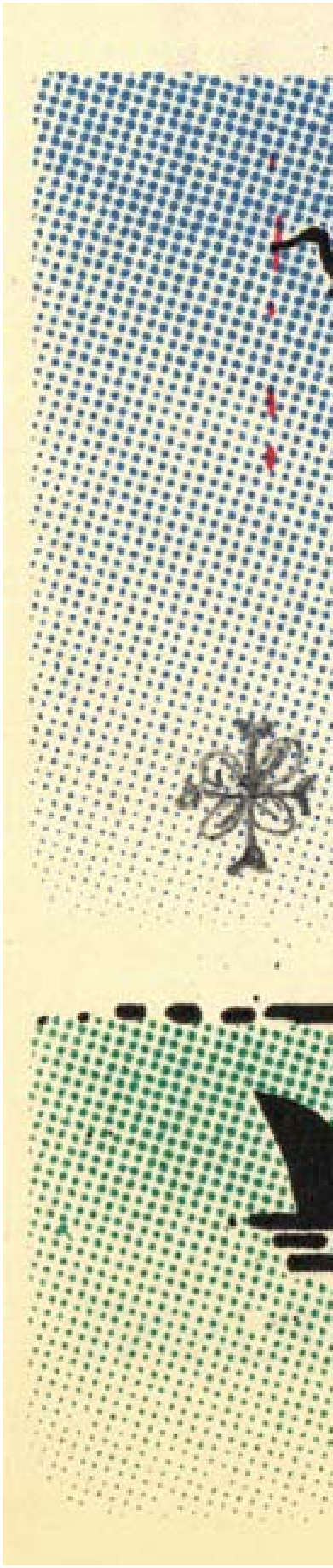
When the money you have invested is drained by hidden costs, when fund fees surreptitiously siphon away your savings, what you have is

Quiet leakage

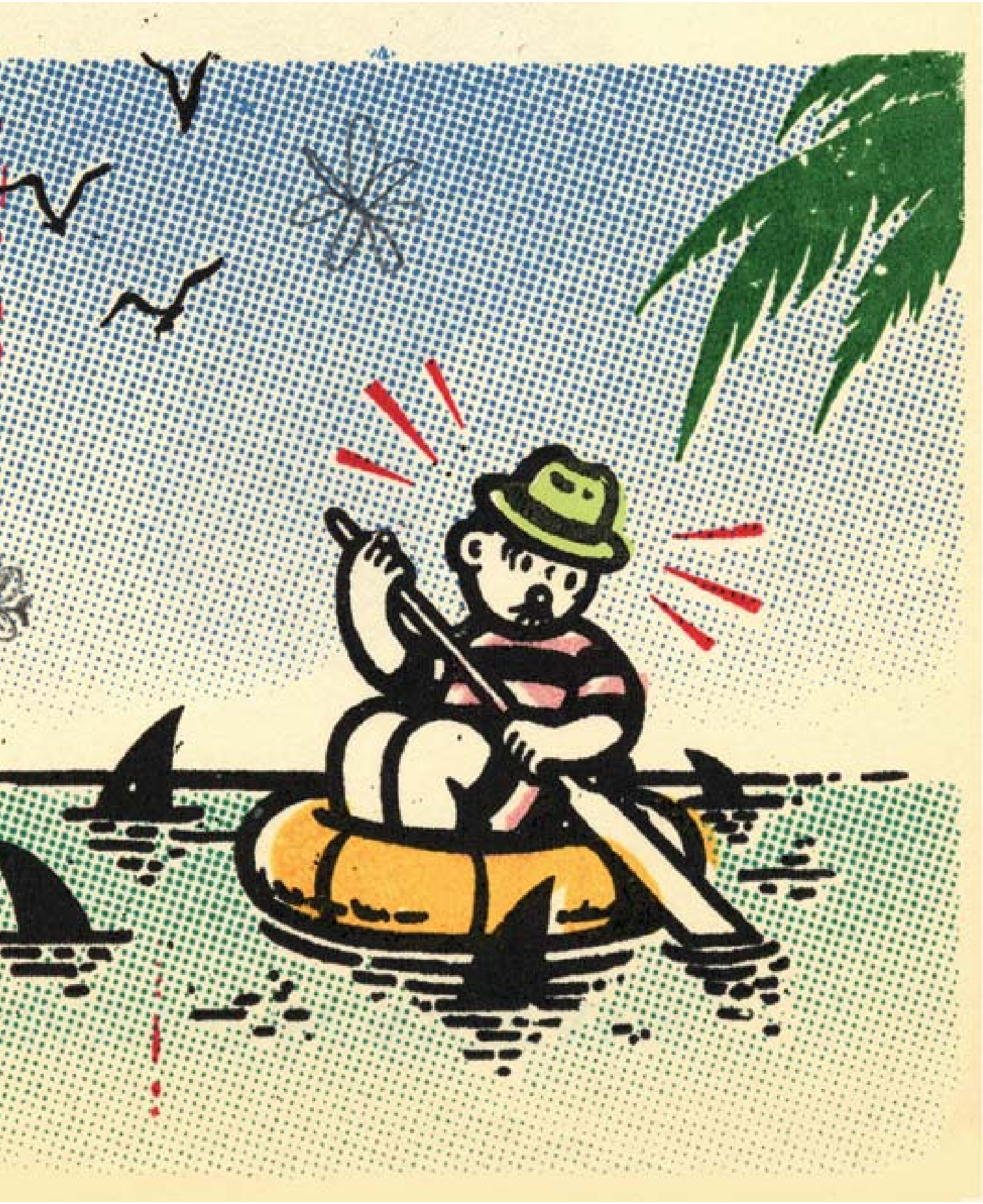
By Robert Pouliot



Fees for financial transactions are both decried and regarded as a necessary evil. They fluctuate, just like the underlying investment risk. But when they swallow up 25% to 33% of mutual fund returns in Canada, to many they become a scourge. Canada is hit the hardest by fees, which reduces the performance of mutual funds by $23 billion to $46 billion out of a total of $2.3 trillion of assets under management. This nearly invisible hemorrhage may potentially deprive investors of one-third of the capital they could have accumulated to retire.

The problem is not endemic to Canada. Financial fees cost investors the world over hundreds of billions of dollars each year. The world's supply

Illustration by GARY TAXALI



of capital has reached a record US$150 trillion. Thankfully, the introduction of numerous regulations and practices in certain jurisdictions is helping to stanch the massive flow of funds.

Canada has the highest mutual fund fees in the world, according to the study Mutual Funds Fees Around the World, updated in May 2007 by researchers from the London Business School and Harvard Business School. Compared with the US, the average management fees for equity funds are two and a half times higher in Canada. If we factor in all management and administrative fees, Canadians pay on average $2.56 per $100 invested each year, while their US neighbours pay $1.11 for the same amount.

Based on a $100 investment, on average, fees for equity funds and for bond funds are respectively 73% and 92% more expensive than anywhere else in the world. Compared with the US, the difference is approximately 130% in both cases. However, the gap really becomes significant when the impact of these fees on the potential returns of an equity or bond fund is calculated. In the case of equity funds, fees make up 25% of all potential returns, which is 83% more than the average in nine other countries (see table below). Bond funds have higher fees, which account for one-third of potential returns that are then sacrificed to a stream of intermediaries. And those fees don't include front- or back-end loads or the cost of purchasing or selling securities.

Why such a disparity? One reason is that Canada and the US are among the most protectionist countries where mutual funds are concerned. This is evident in the North American Free Trade Agreement, which does not apply to financial products. But while the US has a fiercely competitive domestic market, Canada suffers from having one of the highest levels of financial concentration in the world. Compared with investment funds in nine other industrialized countries, the additional cost for Canadians is at least 1% a year.

One dollar out of every 100 may not seem like much, but the amount becomes astronomical when we consider that Canadians hold $750 billion in long-term mutual funds. If we factor in close to half a percentage point of annual underperformance of Canadian funds due to higher transaction costs and a less liquid market compared with nine industrialized nations, Canadian investors are paying out $10 billion a year. Most troubling is that the majority of Canadians are unaware of these facts.

This has become such a serious global problem that we no longer notice its consequences. A 2006 independent study sponsored by the European Commission, entitled White Paper on Enhancing the Single Market Framework for Investment Funds, reveals that if management fees for European funds were cut to match those in the US, returns would increase 3% a year, translating into earnings of 200 billion euros, or $288 billion. Europeans have invested more than seven trillion euros (more than $10 trillion) in mutual funds.

Annual fees for a $100 equity fund

Steps 1 + 2**	$1.25	49.02%
Steps 3 + 4	0.3	11.76%
Steps 5 + 6	0.5	19.61%
Steps 7 + 8	0.55	19.61%
TOTAL	$2.55 to $3.55	100.00%
Visible portion	$2.05 to $2.55	80.39%
Invisible portion	$0.55 to $1	19.61%

** Excluding front-end and back-end loads ($3 to $6 per $100 invested), which are less frequently applied, and assuming that the adviser does not charge fees in addition to the commissions paid by fund manufacturers.

A new financial reality

These massive leakages of funds are tied to fiduciary risk, a new reality in the financial services industry. The capital market has completely changed in the past 25 years. The credit sector (commercial banks, financial leasing, factoring, etc.), which

The most expensive funds in the world are Canadian

	Expected returns (stocks)	Equity fund fees	Fees as % of expected returns	Expected returns (bonds)	Bond fund fees	Fees as % of expected returns
Canada	9.70%	2.56%	26.4%	5.00%	1.79%	35.8%
Switzerland	7.60	1.54	20.3	5.10	0.97	19.0
Netherlands	9.00	1.61	17.9	4.10	1.01	24.6
Germany	9.70	1.47	15.2	2.80	0.91	32.5
Italy	12.00	1.79	14.9	6.70	1.06	15.8
Sweden	11.60	1.68	14.5	6.20	1.07	17.3
United Kingdom	10.10	1.42	14.1	5.40	1.02	18.9
France	12.10	1.49	12.3	6.80	0.96	14.1
United States	10.10	1.11	11.0	4.80	0.78	16.3
Australia	11.90	1.17	9.8	5.20	0.63	12.1
Global average	10.38	1.58	15.6	5.21	1.02	20.6
Average excluding Canada	10.46	1.48	14.4	5.23	0.93	19.0
Comparison with average excluding Canada	-7.2%	73.5%	82.9%	-4.5%	91.6%	88.9%
Comparison with United States	27.6%	66.2%	30.2%	-2.0%	84.5%	88.2%

dominated the world's supply of capital until the early 1980s, gave way to a capital market ruled by securities (stocks, bonds, derivatives, mutual funds). They are traded, exchanged and measured on the basis of their intrinsic value and return. This industry of other people's money, based entirely on trust, is also called the fiduciary industry. But whereas the credit industry has an obligation to deliver results, the fiduciary sector's only duty is to apply proper methods. This sector rests on three pillars, consisting of brokers, financial advisers and consultants, followed by portfolio managers and trustees, and finally securities custodians and administrators. Pension funds, savings plans and insurance companies owe their phenomenal growth to all these fiduciary agents. Unfortunately, this growth has led to more conflicts of interest and the risk of undermining investor confidence by failing to use appropriate methods.

A symptom of this shift to an industry based on fiduciary risk is that since 1998, Canadian banks earn less revenue from interest than from fees for credit cards, brokerage activities, safekeeping of securities, securitization and third-party portfolio management, including mutual-fund management.

Currently, two banking institutions, RBC Financial Group and the National Bank of Canada, derive more revenue from their fiduciary transactions than from any other activity. Another sign of the times: the assets of all pension plans, mutual funds and segregated funds under management in Canada, which total nearly $2.3 trillion, now exceed the combined assets of all Canadian banks. In short, credit is increasingly becoming a secondary source of profit for Canadian banks, as illustrated so well by the mortgage loan crisis that shook the markets this summer.

Keith Ambachtsheer, director of the Rotman International

Distribution has become the most expensive link. One-third of all brokerage fees come from mutual fund sales

Centre for Pension Management at the University of Toronto and international pension-fund guru, believes that losses due to fiduciary risk affect the securities industry to such an extent that the concept of fiduciary risk should be included in modern portfolio theory, which is relied on by tens of thousands of managers worldwide. His studies, conducted in 1998 and 2005, show that better governance practices can increase pension-fund returns by 1% to 2% a year. Assuming a monetary mass of $1.2 trillion invested in pension funds of every type in Canada, this increase would represent between $12 billion and $24 billion a year. If we multiply this amount by 20 or 30 years, factoring in the compounding effect, the sums relinquished by investors become colossal.

Ambachtsheer completed a second study this year comparing the performance from 1996 to 2004 of hundreds of pension funds comprising equity mutual funds. He wanted to understand why a pension fund that invested in Canadian shares earns 3.8% more a year than a mutual fund invested during the same period in the same asset class and based on the same benchmark index. Investor credulity and the industry's fiduciary practices result in an annual shortfall of $25 billion. This lost revenue means that a Canadian investor who depends solely on mutual funds for retirement income instead of on a conventional pension fund will receive 64% to 22% less in annuities. According to this specialist, pension funds are much better than individuals at managing fiduciary risk.

"What should the government do?" Ambachtsheer asks. "Should it consider this opportunity cost a case of negligence and remind investors to be vigilant? Or is this not proof of a monumental failure of the system requiring a major overhaul?"

The reintermediation process

Where is all this money disappearing to? Into the pockets of an army of fiduciary agents who now manage two-thirds of the world's capital, estimated at US$150 trillion. Countless advisers and sellers have launched an assault on the mountain of dollars that baby boomers will have accumulated by 2010, while millions of other agents manage, monitor and trade.

To counter fiduciary risk and avoid the type of concentration that generates conflicts of interest, regulators encourage the segregation of power throughout the investment chain. The result is that the investment process becomes increasingly long and costly. Mutual funds, with their eight levels of intermediaries, are a prime example of this buildup.

Investors purchase their mutual funds through a financial adviser (1), who buys them from a mutual-fund broker (2), who obtains them from a fund promoter (3), who delegates investments on a day-to-day basis to a central administrator (4). Cash and securities are then entrusted to a custodian of securities (5), who confirms the transactions of the portfolio manager (6), who retains one or more brokers (7) to place orders on increasingly competitive markets (8). (See "Annual fees for a $100 equity fund," p. 24.)

Distribution has become the most expensive link in the chain. One-third of all brokerage fees in Canada now come from mutual-fund sales. The broker receives an annual income as long as the client keeps the fund, in contrast with directly held shares or bonds, on which fees are charged only when they are traded. As a percentage of total fees investors pay each year to maintain a mutual fund, distribution expenses vary throughout the world, from 31% in the US to 57% in Japan and 75% in Italy.

The situation is so serious the European Commission decided last year to

THE "BEST EXECUTION" RULE

This year, the rule of best execution of stock market orders is giving rise to one of the most profound revolutions in the functioning of global capital markets in the past 30 years, since the abolishment of fixed brokerage fees. This rule accurately reflects the kind of conflict generated by fiduciary risk.

For Canada, which has fallen behind the US by three years to five years when it comes to execution quality, this revolution implies the introduction, in the space of 24 months, of six new equity markets competing directly with the Toronto Stock Exchange.

This sea change will dramatically alter the habits of those in charge of pension and savings funds, managers and financial advisers. All will need to adopt new execution performance measurement tools to meet their fiduciary obligations. To make this shift possible, the industry expects to spend between $3 million and $15 million a company, not counting the overall implementation, which will cost the industry $5 billion.

These rules, which took 30 years to implement in the US and 12 years in Europe, are still the subject of consultations by the Canadian Securities Administrators, which plans to introduce them by 2009.

The broker's best execution duty is based on four criteria: ensuring the best transaction cost; minimizing the impact of the transaction on stock prices; completing the transaction within the shortest and most appropriate time frame, and making sure that no business opportunity, such as trading with the best counterparty or using the best platforms (hence the new Canadian exchanges), is overlooked.

Current Canadian rules are somewhat unclear. Although brokers trading in Canada are required to apply the best possible execution, they are not required to prove it to their clients, unlike in the US or Europe. Therefore, as they have no duty of proof, fund promoters only disclose brokerage fees, which are the tip of the iceberg of the real management costs. Visible costs represent a mere fraction of total costs. In transactions involving large-cap securities, brokerage fees represent only 12% of the total cost, or 12¢ out of $1.01. In the case of small or mid-cap securities, they represent 4.9%, or 22¢ out of $4.49.

According to the documentation available on the subject, brokerage commissions account for only $6 billion out of an annual $1.4 trillion transacted at the Toronto Stock Exchange. But if we consider the entire iceberg of fees paid by investors, it varies between $60 billion and $120 billion. According to many analysts, good fiduciary practices may save 20¢ to $1 on a $100 transaction, or even more depending on whether the security being traded is a small or large-cap stock.

tackle distribution first to reduce barriers to individual savings. However, the entire system must be overhauled, according to Jack Bogle, founder of Vanguard, a client-owned US index-fund company with more than US$1 trillion of assets under management. Bogle is the author of *The Battle for the Soul of Capitalism: How the Financial System Undermined Social Ideals, Damaged Trust in the Markets, Robbed Investors of Trillions — and What to Do About It.*

Moreover, the financial scandals that occurred from 2001 to 2003 and involved Canadian as well as US mutual-fund families that carried out late-trading or market-timing activities have shaken regulators, leading to significant changes.

The Canadian Securities Administrators, which is made up

of 13 provincial and territorial authorities, followed the lead of the US Securities and Exchange Commission in Washington. The CSA tightened market rules and accelerated the implementation of the passport system to allow an organization to register in one province and trade on markets across Canada. Canadian regulators have recently introduced the requirement, effective November 1, 2007, that mutual-fund families create independent review committees to better handle fund managers' conflicts of interest.

In Quebec, the Supplemental Pension Plans Act will require all pension funds to have a governance plan as of December 17, 2007. This plan ascribes full fiduciary liability to pension plan advisers (actuaries, consultants, managers) and requires much stricter oversight of portfolio managers.

New occupations

What can be done to plug all these holes? Shut the industry down, start over from scratch or go back to the early days of the credit sector? The implications are so enormous all stakeholders have no choice but to adopt better fiduciary practices and demonstrate that they are applying them. This opens the door to a gamut of new valuation and audit positions for accountants, actuaries, financial analysts and compliance experts, not to mention a whole new generation of members of regulatory authorities who will ensure that trustees render their services fairly, impartially and in accordance with rules. It is not surprising that compensation for compliance officers jumped by 25% last year, according to executive search firm Russell Reynolds Associates.

A number of accounting firms already offer performance audit services (Global Investment Performance Standards of the CFA Institute) and systems audit services (Section 5970, *CICA Handbook — Accounting*) to prevent manipulation of performance data and identify operating risks among custodians and trust companies. Due diligence reviews of fund managers, administrators and brokers, which traditionally were performed by consulting actuaries and pension plan advisers, are providing new opportunities for auditing, assurance and trust rating.

The purpose of an audit is to determine how a specific standard or a set of practices applies to organizations, back-office functions and information technology that serve pension plans. In the case of audits based on standards like the SAS 70, its Canadian equivalent (Section 5970) or FRAG 21 in England, the examination consists of determining whether there is internal consistency. Operational risk analyses, as performed by Amber Partners (London) and Albourne (EU) in the hedge-fund industry, are other examples of audits that are not based on recognized standards, as there is no rating or ranking, unlike the criteria applied by S&P Fund Rating, Value Line Manager Rating and Morningstar. They evaluate funds instead of their managers, especially on performance.

Certification is a service that provides an attestation of an organization's compliance with predetermined fiduciary principles in order to reduce the risk of conflict

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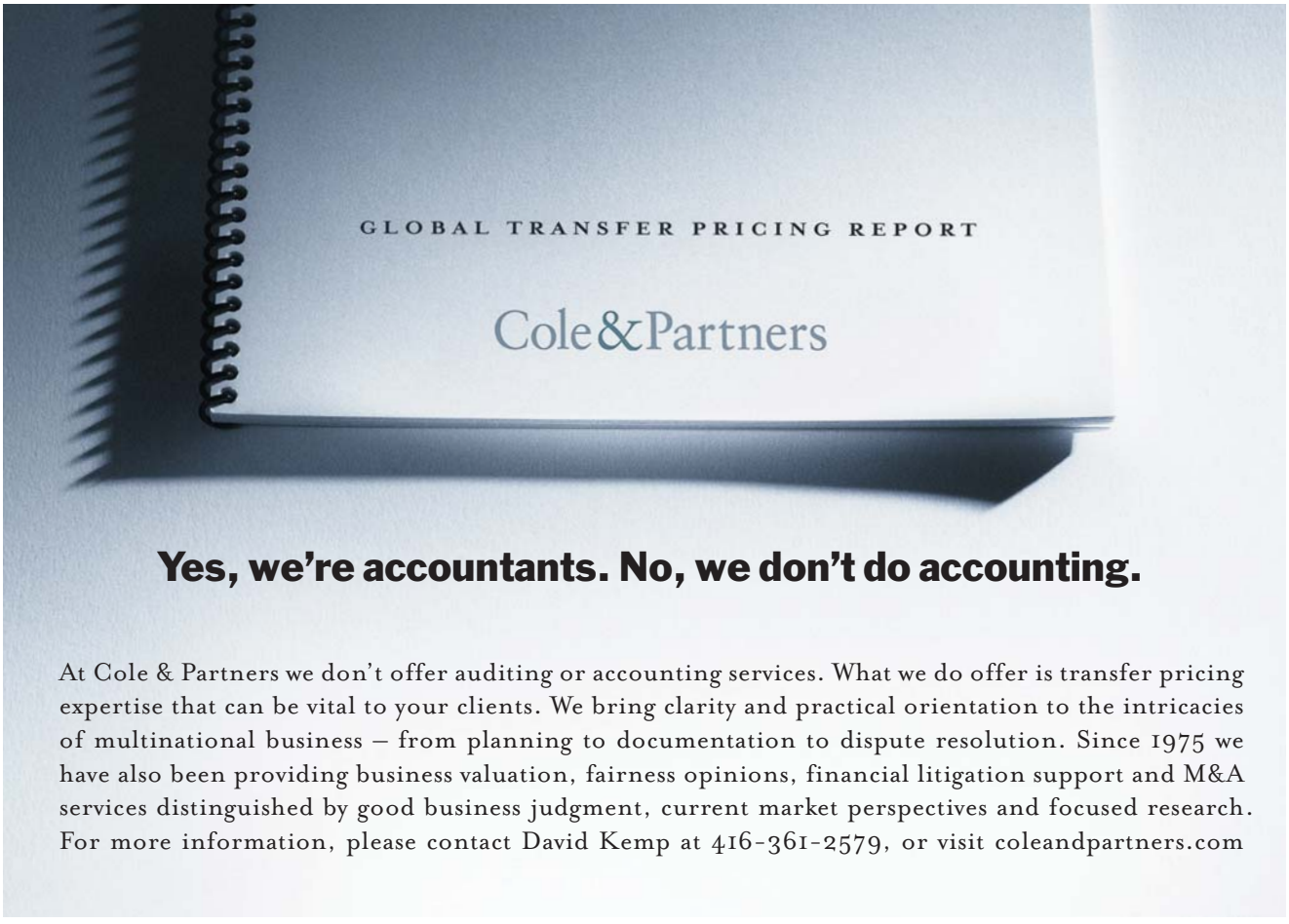
"Even when we have all the performance data, doubt will always remain on the true ability of managers"

of interest, much like ISO certification in the manufacturing and services industry. The analyst issues a compliance opinion and the certification review acts as a risk reducer. Toronto's Centre for Fiduciary Excellence (CEFEX), an international initiative, certifies investment advisers and management companies. Certification is a pass or repeat process. Managers must comply with a minimum set of practices to pass the exam.

Rating is a more dynamic process, which, as in the US, is based on principles recognized by leading professional organizations such as the CFA Institute. Ratings measure the fiduciary risk of entrusting one's money to a third party by estimating the likelihood that a management organization will stay on track. Today, the system is applied by Fitch Rating Services, Moody's Investors Service and CEFEX.

Instead of asking investors to pay for a management company's reliability check, the company bears the cost of rating, in the same way that debt issuers pay fees to rating agencies such as Moody's and S&P.

Morneau Sobeco, a Canadian actuarial consulting firm, launched a program in collaboration with numerous Canadian pension and savings plans to compare the fiduciary practices of managers. "Even when we obtain all the required performance data, including thorough attribution analysis data with a breakdown of performance components, doubt will always remain on the true ability of managers to optimize their practices to maximize returns," says Jean Bergeron, asset management director. "It's not surprising that 85% of the 242 pension funds in Canada believe that fiduciary practices have a moderate to high impact on portfolio performance." The firm believes that the classic pension fund manager selection model is becoming riskier, as evidenced by the SEC's and US Department of Labor's discovery that more than half of all large consulting firms were in conflict of interest (by charging pension funds for selecting managers and then charging those managers for inclusion on their list) and that funds using their services posted a 1.3% annual underperformance compared with funds that did not employ these firms.

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