

Mastertrusts take return out of risk and return

INVESTMENTS: High hidden fees take the gloss off this type of investment vehicle

BY BRENT SHEATHER

If we are to believe the marketing brochures, financial markets today are far too complex to "do it yourself". Better to delegate the job of reading those investment statements to a stockbroker or financial planner.

The administration of these investments is also increasing in importance and cost.

Many advisers employ a third party, most commonly their favourite fund manager, to undertake the overall management of each of their client's accounts via a mastertrust structure.

A mastertrust is a computer-based platform that permits investors access to a range of fund managers and unit trusts through one investment door. Many of New Zealand's largest financial planning firms base their business around a mastertrust structure. Although mastertrusts are promoted as making the administration of their investments cheaper and simpler for clients, a closer look at these products suggest their fee structures are prohibitive and what benefits there are accrue principally to the adviser.

These benefits include economies of scale in executing trades and the reporting to and billing of clients. Other advantages from the planners' perspective include the custodial function which looks after the paperwork and shields the client from mail drops from lower-cost competitors such as NZX's MOZY fund.

Mastertrusts also allow large financial planning firms to limit the products their advisory staff can sell.

While the glossy brochures boast of lower fees and the elimination of administrative hassles, these vehicles usually offer only a limited range of high-cost funds with multiple levels of fees.

In reality, most mums and dads who can dress themselves can cope with the administrative demands of a more direct investment strategy.

The cost profiles of four of the largest master funds are summarised in the table.

Buying or selling investments costs money. These costs include brokerage, commissions, stamp duty and market impact - the extent to which the price of a security is pushed up or down by a large buy or sell order.

Active fund managers turn over about 40 per cent to 50 per cent of their portfolios each year, compared with less than 10 per cent for an index manager.

This turnover adds annual transaction costs of 0.4 to 0.7 per cent of funds under management, according to Vanguard, the second largest fund manager in the US.

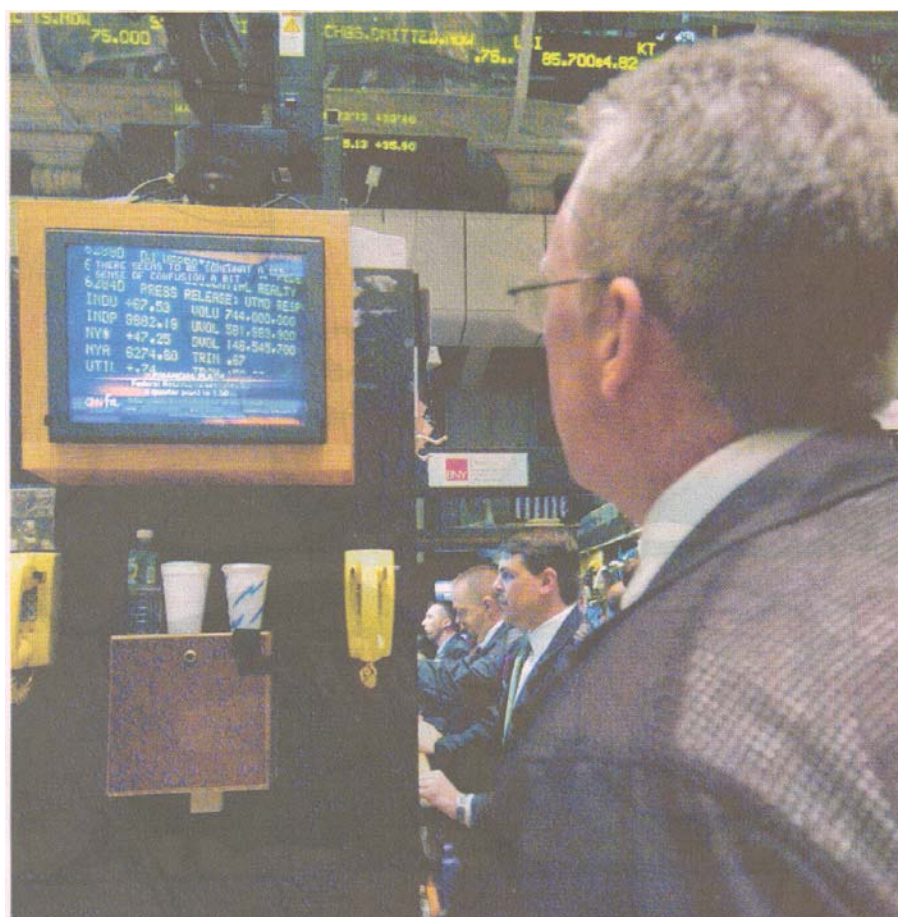
Mastertrusts were conceived some 10 years ago at a time when all the stars were aligned for financial markets and shares were regularly producing double-digit returns. However, their cost structures in today's low-inflation, low-return, environment are a luxury few can afford.

With luminaries like Warren Buffet and John Bogle warning of single-digit returns from even the best-performing asset class, equities, mastertrust fees of 3 per cent a year before monitoring or commission expenses are way too high.

One equity fund in a popular mastertrust actually had total annual fees excluding trading costs of an extraordinary 4.5 per cent. The magnitude of these charges may come as a surprise to some investors in mastertrusts as not one of the investment statements fully disclosed the annual fees.

Furthermore, several funds detailed the existence of open-ended fee structures whereby the manager "is entitled to be reimbursed for expenses incurred. There is no limit upon the amount of these expenses."

The only way to see the full extent of each fund's fee structure is to get hold of the financial statements of each trust and as this information is not handed out with the investment statement virtually no one reads it. The financial statements of the various masterfunds showed that in many cases all of the funds' income went in fees.



EXPENSIVE: Long-term nominal returns from shares have been estimated at 7.5%, assuming inflation of about 2%, so if your average mastertrust costs 3% a year to run that's almost half of your return gone.

Cost profiles

	M Trust 1	M Trust 2	M Trust 3	M Trust 4
Management Fee	1.75%	1.75%	1.75%	
Trustees Fees	0.12%	0.40%	0.05%	2.70%
Other Expenses	0.70%	0.50%	0.50%	
Turnover Costs	0.50%	0.50%	0.50%	0.50%
TOTAL	3.07%	3.15%	2.80%	3.20%

But just how bad are these mastertrust costs? A few years ago one "Fund Manager of the Year" declared that costs were irrelevant, it was performance that mattered.

Of course, his view was quite ridiculous - various studies in the US and the UK show that a managed fund's performance is inversely proportional to fees, but to put these costs into proper perspective we need to know what sort of return is likely from a balanced portfolio in the next 20 years.

If we can expect 15 per cent a year from shares and 5 per cent from the bank who cares if fees are 3 per cent or even 4 per cent? Alas, 15 per cent from shares is unlikely short term and impossible long term. Economics says that returns from shares will be equal to the dividend plus the growth rate, ie for international shares today the prospective return is 2 per cent to 3 per cent plus 4 per cent = 6-7 per cent.

The leading regulatory body of the banking and financial services sector in the UK, the FSA, last month

produced a discussion paper on what is acceptable practice as regards projections of future returns by the financial services industry.

The FSA paper refers to a document it commissioned international accounting firm PriceWaterhouseCoopers to produce and they forecast long-term nominal returns from bonds and shares at 4.5 per cent and 7.5 per cent respectively, assuming inflation of about 2 per cent.

If we use the FSA's figures plus 1 per cent for good measure, we get a pre-tax, pre-fee return from a balanced portfolio of around 6.5 per cent.

Thus if your average mastertrust costs 3 per cent a year to run that's almost half of your return gone. Mastertrusts thus effectively eliminate the risk premium - they offer investors the return of bonds with the risk of equities. Not a good look.

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