Investment fees: could you be paying less?

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There is a continuum of investment advice available to Canadian investors. Generally, the more services and advice an investment advisor provides a client, the more he or she needs to be compensated. And the more individual investors are willing to research and execute trades on their own, the lower the cost.

Discount broker fees
Many older investors may have started out using a full-time stock broker or a mutual fund salesperson. Interestingly, these two models illustrate the two main ways investment advisors are compensated even today. The old-time stock-broker typically made money on transactions: every time a stock was bought or sold, he or she earned a commission. This commission once was much heftier than the $10 per trade (or less) that discount brokerages charge do-it-yourself investors today. I recall the days when I used a full-service broker and would typically pay commissions of close to $200 on a $5,000 trade.

Mutual fund fees
Full-service commissions still exist, but generally the industry has attempted to shift to an "asset-based" model whereby they earn annual fees based on a percentage of the client assets under management. This is quite similar to the second model: mutual fund salespeople. In the early days, mutual funds were sold with upfront sales charges of as much as 9% of the initial purchase price of the fund. So, for example, if you wanted to buy $1,000 worth of a particular fund, you'd pay $90 commission on the trade (just like on a stock) so that, in effect, only $910 was actually invested in the fund units. There would also have been a small annual investment management fee.

Today, it's common to buy mutual funds with zero per cent upfront charge, but the annual management expense ratios (MERs) have typically risen to somewhere between 1.5% and 3% a year. Just as common are so-called "rear-load" or deferred sales charge (DSC) funds. You can avoid triggering redemptions charges on these funds by remaining with them for the duration of a six- or seven-year schedule, but these funds will typically carry higher annual MERs (between 2% and 3%). Either way, roughly half goes as compensation to the advisor and half goes to the investment managers running the fund.

Wealth management fees
The wealth management industry practices merely another version of this model. Investment counsellors may provide portfolios of individual securities or (more often these days) of exchange-traded funds (ETFs), and levy annual fees that may run anywhere from 0.5 to 1.5% (or more) of the client portfolio. Depending on the managed amount – perhaps $500,000 or $1 million – this annual fee may be "tapered" down.

So-called wrap accounts or wrap programs work in a similar fashion: all investment management and associated services (including custodial and trading fees) are "wrapped" into a single service, with an asset-based fee that's typically between 2 and 3% in Canada.

Is this a lot to pay? If you have no expertise in security selection and no particular interest in following the markets on a day to day basis, then you may have little choice but to pay this. The stock market can inflict nasty losses on those unprepared to do the necessary legwork or to delegate it to a professional. On the other hand, with interest rates still hovering near all-time lows, I'd say 3% is a high price to pay at least for the fixed-income portion of a portfolio.

How little is it possible to pay?
Well, true do-it-yourself investors at discount brokerages could pay close to zero if they choose to buy quality dividend-paying stocks and hold them long-term. You could, for example, pay $10 or less for each of a handful of Canadian bank stocks, a few telecommunications or utility stocks and blue-chip US tech or consumer stocks, collect the dividends every year, reinvest them through a dividend reinvestment plan (DRIP) and pay almost nothing in subsequent years: except perhaps annual administration fees of $100 or so. Remember, there is no "MER" on individual stocks. But if you prefer a diversified portfolio, you could buy ETFs that might charge somewhere between 0.1% and 0.55% a year in MERs: much less than the 1.5% to 2.5% typical of mutual funds sold in Canada.

As noted in my previous blog post, the light-advice or robo-advisor model will come out roughly half way between the extremes of a full-service offering and the do-it-yourself stock investor. You can also find firms that will help you assemble portfolios of ETFs or even actively managed “F class” mutual funds, and provide full-service advice for perhaps 1% a year on top of the underlying fund fees. This is the asset-based model described earlier but it’s also possible to use a fee-for-service financial planner and pay by the hour (or project) for financial planning help associated with a discount brokerage account through which you’d conduct your own trades. Personally, I find the latter route the best combination of reasonable cost and helpful advice but as a financial journalist, I spend a lot of time monitoring markets and also have the advantage of being able to call up any number of experts when I need help on a particular issue.

As a rule of thumb, I’d say 2.5% to 3% is on the high side, 1% to 1.25% is reasonable if you want some help but are willing to do a lot on your own. If you really want to shave all-in costs below 1%, be prepared to do your own research, execute the trades, monitor and rebalance at least once a year. Do-it-yourselfers can also get expert help from newsletter services. To get help finding the best newsletters, refer to Mark Hulbert’s Hulbert Financial Digest, which ranks some of the best U.S. and Canadian investment newsletters. Many of these can be found at your local library.

If you’re new to discount brokers, they will make available representatives to help and the sites often feature user-friendly videos. Call it “ultra-light” advice!

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