

Products: Check your Portfolio

Managed Products – the Hidden Cost Traps

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No matter what pricing model you choose, they have all one thing in common: You only see the direct costs such as transactions costs, flat- or performance-fees. What you do not see, but pay as well, are the hidden fees and costs for the various investment products in your portfolio. These costs are called “hidden”, because most of the times neither the banks nor the wealth managers communicate them clearly to the client. The various hidden costs can easily add up to 3% of your investment amount p.a.

Following is a summary of the hidden costs generated by the main product groups:

- **Mutual funds:** When investing in a mutual fund the client has to pay an annual management fee (deducted from the invested assets), and often also a “front-load” fee, for buying the fund. Some funds charge an additional performance fee. A first indication about the costs of a fund is given with the Total Expense Ratio (TER) as published in the fund prospect. On average, the TER of a mutual fund is between 1% to 2% a year. The one-time front load surcharge can run up to 5% of the initial investment amount.
- **Hedge funds:** Hedge funds have a lot of freedom in investment decisions, and also for calculating their costs. Usually the management fee is between 1.5% to 2.5% per year. Additionally, hedge funds often charge a performance fee of on average 15% to 20% on the yearly returns as long as the performance is above the highest performance ever achieved in previous years (“High Water Mark”). Many times the wealth managers offer their clients “Funds of hedge funds” to diversify their risk. However, for this vehicle the client has to pay additional management fees and performance fees to the manager of the fund of funds. Hereby “Funds of hedge funds” can cost the client up to 5% and more per year. This is charged on top of all other fees.
- **Structured products:** In recent years, structured products have been heavily pushed by their issuers and wealth managers. Firstly, because the issuer can usually combine a direct investment in an asset class with a derivative, and then set the price himself. This makes it very difficult for an outsider to calculate the margin – and easy for the issuer to hide high costs. Secondly, because investors are easily lured by the promise of achieving above average returns at a lower risk than with direct investments. However, research shows that this is not the case overall. Rather, simple structured products still have total costs in the range of 2%-3% per year. These can easily go up to 4% and more annually

when some extra "features" are added to the product.

An increasingly popular vehicle to avoid the high hidden costs without sacrificing diversification and investment opportunities are Exchange traded funds (ETFs) and other index-based funds. These are mutual funds that are not actively managed and simply reflect a certain index of an asset class one-to-one. ETFs are very cost effective since no active fund manager has to be paid and transactions only occur when the composition of the index changes. Accordingly, the yearly costs are relatively low, ranging from 0.15% to 0.5% per year. A real alternative to funds and structured products.