

Underestimate  
the impact of  
fees

Profit

Cost



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Management

Andrew Stotz, PhD, CFA



Keep financial  
costs low

Profit

Cost

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# Learning outcomes

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- Learn the full costs of financial services
- Understand the cost difference between active and passive funds

# Learning outcomes

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- See the benefit of keeping investment cost low



# Learning outcomes

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- Remember that most people contacting you want your money
- See why it's critical to reduce taxes on investments, especially in your early years

# Low costs matter

- ★ One of the most reliable predictors of successful investment performance is the degree to which an investor keeps their investment costs low

# Low costs matter

- ★ If you keep the costs you pay to financial professionals as low as possible, you will be more likely to earn a higher return on your money than even an active fund manager could

# Low costs matter

- ★ Unfortunately, most people never even consider the fees they are paying to financial professionals



# Know your costs

- ★ Imagine you want to buy a new TV
- ★ You walk into an electronics store and see an entire wall of TVs

# Know your costs

- ★ The salesperson is there to help you, and explains why everything costs what it does

# Know your costs

- ★ They might say that one TV is more expensive because it is a new model with higher resolution



# Know your costs

- ★ Or that the smaller ones are cheaper because they do not cost as much to make and deliver

# Know your costs

- ★ By the time you leave the store, you understand what each TV costs and why

# Know your costs

- ★ And of course, if you buy a TV, the salesperson will probably get a commission from your purchase



# Know your costs

- ★ We view this commission as an acceptable source of their income

# Know your costs

- ★ The financial world is not much different

# Know your costs

- ★ Except that most individuals have no idea what fees or commission they are paying or how those fees are eating into their long-term wealth



# Know your costs

- ★ Remember: Just like at the electronics store
- ★ Nearly every person you come into contact in the financial world is going to make their income from your money

# Know your costs

- ★ Of course, financial professionals cannot work for free, but you must always be careful not to pay too much

# Never be afraid to ask

- ★ Always ask for a clear explanation of any and all fees you are charged



# Never be afraid to ask

- ★ You can (and should) ask
  - “How does this option compare to that option, in terms of fees?”

# Never be afraid to ask

- ★ You, the customer, have the right to know what you are paying for, and it is your responsibility to ask

# Never be afraid to ask

- ★ Any ethical financial professional knows it is their duty to explain the fees you are paying

# Let's look more deeply into fees

- ★ So, let's consider some fees you pay when buying an actively managed mutual fund

# Let's look more deeply into fees

- ★ According to the US Securities and Exchange Commission, there are two broad categories of expenses related to mutual funds:
  - Shareholder fees and Operating costs

# Let's look more deeply into fees

## ★ Shareholder fees

- Paid when you buy, sell, or exchange mutual funds



# Let's look more deeply into fees

## ★ Operating costs

- Fees for managing the fund, marketing and distribution, legal, accounting, and other administrative expenses

# Let's look more deeply into fees

## ★ Operating costs

- Taken each year from the amount of money you have in the fund

# Let's look more deeply into fees

- ★ If you had \$100,000 at the end of one year and the operating costs were 1%
- ★ The fund management company would deduct \$1,000 from your account that year

# Let's look more deeply into fees

- ★ If your account grew to be \$200,000 by the end of the next year, then they would deduct \$2,000 that year

# Let's look more deeply into fees

- ★ The US National Association of Investment Companies provides an excellent rundown on the mutual fund industry, completely free

**Research**



# Let's look more deeply into fees

- ★ It shows that the latest US active mutual fund's annual operating cost is about 1% of the amount you have in the fund
  - Compared to 0.14% for the average passively managed fund

**Research**





# Let's look more deeply into fees

- ★ This stark difference exists for three reasons

**Research**



# Let's look more deeply into fees

- ★ 1) Passively managed index funds only try to match the market
  - Therefore there are no costs related to researching and selecting individual stocks
  - The only costs are administrative

# Let's look more deeply into fees

- ★ 2) A passively managed index fund often focuses on investing in large companies
  - An actively managed fund may look for smaller companies that might outperform

# Let's look more deeply into fees

- ★ The search for these companies, as well as the cost of trading smaller stocks, raises the costs of actively managed funds

# Let's look more deeply into fees

- ★ 3) Passively managed index funds are often much larger than actively managed funds, allowing the benefit of economies of scale

# Let's look more deeply into fees

- ★ Besides these explicit fees, depending on where you live and where you invest, taxes can become one of the largest fees of all



# Let's look more deeply into fees

- ★ In some countries, there are taxes as high as 50% on your stock market gains

# Let's look more deeply into fees

- ★ Here's a selective list of countries that don't have a capital gains tax
  - Bahrain, Belgium, Cayman Islands, Hong Kong, Kuwait, Malaysia, Monaco, New Zealand, Oman, Qatar, Singapore, Switzerland, Thailand, and UAE

# Let's look more deeply into fees

- ★ Taxes on investments are paid mainly when you sell your stocks

# Let's look more deeply into fees

- ★ If there comes a time when you want to sell a stock, it may not be in your best interest to do so – the tax rate might just be too high

# Let's look more deeply into fees

- ★ Focus on investing money in the stock market and leaving it there, because the less you sell and trade, the less you will pay in taxes

# The long-term impact of fees

- ★ Let's consider the impact of fees
- ★ If you are paying 1% of your assets to a fund manager each year, and you paid a sales charge of 1% when you bought the fund, you paid 2% of your assets in the first year

# The long-term impact of fees

- ★ This means that if the market had a 10% return in that year, the fund manager must outperform the market and earn a 12% return just to give you the stock market's return of 10%



# The long-term impact of fees

- ★ As we have discussed in previous chapters, consistently outperforming the stock market is a very difficult thing to do

# The long-term impact of fees

- ★ Having to make up for high fees makes it even harder

# The long-term impact of fees

- ★ The best way to reduce these excessive costs is to put your money in a passively managed index fund, rather than an actively managed fund

# Passive vs active funds

- ★ Different countries have different options
- ★ For passive funds; the US is currently the leader, and they are incredibly low-priced

# Passive vs active funds

- ★ Passive funds in other countries may be more expensive, but are still usually cheaper than active funds

# Passive vs active funds

- ★ To better understand this cost difference, let's assume that the long-term return of the stock market is 8% and that you have \$1,000 to invest in a mutual fund now

# Passive vs active funds

- ★ You can invest that money in an actively managed fund that charges a reasonable 1% management fee, or a passively managed fund, which charges a very attractive 0.20% fee

# Passive vs active funds

- ★ In 30 years, the \$1,000 in the passively managed fund would grow to be about \$9,500, while your \$1,000 invested in the actively managed fund would grow to be only \$7,600



# Passive vs active funds

- ★ With the active fund you would end up with 20% less money at the end of the investment period than if you had invested in the passive fund

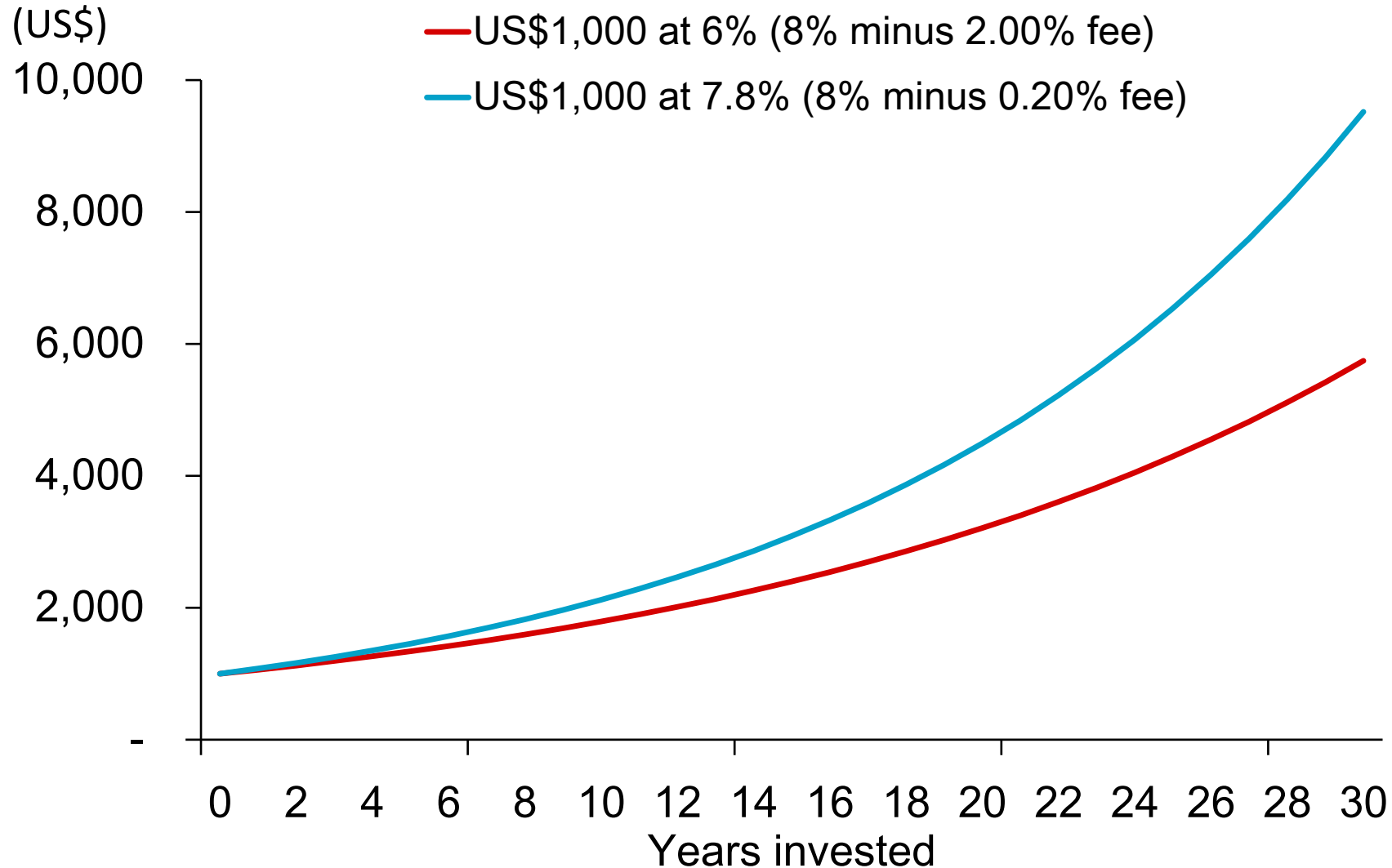
# Passive vs active funds

- ★ 1% is a very low cost for an active fund, if you put your \$1,000 in a higher cost 2% fee actively managed fund, your ending value would only be about \$5,700,

# Passive vs active funds

- ★ 66% lower than if you put your money in a passively managed fund

# Fees have a massive impact on your wealth



Steps 1 2 3 4 5 6 7 **8** 9 10 11 12

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# Passive vs active funds

- ★ Putting your money in an actively managed fund that charges fees of 1% or even 2% would not be a problem if

# Passive vs active funds

- ★ You could expect that active fund manager to outperform the market and make up for that fee

# Passive vs active funds

- ★ Unfortunately, you have already seen that this is an unrealistic expectation

# Passive vs active funds

- ★ You also now know that though there will always be a long-term outperformer such as Warren Buffett,



# Passive vs active funds

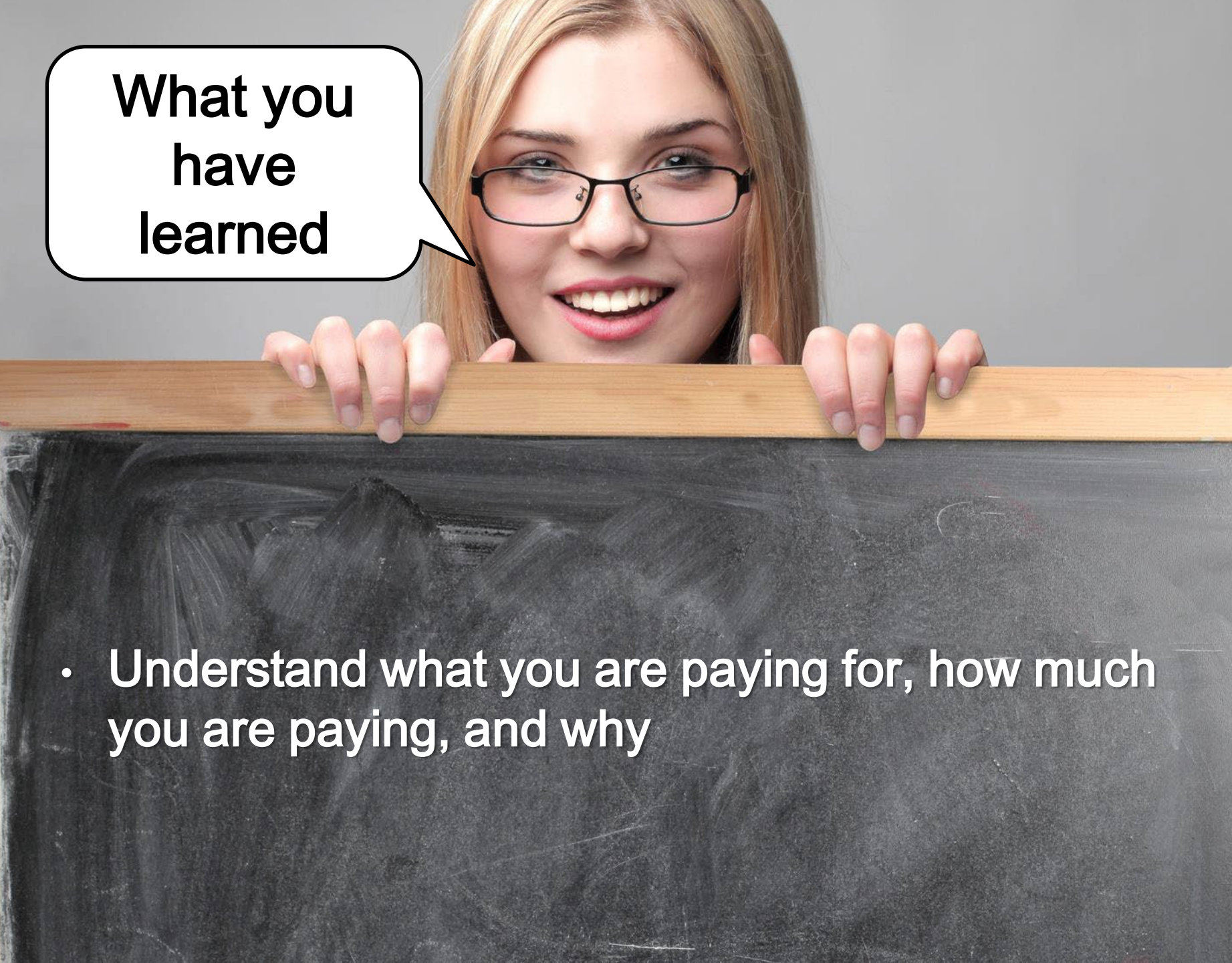
- ★ Your probability of finding him before he becomes successful is very low

# Keep financial costs as low as possible

- ★ Keep your financial costs as low as possible by investing in a passively managed index fund

# Keep financial costs as low as possible

- ★ Now you better understand how to keep your costs low and the advantages and disadvantages of the different ways to invest



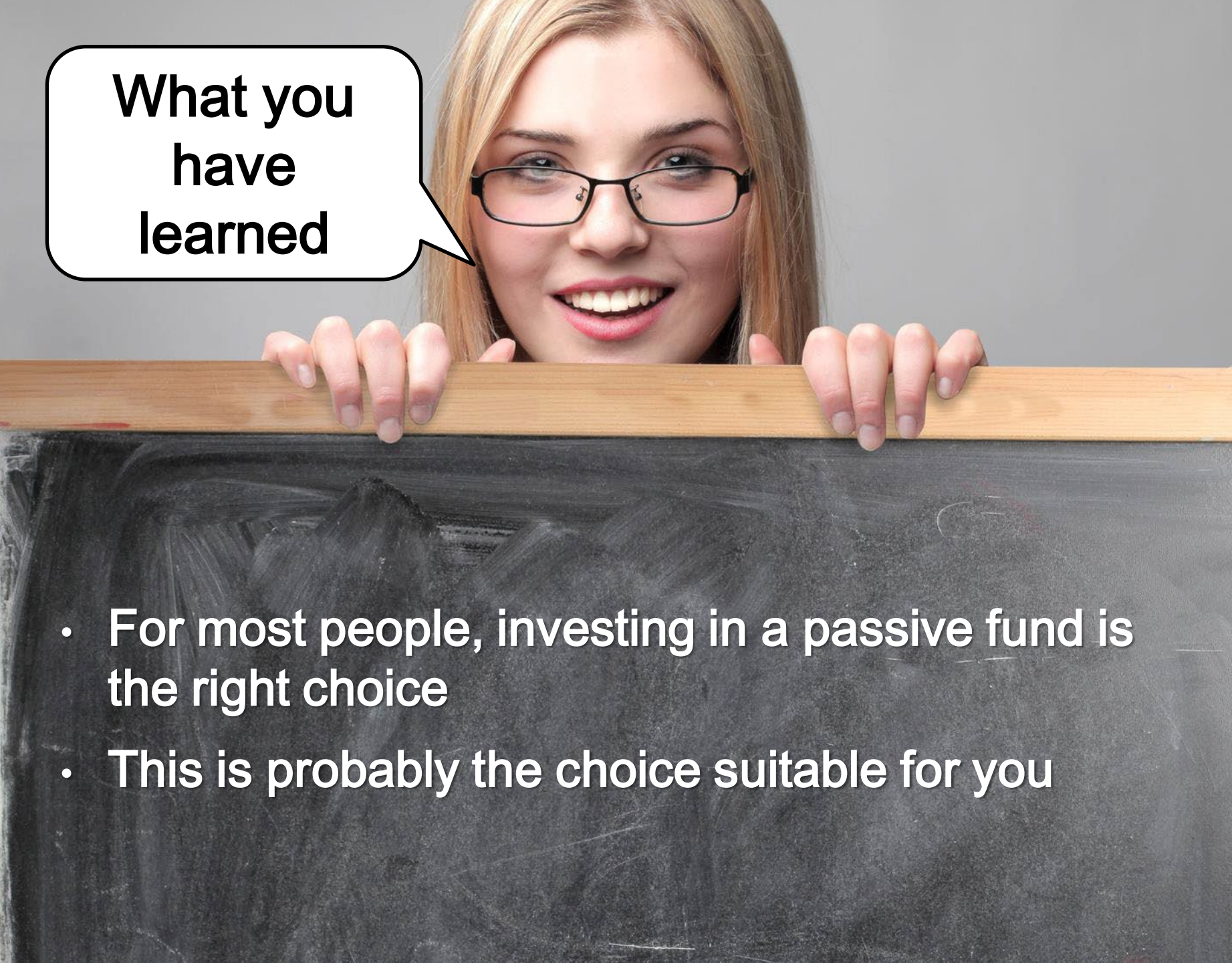
What you  
have  
learned

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- Understand what you are paying for, how much you are paying, and why






What you  
have  
learned

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- Actively managed funds can cost more than you think; passively managed index funds are almost always much cheaper






What you  
have  
learned

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- Successful long-term investment performance mainly comes from keeping investment costs low






What you  
have  
learned

- Always remember that nearly every person contacting you from the financial world makes their income from your money





What you  
have  
learned

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- Try to minimize the realization of taxes when you are young so that your money can compound for you



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