fund.

We are not required to show these extra costs as part of a portfolio of funds in our factsheets, but, given they are now always disclosed we want to make sure our clients can compare the cost of our solutions to those of our peers on a like for like basis. So, we prefer to show both the 'all-in-cost', which we refer to as the Investment Product Cost (IPC), and the ongoing charges figure (OCF). We recommend clients to carefully check which they are comparing.

The difference between the IPC and the OCF are the simple addition, to the OCF fee, of the transaction and additional costs.

This has brought greater transparency, but the greater detail has also created greater complexity, and need for understanding the difference between some 'costs' and 'charges', and how they are calculated.

So how does a fund calculate and report its transaction costs?

The new regulations provide guidelines on how firms should calculate and report transaction costs, but due to the complexity of financial markets there is some room for interpretation, and so too, potential misdirection.

In an effort to capture the 'real' cost of a trade the rules direct that both **explicit** and **implicit** costs should be accounted for.

Explicit transaction costs
These are costs such as:

Broker commission - the costs paid to the market to buy and sell securities:

Research commission - where the asset manager passes these on to the investor*

Taxes and levies - such as stamp duty, regulatory and exchange levies

Securities lending - the cost of borrowing or the admin fee from lending – e.g. for short selling activities.

Implicit transaction costs
Here is where the complexity starts to grow.

For example, in order to assess the impact of trading that a large buyer/seller may have, potentially moving the market against them as they 'work an order' (frictional trading costs) the authorities require some assessment of trading impact to be accounted for:

Arrival cost – this is the difference between the price at which an asset is valued immediately before an order (the arrival price) and the price at which it is actually traded (the execution price).

Consider three managers reacting to some negative news in a stock price:

Manager A reacts quickly and sells on the day of the bad news. They start selling at 100p, and finish selling when the stock hits 95p. They will have to report a cost of 5% (100p-95p/100p) on a sale price that averaged maybe 97.5p

Manager B takes slightly longer to react, perhaps to ensure they better understand the implications of the news. They start their order with the price at 95p and end up with an execution price of 94p. They will have a transaction cost just over 1%. (95p-94p/95p), for an average sale price of perhaps 94.5p.

Manager C takes even longer, selling several days later maybe with the stock beginning to bounce a little – perhaps to look even deeper into the implications of the news, or perhaps to try to sell into a bounce. They start selling at 90p and complete the trade at perhaps 92p. They will have a negative transaction cost of just over 2%, but an average sale price of perhaps only 91p.

Despite all three managers selling after the news, the manager who achieved the highest selling price and best outcome, Manager A, is considered to have the highest transaction costs. The manager that achieved the worst outcome for the clients in terms of average selling price, Manager C, would show negative transaction costs (i.e. implying, if this 'cost' is not understood, they made a trading profit to the benefit of their clients), and so look the best value.

Of course, a large manager placing a trade in an illiquid stock can move the market, even while attracting a lower fee because of the size of the trade. So, it is commendable that the authorities should try to quantify this effect/risk - a large fund driving lower fees is not necessarily a good thing. In doing so the authorities have made life a little more complicated for clients trying to compare funds, or fund-based products, on a like for like cost basis.

There are other implicit costs that now need considering too, such as 'swing pricing for a fund'. Property funds, for example, can 'swing a price' by 5% or more to ensure existing investors aren't hit with property transaction costs when a fund investor sells out, potentially forcing the fund to sell underlying assets. This is arguably a good thing if you are an investor but can make such a fund look expensive, or cheap. If the fund 'swings the price to say 95p 'bid' from 100p 'offered', on a large redemption, but then, in the ensuing days receives several smaller offsetting investments (meaning they don't actually have to sell any holdings), the 5p value of the swing accrues to the fund as negative trading cost.

Performance fees

Fund managers are often accused of adding very little value for their money (being 'closet tracker funds'), and even more criticised when they underperform. This criticism is sometimes misplaced, because a manager can lag performance wise due to simply taking substantially less risk.

Nonetheless, one way to adjust for this is to charge a lower management fee plus a performance fee, so investors pay much lower fees if, or when, the manager doesn't perform, offset by a higher fee when they do.

Accordingly, funds with performance fees tend to have higher fees (at least when the fund is performing). The average fee, of course will then depend on how good performance has been.

So, at the times when ideally you want to own more of such a fund, their fees are higher. This makes owning such funds, when they are performing, look expensive, or cheap when they are underperforming.

Outcomes matter

These examples simply reinforce our recommendation that costs alone do not tell the whole story, and, in line with FCA's approach to applying regulation to investment management, it is outcomes that ultimately matter when making investment decisions.

Transaction costs (and other charges) must always be considered, but in the context of a fund's strategy, the return being achieved, and the risks being taken – outcomes.

Transparency is undoubtedly a good thing, but more detail can also make our lives more complicated, and more confusing. Which fee, OCF or IPC is better to use?

There is no single answer. We simply recommend ensuring you compare fees, as much as possible, on a like for like basis, as is the intent of the regulation, but don't make your investment decision based solely on these either.

The value of investments and the income from them may fall as well as rise and are not guaranteed. Investors may not get back the original amount invested. Past performance of a fund is no guarantee as to its performance in the future. Changes in exchange rates may have an adverse effect on the value, price or income of the product.

enq@sanlam.co.uk

sanlam.co.uk

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