

The Definitive Guide to Investment Costs

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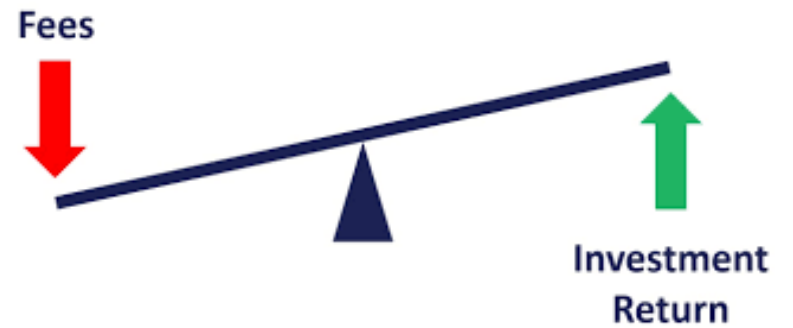
JSE Power Hour
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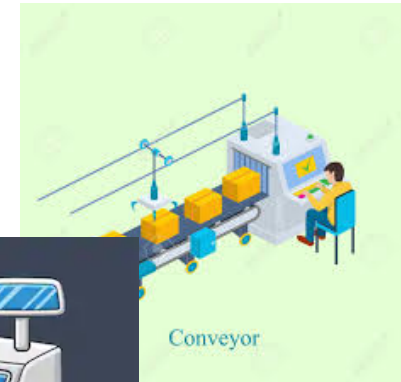
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Components of Investment Costs

- Product
- Acquisition
- Admin/Platform
- Advice
- What else?

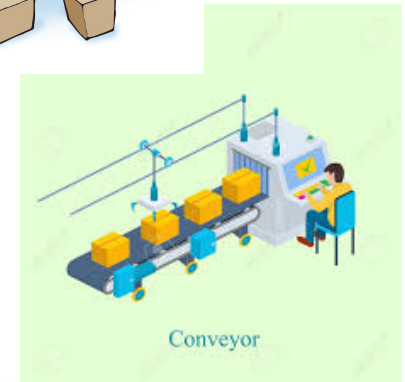


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Product Costs

- What does it cost to “produce” the investment product?
- “Produce”
 - Initial cost to create it?
 - *not my monkey, not my circus*
 - *product provider must pay*
(hold that thought...)
 - Ongoing cost to maintain it
 - TER (Total Expense Ratio)*
 - + *TC (Transaction Costs)*
 - = *TIC (Total Investment Charge)*



Total Expense Ratio (TER) - what's in it?

- **Fixed** costs

- Trustee fee; audit fee; regulatory charges; licensing fees, etc.
- The smaller the fund, the bigger this is as a % of fund size

- **Variable** costs

- ManCo fee (issuing company) – **relatively small**, and standard
- Asset management fee – **varies significantly** according to investment style, incl. active vs. index-tracking
- Performance fee – **can be significant**, especially if the 'hurdle' is inappropriate
- Index licensing fee for index tracking funds – **small**, but still

Total Expense Ratio (TER) – example

CIS (Collective Investment Scheme – *unit trust*) basics:

Expenses	CIS fund	R50m	R500m	R5bn
Fixed costs p.a. (independent of AUM)		1%	0.1%	0.01%
Trustee Fee	R 300 000			
Audit fee	R 200 000			
Variable costs (bps – based on AUM)		0.35%-1.75%	0.35%-1.75%	0.35%-1.75%
ManCo Fee	25			
Asset manager	10-150			
Total TER (%)		1.35%-2.75%	0.45%-1.85%	0.36%-1.76%

Note: only calculated after 12 months

Illustrative example

Total Expense Ratio (TER) comparison

Expenses	Actively managed CIS	Index-tracking CIS	Index-tracking ETF
Fixed costs p.a. (independent of AUM)			
Trustee Fee	R 300 000	R 300 000	R 300 000
Audit fee	R 200 000	R 200 000	R 200 000
Index calculation fee		R 100 000	R 100 000
Listing fees			R 50 000
Variable costs bps (based on AUM)			
ManCo Fee	≈25.0	≈25.0	≈25.0
Asset manager	>>10.0	10.0	10.0
Index tracking license fee		2.0	2.0

*Index-tracking ETF should be the most expensive...
...but it is not!*

Illustrative example

Total Expense Ratio (TER)

Top 40 ETFs		
ETFs	Basis points	(%)
<i>Satrix 40</i>	10	0.10%
<i>Ashburton Top 40</i>	15	0.15%
<i>Sygnia Itrix Top 40</i>	16	0.16%
<i>Stanlib Top 40</i>	29	0.29%

Source: ProfileData; etfSA.co.za from ETF Issuer fact sheets, Feb-19

Targeted TER

How does that work?

- ETF is launched with an intended (**target**) TER
- **Daily** pricing of ETF accrues **1/365th** of target TER
- At the end of one year (365 days) the **actual** TER will **equal** the **target** TER
- In terms of **actual** costs incurred:
 - ETF **issuer receives** the accrued amount of expenses
 - ETF **issuer pays** the actual costs
 - ETF **issuer subsidises** the shortfall

Total Expense Ratio (TER)

Average Total Expense Ratios (TER)		
ETFs	Basis points	(%)
<i>Satrix 40</i>	10	0.10%
<i>Ashburton Top 40</i>	15	0.15%
<i>Sygnia Itrix Top 40</i>	16	0.16%
<i>Stanlib Top 40</i>	29	0.29%
Average of all local ETFs	31	0.31%
Average of all local Index-tracking Unit Trusts	73	0.73%
Average of all SA General Equity Funds	154	1.54%
Source: ProfileData; etfSA.co.za from ETF Issuer fact sheets, Feb-19		

But the TER does not include all the costs!

Adding Trading Costs (TC)

Expenses	Actively managed CIS	Index-tracking CIS	Index-tracking ETF
Fixed costs p.a. (independent of AUM)			
Trustee Fee	R 300 000	R 300 000	R 300 000
Audit fee	R 200 000	R 200 000	R 200 000
Index calculation fee		R 100 000	R 100 000
Listing fees			R 50 000
Variable costs bps (based on AUM)			
Manco Fee	≈25.0	≈25.0	≈25.0
Asset manager	>>10.0	10.0	10.0
Index tracking license fee	2.0	2.0	
Trading costs	medium-ultra high	low-medium	minimal

Level of activity determines the amount of trading costs

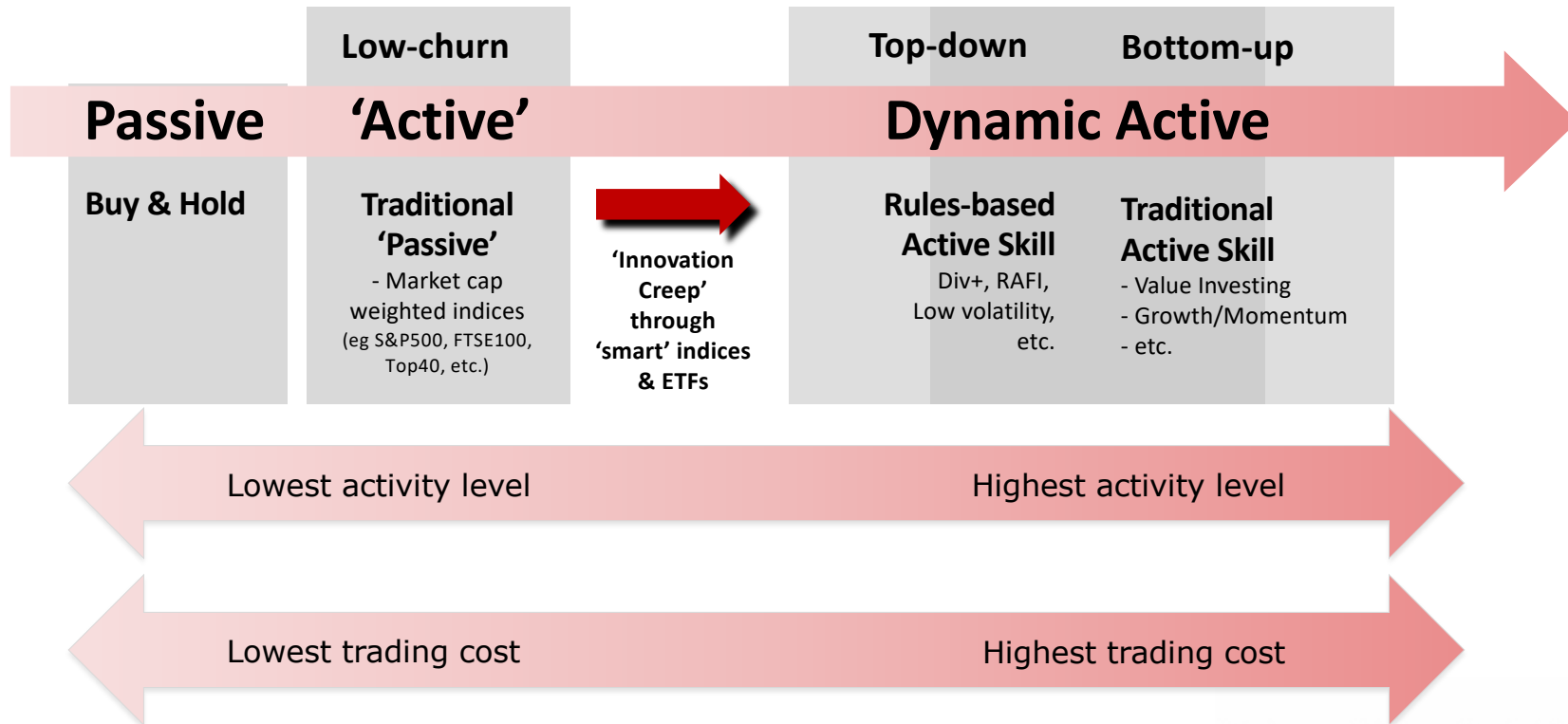
Illustrative example

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All Investing is Active...

...but the level of activity varies



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The Activity-Cost Gradient

Passive

costs less than

Active

The Activity-Cost Gradient

Buy & Hold Passive

costs less than

So-called **Passive**

costs less than

Active

doesn't exist

The Activity-Cost Gradient

Buy & Hold Passive
costs less than

So-called **Passive**
costs less than

Rules-based Active
costs less than

Traditional **Active**

doesn't exist

'smart' beta



But TIC is not the full story! What else affects “product costs”?

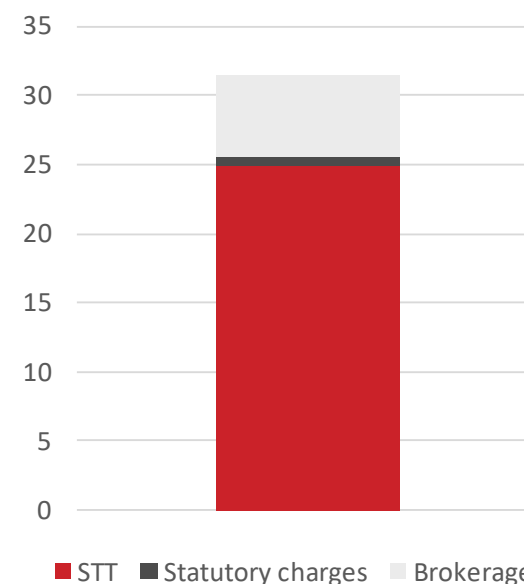
- Cash flows!
- New investments into the fund
requiring the creation of units
or
- Withdrawals from the fund
requiring the redemption of units

Primary market operations

How big is impact of cash flows?

- What does it cost to invest R100m in the All Share Index at 5bps brokerage?

Basket of ALSI shares	
Gross investment amount	R 100 000 000
Brokerage (5 bps - 0.05% + VAT)	R 57 500
JSE fees & levies	R 6 855
STT* (only buy)	R 250 000
Net investment amount	R 99 685 645
Total cost of investment (bps)	31.1



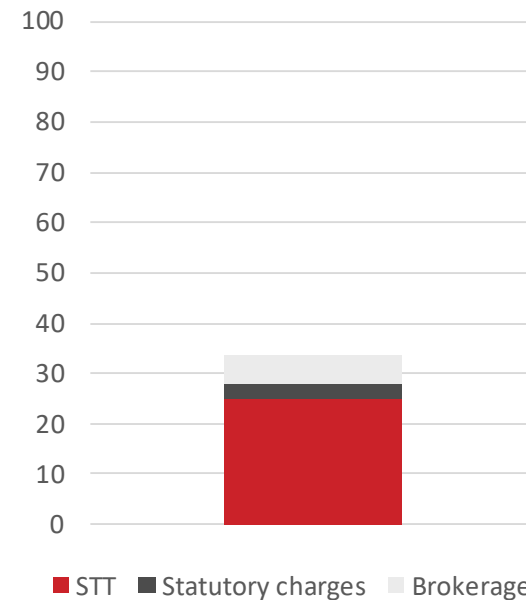
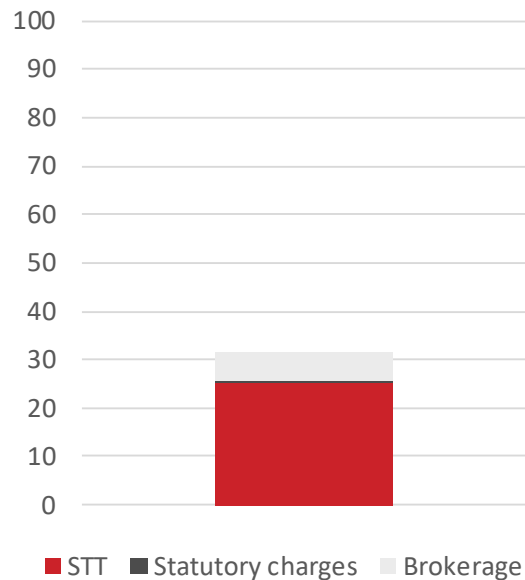
* STT: Securities Transfer Tax = 0.25% non-negotiable

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How big is impact of periodic cash flows?

- R100m lump sum (31.1 bps) vs. 4 flows of R25m each (33.6 bps)



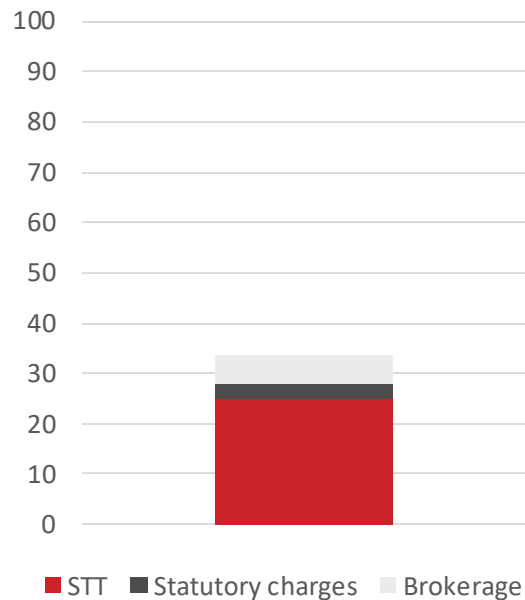
Source: JSE / Strate data; etfSA calculations

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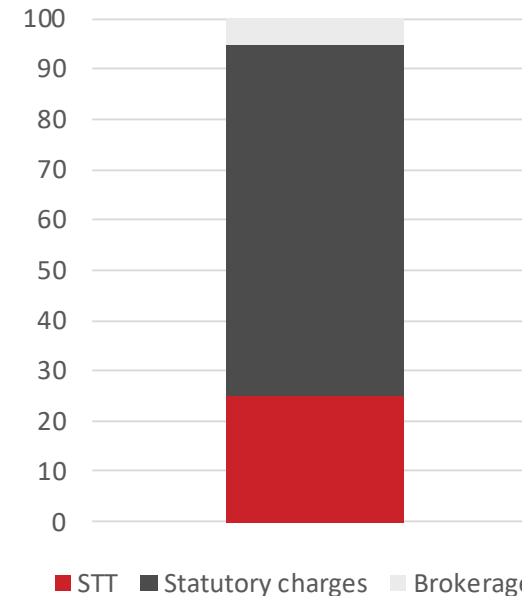


Small, frequent periodic cash flows have significant cost implications

- R25m lump sum (33.6 bps) vs. 5 flows of R5m each (100.8 bps)



It all comes down to the number of 'hits'



Source: JSE / Strate data; etfSA calculations

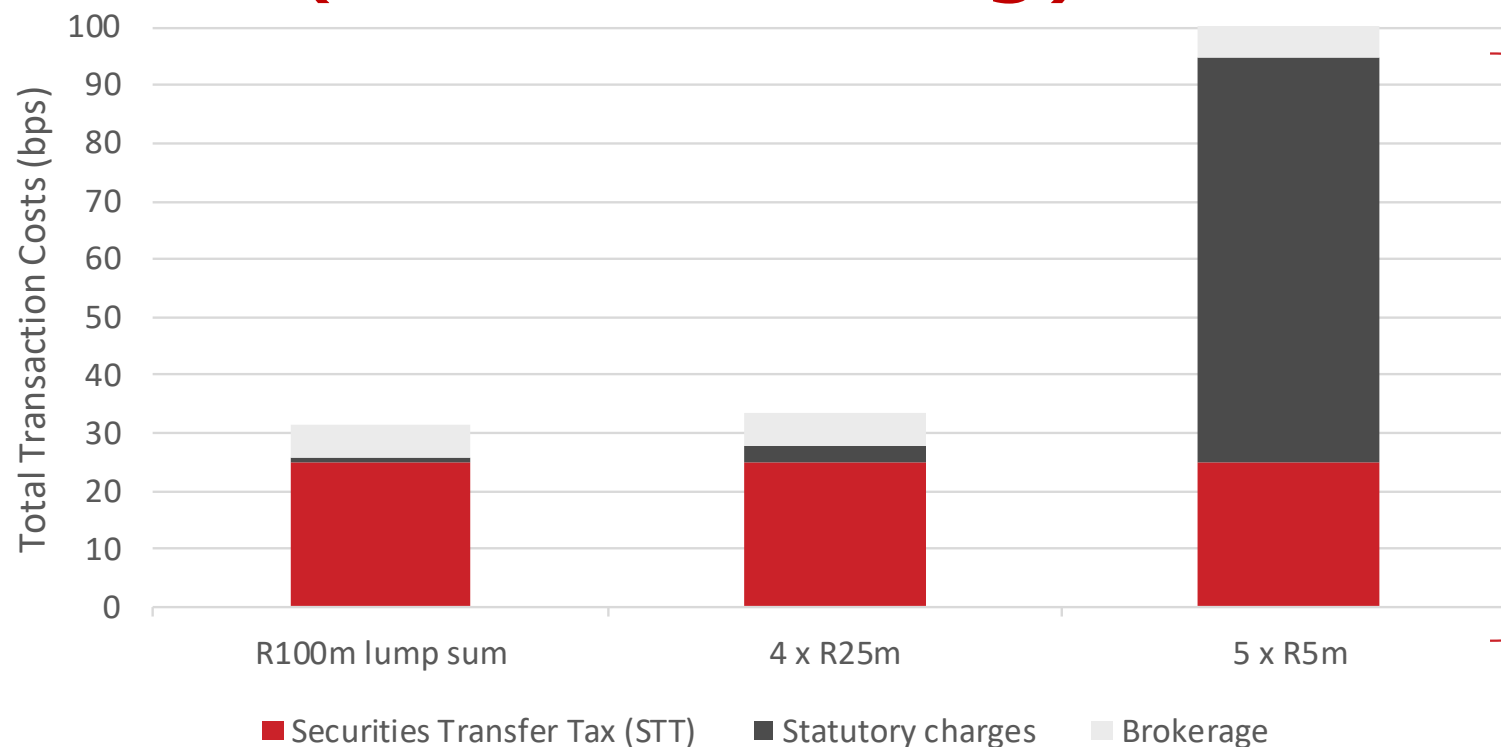
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Who pays for this? (primary market operations)

- CIS (unit trust)
 - It is deemed a **capital** event
i.e. it is not included in the TER or the TIC
It reduces the NAV, so affects performance over time ☹
 - All existing / remaining **investors**!

Impact of cash flows on (index tracking) unit trusts



The costs of investing daily cash flows are not included in the TER or TIC, but negatively affect the NAV price

Source: JSE / Strate data; etfSA calculations

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Who pays for this? (primary market operations)

- CIS (unit trust)
 - It is deemed a **capital** event
i.e. it is not included in the TER or the TIC
It reduces the NAV, so affects performance over time ☹
 - All existing / remaining **investors**!
- ETF (Exchange Traded Fund)
 - Done by the market maker on behalf of ETF provider / issuer
 - Costs are incurred **outside** the fund
 - Costs are absorbed by the **issuer**, not by the investors

Let's observe the evidence

Why does an index-tracking unit trust underperform an ETF, from the same issuer, that track the same index?

- For example – three years to 8-Apr-19 (*source: ProfileData*):
 - **Satrix Top40** ETF(A): **7.29%** p.a. vs.
Satrix 40 Index Fund(A1): **6.85%** p.a. (0.44% p.a.)
 - **Satrix RAFI40** Total Return ETF(A): **11.19%** p.a. vs.
Satrix RAFI40 Index Fund(A1): **10.63%** p.a. (0.56% p.a.)
 - **Satrix Divi+** ETF(A): **13.24%** p.a. vs.
Satrix Dividend+ Index Fund(A1): **12.75%** p.a. (0.49% p.a.)
- It's all about the **trading costs** associated with investment flows – depends on
 - Frequency and size of cash flows
 - Churn (turnover) rate

Final thoughts on TER

- You **can't avoid** it
- You **can't negotiate** it
- BUT you can **choose lower** costs
 - Consider cost of making a change (rather deploy new money)
 - Beware of switching "penny-wise / pound-foolish"
- TER is **not a cash flow** expense (you won't see it in rands and cents in any investment statement)
- TER is **already in price** that you pay
THUS, it affects your **returns**

Acquisition Costs

- Transaction costs
 - Initial buy
 - Reinvestment of dividends (after DWT*)
 - Selling / switching
- What are the components
 - Trading costs, incl. brokerage & statutory charges
 - Bid-offer spread
 - Possible CGT**



* DWT: Dividend Withholding Tax = 20%, non-negotiable

** CGT: Capital Gains Tax = max 18%, non-negotiable but variable

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The cost of a DIY share portfolio

- Buying & selling 40 individual shares rather than 1 ETF is a LOT more expensive...

	Basket of Top 40 shares	Top 40 ETF
Gross investment amount	R 100 000	R 100 000
Brokerage (0.5% + VAT)*	R 575	R 575
JSE fees & levies**	R 443	R 11
STT (only buy)	R 250	
Net investment amount	R 98 732	R 99 414
Total cost of investment	1.3%	0.6%

* *etfSA.co.za* brokerage is only 0.08%+VAT – less than R1 per R1,000

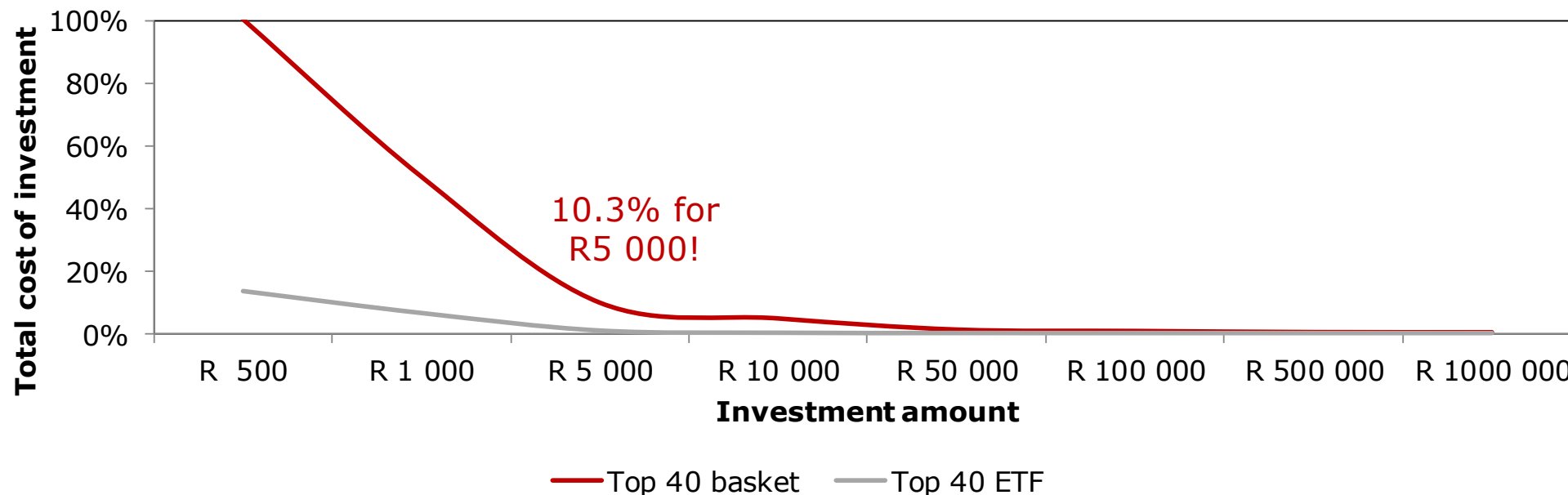
** *Statutory charges are shared amongst all investors on the day due to bulking*

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The cost of a DIY share portfolio

- ...especially if your investment amount is relatively small (retail investors)



Acquisition Costs

Different cost models

- Percentage, e.g.
 - etfSA.co.za: 0.092%
 - EasyEquities: 0.2875%
 - Standard Bank OST*: 0.575%, subject to MFC**
- Minimum fixed cost
 - SB OST: R57.50 per trade
 - Negotiable if you trade >R500k p.m.
- Withdrawal fee to your bank account: R4.56
- Transfer of portfolio: R60.42 per share holding **ETC.**

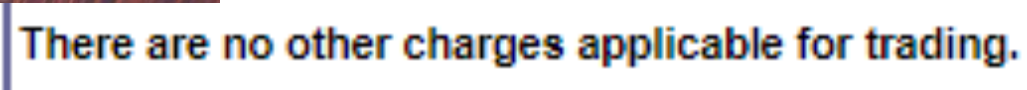
All fees incl. of VAT

** Online Share Trading*

*** Minimum Fixed Cost*

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Acquisition Costs

PPF* Model

- Are you investing R500 or R50,000 or R5m?
- Are you buying 5 ETFs or 50 shares?
- Are you compounding (reinvesting distributions)?
- Are you a trader or an investor?
- Do you have itchy fingers or are you patient with your process?
- Compare different models based on your behaviour

** Personalised Pro Forma*

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Acquisition Costs

Indirect costs

- Bid-offer **spread** (also known as the “**double**”)
 - Difference between buying & selling price – **market maker** “fee”
 - Mid of BBO* = NAV**
- Beware cents vs. % – which spread is **bigger**?
 - 245-255
 - 5700-5800
 - 39000-41000
- Beware “**blind**” trading
- **Mitigate** this by dealing with an **ETF specialist** platform



* *Best Bid-Offer*

** *Net Asset Value*

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Admin / Platform Costs



- % vs. fixed **cost base**
 - % – you are **subsidising** small investors
 - Fixed cost – **not suitable** for small investments
- Beware **requirements**: No monthly / annual fees **IF** you maintain a minimum balance, **OR** trading often enough
- **What else** does it give you?
 - Research? Price feeds? Analytics? Information? Education?
 - Automation, e.g. debit orders, reinvestment of dividends
 - Better execution (trading) than DIY?

Admin / Platform Costs

- Beware “zero fee” offerings – where else are they making their money?
 - It is certainly **not zero cost** for the provider!
 - **Regulatory** charges are unavoidable, incl. safe-guarding of your assets and information, reporting (also to you)
 - Systems; People; Marketing; Overheads... *#Eskompllicated*
- What is **fair**?
 - Determine what is **valuable** to you
e.g. personal client service vs. hi-tech
 - Don't be **naïve**
 - Calculate what you pay in **Rands**, then decide



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Advice Costs

- AUM*-based or flat fee
- Could be incl. in platform fee, but only if **licensed** to do so
- Is the adviser / advice “**fit-for-purpose**”? i.e. specialist in what you need
 - Investments (ETFs, shares, etc.)
 - Insurance
 - Financial planning
 - “Personal trainer”
 - *Commission-earning, blood-sucking leech you’ve never met*
- “Investments should be **bought**, not sold” – Buffett



* Assets Under Management

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What else?

- **Performance** fees
 - *Why pay for the performance someone else got in the past?*
- **Debit order** costs
 - R300 p.m. debit order @ R3 d/o fee = 1% PER MONTH
and you were worried about 5 bps difference in the TER?
- **Tax** – is it a cost?
 - It is unavoidable, but it can be mitigated
 - Make use of tax incentives before discretionary investments (share trading, unit trusts, ETF portfolio, etc.)

All-In Cost Model

Tax-Free Investment Account

- 1% all-inclusive
- R33,000 investment = R330
- Includes*
 - VAT = R43
 - Transaction costs = R137 DIY (or R62 expense to FSP**)
 - Reinvestment of distributions = R679 DIY (or R69 for FSP)
- Cost of DIY = **R859**
- Fee earned by administrator = R78 p.a.
- **Fee earned by FSP = R78 p.a. = R6.50 p.m.**

* Assume 4 ETFs, 4% DY paid quarterly, 0.25% brokerage rate for DIY

** Financial Services Provider

All-In Cost Model

Managed Portfolio Service

- 1% all-inclusive
- R1m investment = R10,000
- Includes*
 - VAT = R1,304
 - Transaction costs = R5,805 DIY (or R1,205 expense to FSP)
 - Reinvestment of distributions = R2,204 DIY (or R1,101 for FSP)
 - Admin = R828
- Cost of DIY = R10,141
- Fee earned by FSP = R5,562 p.a. = R463.50 p.m.

** Assume 5 ETFs, 4% DY paid quarterly, monthly account fee*

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Glossary of other TLAs*

Retirement savings; Insurance-based products

- **EAC** – Effective Annual Cost
 - Investment management
 - Advice
 - Administration
 - Other costs
- **RSC** – Retirement Savings Cost disclosure standard
 - Standardised method of disclosing costs to employers or trustees who want to compare umbrella funds
 - Not aimed at individual members, but rather decision makers
- **RIY** – Reduction in Yield
- **IRR** – Internal Rate of Return

* *Three Letter Acronyms*

In conclusion

- Know your **costs** – it **matters**, a lot!
- Understand what is **unavoidable**, what is **negotiable**, and what is **unnecessary**
- Focus your efforts on where to be **MAD***
- Don't be **naïve** about claims of “no fees” or “zero costs”
- Still not sure what to do?

Invest with the “ETF specialists”

** Make A Difference*

Don't be a
cheapskate
with your investments

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Question time



For ETF and index investment insights and news, follow me on Twitter: [@Nerina_Visser](#)

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