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You don't eat alpha, you eat total returns

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Comparing TER's – it's not all that simple

Total expense ratio (TER) is the new buzz term in investing. Well, maybe not so new anymore, but still buzzing. The widely used, much talked-about, vigorously discussed and diligently compared three-letter acronym.

I would like to start with a question. Do you know the mark-up price on the pair of jeans you bought last week? Or the latest iPhone your teenage daughter bought (while you are still stuck with your iPhone 8… but that's a different topic for another day)? Or how much the GP put in his pocket after your check-up last month? Or the gross profit the farmer made on the watermelon you bought at the grocer?

Or asked differently – do you compare the mark-up price on the BMW or Mercedes Benz when purchasing some new wheels? And while I am way past one question, please allow me a final one – do you make your final decision based on how much profit the manufacturer is making on you?

I don't expect many affirmative answers to the questions above. Yet, when it comes to investing, that is exactly the first thing being prioritised nowadays. The predominant driving factor motivating long-term personal investment decisions, ranking third in certainty behind the formidable death and taxes.

Now, don't get me wrong, I am a big fan of the TER. Unless your surname is Zuckerberg, Bezos, Musk, or Buffet, you are very likely to keep a close eye on the price you pay for something. The TER is a useful tool in telling you how expensive an investment is (well, historically at least, but that's also a topic for another day).

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Its real power is when comparing two products that are very similar to each other. If both money market funds are yielding 5%, you'd be a fool to pay more for the one over the other. But that's about where the power ends. After that, things tend to get difficult and distorted.

Let us get back to my car comparison above. You wouldn't just buy the cheaper one between a Beemer and the Merc, would you? You need to compare the two first. Engine size, top speed, interior design, fuel consumption (a biggie these days!) are among the things you first look at. If, by some miracle, you do know the mark-up percentages on both cars, do you buy the one with the smaller gross profit? Well, perhaps not, because it depends on the bang you are getting for your buck. What do you do if the Beemer is quicker, better-looking, more economical and oozes style, yet it has the higher mark up? Would you still go for the Merc? It's not simple.

This may all sound a bit whimsical. Your money, and where you invest it is serious business and so is what you are paying for it! Let's get serious then.

Compare apples with apples

How do you determine the correct level of fees on an investment? There is, of course, no simple formula or answer to that. It depends on various factors – some quantifiable, and others that are harder to quantify. There are, however, some basic, simple steps to follow that can help you to determine whether you are paying the right price (or better even, the wrong price) for your investment.

There are three main components that make up the return on an investment – the market return (beta), the excess return (alpha), and the risk it took to generate that return.

All things being equal, an investor should be prepared to pay more for something that has the potential to produce higher returns. Cash, being the ultimate risk-free investment, produces the lowest returns over time. Bonds tend to yield more than cash, and equities more than bonds, over longer periods of time. Hence, a rational investor should be willing to pay the highest fee for equities, less for bonds, and the lowest for cash.

The second component of performance is the excess return. This is the extra return over and above the benchmark a manager is able to produce, called alpha. This is the lifting being done by the manager. The lifting done by the asset class (the market) is called beta. Again, all else being equal, an investor should be prepared to pay up for something that produces excess (extra) returns.

The final component of the return on an investment is the risk profile. It does not influence the visible return number, but it influences the risk (and experience) for the investor. This explains how much risk the manager is taking in order to generate the return. Risk is mostly invisible if you only look at single numbers, like a yearly return. It doesn't show how volatile, or risky, the returns were over that year. The higher the risk, the better the chance that the returns miss the target. There are a few mathematical equations quantifying this risk – from standard deviations to volatility to Sharpe and Sortino ratios.

Staying with a rational investor, he or she should be paying less for something that has a higher risk profile, within the same product category all else being equal. Take a simple example. Fund A delivers 0.8% consistently each month to end the year +10%. Fund B has a very erratic return profile, but also ends the year at +10%. The diagram below illustrates the relative riskiness of Fund B versus Fund A. As a paying customer, you should demand a lower fee on Fund B or be prepared to pay a higher fee for Fund A. Graph 2 below shows how there should be an inverse correlation between dispersion of returns and fees.

Fund A		Fund B	
Monthly	Cumltve	Monthly	Cumltve
0.8%	100.80	5.0%	105.00
0.8%	101.61	-6.0%	98.70
0.8%	102.42	10.0%	108.57
0.8%	103.24	-15.0%	92.28
0.8%	104.06	12.0%	103.36
0.8%	104.90	3.0%	106.46
0.8%	105.74	0.0%	106.46
0.8%	106.58	-7.0%	99.01
0.8%	107.43	-6.0%	93.07
0.8%	108.29	15.0%	107.03
0.8%	109.16	2.0%	109.17
0.8%	110.03	0.8%	110.01

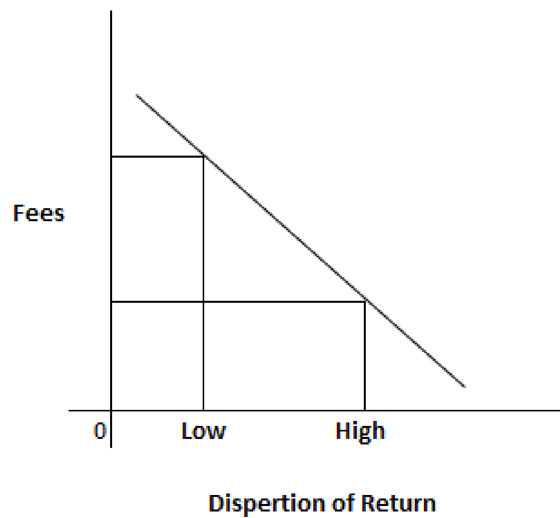
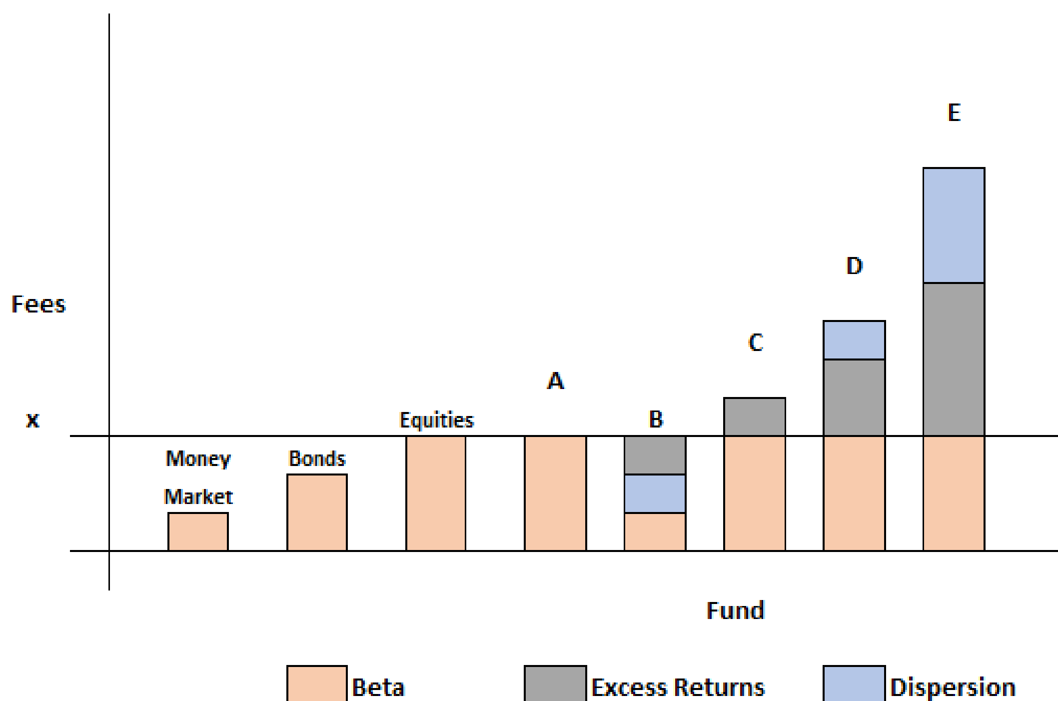


Table 1 **Graph 1**

To compare fees between different products and different asset classes, you need to standardise the fees. That means you need to come up with a way to make the fees directly (or more closely) comparable. Without this, you are comparing apples with oranges. One way to standardise fees is to combine the three components discussed above. The return on an investment is therefore made up of the beta + alpha + risk.

Graph 2 below illustrates this standardisation of fees. You start with the expected long-term return of the market, or the beta. The departure point is to be prepared to pay more for products and asset classes that have the potential to yield higher returns into the future. Next, add the potential excess returns the manager can generate above the benchmark or market. The only way to determine this is to look at the past performance of the manager. Although past performance is not a guarantee of future returns, one should be able to spot a trend. If a manager has consistently underperformed the benchmark, there is a high probability that he or she will continue to do so. Inversely, if a manager has a track record of beating the benchmark on a regular basis, this should give them good odds of beating the benchmark going forward. You can expect to pay more for consistent outperformance.

The final part of the equation is to look at the volatility of the past returns, or said differently, the dispersion of the returns. This is a very good measure of how much risk the manager has taken in order to generate the returns. As a leopard never changes its spots, so fund managers seldom change their risk appetites. Therefore, chances are good that they will continue on the risk path they have been on. The logic is quite simple when comparing similar products – pay less for more risk.



Graph 2

So, armed with this knowledge an investor can now start to standardise returns between different funds, asset classes and managers. Continuing on Graph 2, let's aim to standardise fees on five different equity funds.

Fund A gives exactly the same return as the market, taking exactly the same risk. There are therefore no excess returns, and the fund is no riskier than the market. Knowing that financial markets are efficient and have determined the "right price" for equities (let's take that to be x), an investor should not pay more than x for this fund.

Fund B performs below the market, i.e., detracts returns from the benchmark, and demonstrates a higher level of risk in doing so. An investor will be in a very unfortunate position if they pay the same as Fund A, or the market, for this fund. In fact, there is a strong argument to be made that an investor should demand to pay less than x for this fund.

Fund C, whilst taking the same risk as the market, can generate a small amount of outperformance, and should be able to command a slightly higher fee than x.

Fund D can generate even more alpha and actually does so by being less risky in the process (compared to the market and the first three funds). Being less risky increases the attractiveness of the fund. This fund should be in an even better position than Fund C to command a fee in excess of the market price of x.

Fund E is the rock star of the industry and produces the most amount of alpha, even taking the least amount of risk. Investors should expect this fund to be charging the highest fees among its peer group.

Whilst still not down to an exact science, this process of standardisation should go a long way to assist an investor in comparing the "priciness" of a fund's fee.

Higher fees are not necessarily a bad thing

Over the last few years investors have increasingly focused on the fees they have been paying on their investments, and rightfully so. Trustees and institutional investors have aggressively negotiated for fee discounts. The evidence suggests that they have been very successful, as fees have steadily been lowered across the industry.

However, have investors perhaps taken a rather simplistic approach to reducing fees – one perhaps fraught with adverse selection biases and unintended consequences? Take the hedge fund industry, for example. Some investors are bluntly refusing to pay 1% and 20% on these products, for any manager, let alone anything higher. They will simply pass on the opportunity if the manager is not willing to lower fees. Unfortunately, this eliminates some of the best products and return opportunities out there.

Any product must be competitive on either quality or price, and more often than not, on both. As an example, in any highly competitive industry with thousands of participants and low barriers to entry, a buyer will certainly be looking for the most competitive price for the item they're after. Why pay more for the same thing? Asset management is certainly no different. It is a highly competitive industry, so searching for the lowest cost provider in a commoditised beta world makes perfect sense. In this highly efficient market, the difference in quality between high-cost and low-cost is extremely low, as is often seen by the tight dispersion of returns between top and bottom quartile performers.

This same decision is counterintuitive, and even counterproductive, when searching for alpha generators. Evidence suggests that hedge funds do exhibit persistence of returns over time, as well as significant dispersion between top and bottom quartile managers.

So, one can hardly expect a manager that truly demonstrates an alpha edge to give it away cheaply. It is a high-quality, high-value service. Rather, one should question the practice of selling true alpha at a significant discount to the competition. It's perfectly irrational to expect the highest-quality provider (true alpha generator) to also be a discounter (beta provider/asset gatherer).

Not surprisingly, recent research from Preqin indicates that the managers who generate the strongest returns net of fees charge some of the highest fees. Preqin has found a direct relationship between the annualised returns over several time periods and the performance fees of hedge fund managers. Those firms generating the strongest net of fee returns do in fact charge the highest performance allocations. More interestingly, when volatility is included, the results are the same again. Managers with a higher performance fee generated better risk adjusted returns than lower-cost managers.

This was also confirmed in a recent study by Barclays. They examined annualised returns between 2019 and June 2022 of about 40 multi-manager funds overseeing an average of $7 billion of assets, and 250 traditional funds with an average of $2 billion. They concluded that firms that charge the most – often the industry's biggest names – tend to produce better returns over time than less expensive competitors.

Citywire also echoed the same message in a publication earlier this year, concluding that not all expensive funds are poor. Just as not all cheap funds are good.

While simply searching for the lowest-cost manager clearly makes sense in commoditised beta space, knowingly taking a portfolio tilt away from the highest alpha generators when seeking alpha does not. Now this is not to say that investors should not seek to reduce fees and access the highest-quality managers at the best possible price point. Instead, investors should take a more subtle approach to seeking access to the most desirable return streams as efficiently and cheaply as possible.

Christopher M. Schelling, Professor of Finance at the University of Kentucky, perhaps paraphrased it best: “In the end, you don’t eat alpha; you eat total return.” Nominal fees are meaningless. Fees relative to the level of risk-adjusted returns and alpha generated, are what counts. Disentangling alpha and beta is admittedly difficult, so fees relative to net-of-fee total returns are also important.

In the final analysis, cheap is not necessarily good and expensive is not guaranteed to be bad.

Glacier Research would like to thank Werner Prinsloo for his contribution to this week's *Funds on Friday*

Werner Prinsloo

CIO and Founder of X-Chequer Fund Management

An actuary by training, Werner's career-path crossed over into investments at an early stage; a passion that started at a young age.

Initially part of the management buy-out to establish Fairtree Capital, he went on to start X-Chequer Fund Management in 2007. The firm has been successfully managing alternative and traditional funds for over 15 years, with the flagship X-Chequer Market Neutral Fund having been nominated for and winning numerous awards over the years.

He has been applying his craft in the hedge fund space for almost 20 years. Apart from his analytical skills, his training in risk management has blended into an investment style and approach that have stood the test of time throughout all market conditions over the last two decades.