PRUDENTIAL
INVESTMENT MANAGERS

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OPINION: You Get What You Pay For

Coverage of the investment management industry over the last few months has been characterised by persistent and often excruciating arguments about the level of fees. "*Tracker funds are the future!*" scream taglines; "*Passive is the only way!*" bellow index trackers. The din is such that a casual observer might conclude the argument is over, and zero fees the only end-point.

Whilst fees paid to the manager obviously reduce the investment return earned, this myopic focus on the absolute level of fees distracts, like a magician's skilled hands, from the real trick: *after-fee returns received by the client.* This distraction is in many cases no accident. With the exception of a few respected, unfettered financial journalists many of the commentators have "*skin in the game*", and unashamedly grab media exposure to advance their own passive asset management businesses.

What is typically left unaddressed (because it does not fit the narrative) is the obvious drawback that all tracker funds (and many passive offerings) are designed to under-perform their benchmarks. That's correct: failure is built into their DNA. By definition, a fund that delivers the same gross performance as an index will underperform that index by the fee charged, so the investment outcome is guaranteed to disappoint. This would be true even in a perfect world with frictionless portfolio rebalances to track index changes. In the real world, observed net performance of such funds has been known to lag the index being tracked by more than the fees charged.

Further, these publicity-loving commentators grossly overstate the difference in cost between passive and active funds, implying that trackers are orders of magnitude cheaper. In practice, both feature a wide range of fees and expense ratios. According to Morningstar data, some passive funds cost more than the average expense ratio of ASISA general equity funds.

The emphasis on only buying cheap, with scant regard for the quality of the underlying product, is at odds with consumer behaviour in virtually all other spheres. From wine to cars to clothes, premium offerings command higher prices as long as they continue to meet the brand promise. Similarly, high-quality active asset managers will always cost more than the index-tracking competition, and will continue to prosper if they deliver benchmark-beating returns after costs.

SA investment managers are adapting to competitive market forces embracing technological developments. Operational costs are being driven relentlessly downward through technology and efficiency enhancements. Emergent tools such as Blockchain will completely transform the transaction and execution cost chain, whilst artificial intelligence will play an increasing role in aiding investment analysis and further reduce active management costs. Established managers are dedicating significant resources toward adopting these technologies and staying ahead of the curve.

Zero operating costs will, however, never be possible. Managing people's money is serious business and one cannot wish away the need for robust, accurate, dependable and auditable operating systems. Indeed, it is often in these areas where the quality of an organisation becomes evident - reliability of back office, operational governance, ability to invest in and improve operational stability, minimal error rates and the organisation's response when the inevitable errors do occur.

An established principle of behaviour is that if something is free it is not valued. Irrespective of its price tag, an item received without the investment of time or resources is less appreciated than one worked for. Saving for the future is one of the most important aspects of modern life, as governments shift the burden of future provision onto citizens and life expectancy continues to rise. The future is a very long place! The danger is that society's collective willingness to defer consumption in favour of vague future returns is undermined every time end results do not meet expectations. An unthinking take-up of passive funds simply because they are cheap potentially guarantees this unfortunate situation for decades to come.

The cacophony of comment arguing that cheap tracker funds are a panacea for all things investment-related is menacing and misleading. What is required instead is sober assessment of the characteristics of different investment vehicles, education about the long-term implications of underperformance, honest evaluation of after-fee returns and intelligent illustration of clients' progress along their personal savings trajectory.

At Prudential Investment Managers we are unashamedly active in our approach to investing - both in portfolio management and stewardship - and prepared to be measured by after-fee investment performance. We know it is necessary to be efficient and minimise operating costs, and this receives ongoing focus in the business. But we also understand that the real driver of continued success is the generation of market-beating returns so our clients can achieve their investment goals.

https://www.prudential.co.za/insights/articlesreleases/investment-management-you-get-what-you-pay-for/