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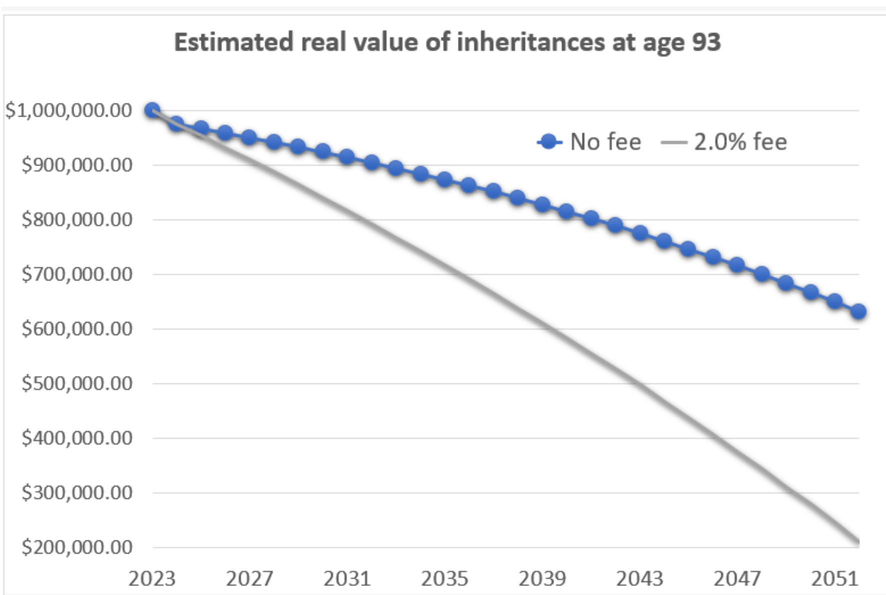
Private Asset Management Ltd

Brent Sheather is a Financial Advice Provider and a personal finance and investments writer.

QUANTIFYING THE LONG-TERM IMPACT OF ASSET MANAGEMENT FEES ON RETIREE INCOME AND INHERITANCES – Part 3



"The children of parents with managed portfolios have more reason than most to keep an eye on fees: at a 4% withdrawal rate we estimate that 2% in annual fees reduces the real value of inheritances by approximately 60%."

Source: Private Asset Management (model RINCOME)

In the first article in this series, we reviewed a paper looking at the impact of fees on how much money a retiree's portfolio will produce for them in retirement and the extent of the hit their beneficiaries will incur when the retiree moves to the next life. In the second story we analysed the fee data we needed to assemble so as to run a model which could examine those issues in a NZ context. This week we will run the model and consider the results. For a portfolio of $1m we will investigate the impact of various annual fee structures, ignoring initial setup fees and look at two scenarios: firstly, the maximum level of annual withdrawal possible, leaving no residual sum and, secondly, the impact on the residual sum, where withdrawals are fixed at $800 per week in real terms.

First off we make some further assumptions as follows:

- Asset allocation for a 65 year old newly retired investor will be 40% bonds and 60% equities, with the bonds invested locally and equities diversified over Australasian and global stockmarkets.
- Average NZ investment grade bond yield of 5.7%.
- Forecast return for equities is 8% pa.
- All investments are via PIEs. (For simplicity rather than necessarily to minimise tax and fees).
- Tax rate is 28%.

QUANTIFYING THE LONG-TERM IMPACT OF ASSET MANAGEMENT FEES ON RETIREE INCOME AND INHERITANCES – Part 3

First Scenario: Maximum withdrawal level with no portfolio value at death aged 93

	Annual post-tax withdrawal in real (2024) terms
At zero fees	$56,000
At 1% total fees	$51,000
At 2% total fees	$46,000
At 2.5% total fees	$43,000
2.5% fees and 1% underperformance of benchmark return	$39,000

The table adjacent shows that annual fees at a 1% level reduces the maximum annual post-tax level of withdrawal by 9%, i.e. from $56,000 pa to $51,000 pa. Anecdotal evidence however suggests that the average annual fee incurred by retail investors is typically between 1.5% pa and 2.0% pa. At the 2.0% level income falls by 18% to $46,000 pa. This doesn't sound like much but over the entire period of retirement fees reduce income by about $290,000 in 2024 $ terms. For more perspective on this issue estimated annual fees at the 2% level, over the 29 year investment horizon, total $360,000, also in 2024 dollars. The last permutation we look at is a combination of high fees and a 1% underperformance of benchmark returns, pre-fees. This level of underperformance can arise from poor stock selection, chasing fashionable sectors and a multitude of other poor investment decisions. In this unfortunate combination of high fees and poor returns the maximum annual post-tax withdrawal in 2024 dollars falls by 30% to $39,000 pa.

Note that all of these estimates are based on the simplistic and unrealistic assumptions that equity markets rise consistently by 8% pa and bond yields stay at 5.7%. In reality equity markets go up more often than they go down but they do fall every 6 years or so on average.

Second Scenario: Impact on residual sum where withdrawals are fixed at $800 per week in real terms

	Residual value at age 93 in nominal terms
At zero fees	$1.2m
At 1% total fees	$0.8m
At 2% total fees	$0.5m
At 2.5% total fees	$0.3m
2.5% fees and 1% underperformance of benchmark return	Zero

This scenario really highlights the impact of fees because the residual value of the portfolio is what is left over after the income needs of the beneficiaries have been satisfied. As per the table we see that after withdrawing about $40,000 a year in real terms with zero fees the residual value will be a very healthy $1.2m albeit in nominal terms ($600,000 in real terms). However at just 1% in fees, the residual value falls by a third and at 2% fees the residual value is down by 58%.

So what are the lessons that investors can take from the above? Probably the number 1 point is that fees are important. Yes, speculating as to the prospects of the latest tech stock IPO is fun whereas determining what the total annual fee you are paying to the investment community is tedious and requires some expertise. But fees are certain whereas returns are not and investors should concentrate on those investment parameters they can control. Additionally and despite the assurances in the previous article from the FMA and MBIE to the effect that "financial advisors are required to disclose fees to retail clients in a clear and concise manner", my view is that, from 40 years in this industry, many investors are oblivious to the extent of the fees they are paying and the impact these fees have on their key investment objectives. The UK equivalent of the FMA, the Financial Conduct Authority (FCA) doesn't share FMA/MBIE's confidence that consumers are getting a good deal from intermediaries. In early November it sent a letter out to the chief executives of every wealth management and stock broking firm in the UK warning them they will need to justify high fees, fix unclear disclosure and explain the value of ongoing advice charges. An excerpt from this letter follows: "We continue to see firms charging for services which are not delivered (such as ongoing advice), overtrading on portfolios to generate high transaction fees and providing a product or service which does not align with the needs of consumers (such as an expensive discretionary offering for a low-risk consumer). We are also concerned that firms are not consistently providing clear disclosures on their fees or charging structures. As a result, consumers can be unaware of high fees that significantly reduce their investment returns. In particular, we have seen firms charge high average fees and charge particular individuals very high fees. We will challenge firms to justify such high charges. Firms must also consider the value of their products and services. Too many firms are not considering all revenue streams from consumers across all aspects of the value chain. Many firms are not passing on fair interest on client money balances, despite interest rates having risen. In some instances, they also charge a fee for holding these funds which can further erode value and returns. We expect your firm to change these practices if they exist and to regularly assess the overall cost and value for money of your products and services and make changes when poor value is identified." Recent research from Lang Cat found that, subsequent to the FCA's new consumer duty rules, about 40% of financial advisers have revised their fee structures.

The extent of the impact on income and particularly residual value set out above illustrates the potential harm that is pre-occupying the FCA. Understanding what you are paying and how it impacts your financial well-being is a worthwhile exercise, particularly if you're a professional trustee with an attendant obligation or stand to inherit the residual portfolio when your parents go to heaven.

Equally all investors, particularly trustees who are paid to provide some professional oversight, need to regularly review performance by asset class relative to industry standard benchmarks so as to be able to assess how well their private bank or stockbroker is performing. Consistent longer-term underperformance can highlight important issues like high turnover, a concentrated portfolio and various related conflicts of interest. These factors can have important implications for that other critical investment dimension- risk.