Cazenove Capital

Value for money

A practical guide and some thoughts on a framework for assessing the fees charged by your investment manager.

Part of the Schroders Group

"Fees in investment management are remarkable in a significant way: nobody actually pays the fees by writing a cheque for an explicit amount. Instead, fees are quietly and automatically deducted by the investment managers and, by custom, are stated not in dollars but as a percentage of assets."

The Rise and Fall of Performance Investing, Charles D. Ellis, CFA, 2014

August 2017.

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The fees charged to charities by their investment managers are in the spotlight. However, there is no common approach or methodology for reporting or looking at them. Fees are often bundled or estimated, leading to a difference between those stated and those actually paid. In an era of low interest rates and low global growth, precious basis points of positive returns can be eroded through fees.

The introduction of European financial regulation, MiFID II, requires companies providing investment management services to be more transparent than ever about the fees they charge.

But even then, Trustees will need to ensure they are getting the best value for money out of their investment managers.

Kate Rogers, Head of Policy, and Giles Neville, Head of Charities at Cazenove Capital, have run a series of working groups with a collection of charity representatives from all backgrounds addressing this topic. Amy Browne, Portfolio Manager at Cazenove Charities, summarises their findings and sets out some practical insights to guide your way through the process of assessing value for money.

About the contributors

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Head of Charities

Giles is Head of Charities at Cazenove Capital, having joined Schroders in 1987. After the acquisition of Cazenove Capital by Schroders in 2013, Giles assumed responsibility for the combined charities team, with 25 employees and more than £8 billion of charity assets under management. Giles holds an MA in Economics from the University of Cambridge and is a Chartered Fellow of the Institute of Securities and Investment. He sits on the Investment Committee of a Cambridge College.

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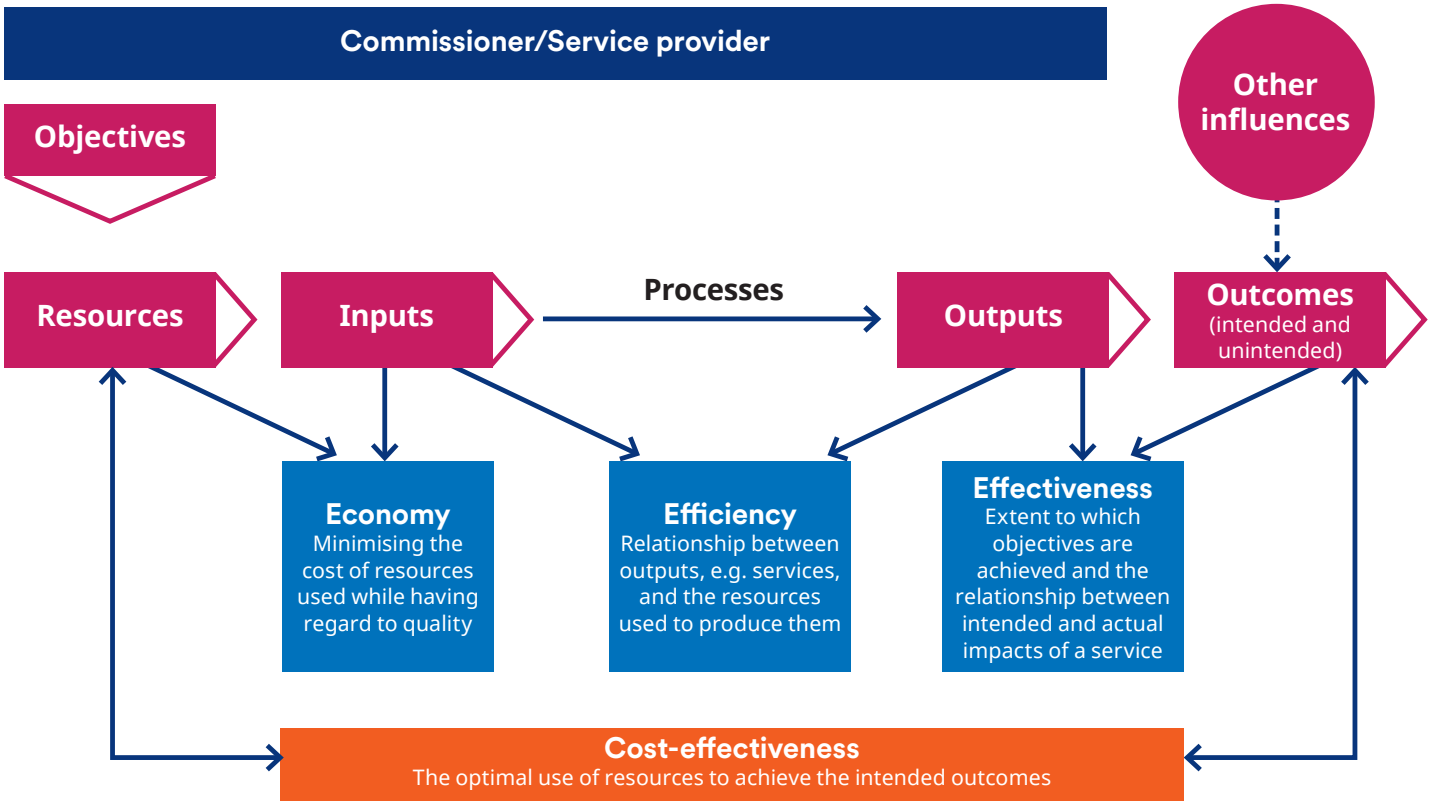
Executive Summary

What exactly is value for money and why is it important?

Good value for money is the optimal use of resources to achieve the intended outcomes. It is not about achieving the lowest price.

The National Audit office has produced this chart, which maps out how it assesses value for money in the sphere of public spending.

The image is complex but the message is clear: **appraise the money you are spending in light of the outcomes you wish to achieve.**



In the following pages, we explore the ways in which trustees can assess the value for money offered by investment managers. We will also highlight a number of insights that are designed to help trustees frame an assessment process. These are distilled in the concluding pages and are intended to help trustees to find the right approach for their charity.

What became abundantly clear during our research was that although there are a number of common themes, opinions varied widely as to the acceptable level of fees that investment managers should be charging. For a typical inflation +4% mandate, this varied from a total charge of 0.7% to 1.5%. On the other hand, there is one point on which everyone agrees: trustees across the board feel that the fee charging process is too complicated and unnecessarily opaque.

We hope that this paper will clarify some of the misgivings around the topic and provide a guide to assess what you should be paying for and whether you are, in fact, getting good value for money.

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Some questions for trustees to consider:

What are you paying your investment managers to do?

What are you trying to achieve with your charity's assets?

How much would you be prepared to pay for a target return of inflation +4%?

If better off net of fees, does the outright fee level matter?

What are the measurable and unmeasurable outcomes you expect to see?

Is it worth paying for active investment management?

1 Appraise outcomes relative to your objectives

Setting objectives

As a charity investor, the best place to start is with your objectives: **What are we trying to achieve with our assets?**

If your charity has investments, it should have a written investment policy[1] that sets out what it is aiming to achieve with those investments. Apart from demonstrating good governance, a written policy provides a framework for making good investment decisions and managing resources efficiently.

Appraising outcomes

In applying resources to the objectives (i.e. paying a fee), how can you best assess whether your manager is achieving them? Have in mind a list of outcomes that you would like to see demonstrated.

At a minimum, investment objectives should cover the following criteria:

Objectives		Outcomes
What level of return are you aiming to achieve with your investments?	**Return**	Are your long-term growth and return targets being met? Are you able to fulfil your financial aims?
How much volatility are you willing to take to achieve your return objectives?	**Risk**	Are you keeping within your stated risk tolerance? Are the trustees content with the level of volatility? Are your risk and return targets consistent?
How much money do you need to keep aside for spending obligations and how easily will you want to access your investments on a day-to-day basis?	**Liquidity**	Do you have enough cash? Can you access your portfolio when you need it? Do you have an appropriate level of liquidity?
For how long do you want to invest and what is the time horizon for these investments?	**Time**	Are you on target? Has anything changed?

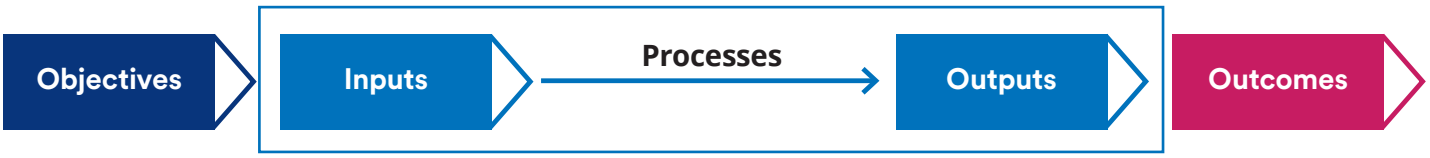
If you feel that your objectives are being met, or even if there has been a constructive conversation about these issues, then you can feel assured that your manager is giving proper consideration to your circumstances. But are you getting good value for money? And if your objectives are being achieved, does the amount you are paying actually matter?

1 Writing your charity's investment policy: A guide, Charity Investors' Group, CFG

2 Paying for much more than just performance

What are you paying your managers to do?

Between identifying your charity's investment objectives and listing the outcomes you wish to see, what exactly is involved?



According to our feedback, the primary outcome that trustees are looking to achieve is good risk-adjusted performance. This was expressed in a number of ways:

Performance

Growth of **income** and **capital**

Protect from **inflation** and **increase** the capital

Long term **growth**

Better **performance** than the **peer** group

Outperformance of a benchmark

Generating a good level of financial return is clearly an important objective. However, identifying good performance is only part of the solution; finding individuals or firms with whom the institution can build a long-term relationship is often equally important.

This is a case in point when it comes to changing managers. Investment committees consider changing their managers for all sorts of reasons and it is unusual that a patch of poor performance is the only factor. Grounds for changing managers vary from consistently poor returns, to persistent breaches in investment guidelines or problems with the overall quality of service. Equally, if the services they offer change – perhaps they no longer offer custody, investment advice or cash management – then this can also be a prompt to seek an alternative option.

These reasons point to the multiplicity of roles that you are paying your investment managers to carry out in return for a fee. Put simply, the services provided by your manager go far beyond simply picking good investments.

What are you paying for?

The services of one investment manager are not necessarily the same as another. It is worth understanding what services are included within the portfolio management charge and what may incur additional cost (for example dealing or custody). Managers should be clear about what they can and can't offer; for example the provision of advice is a regulated activity and one that not all charity investment managers are able to offer. This is important as the Charity Commission guidance on investment (CC14) is clear that trustees must 'take advice from someone experienced in investment matters unless they have good reason for not doing so'.

Equally, some managers are better than others at stewardship, engagement and the provision of responsible investment – services that may have value to your organisation.

Services	Charge
Investment management	– Portfolio management charge, plus VAT – External and in-house fund fees, where applicable – Performance fees, where applicable
Implementation	– Commissions paid to the manager – Commissions paid to the broker through whom any trade is executed – Front end charges for applicable funds
Custody and administration	– Custody fee (custodian may also be your investment manager) – Collection charges for income payments and for tax reclaims – Foreign exchange transaction fees when currency is exchanged to purchase or repatriate proceeds from investments overseas
Others	Often included in portfolio management charge: – Advice on strategy and positioning, including risk management – Stewardship, engagement and responsible investment services – Policy advocacy – Meetings and reporting – Trustee training and events – Publications and relevant material to keep trustees up to date on salient issues

Trustees must 'take advice from someone experienced in investment matters unless they have good reason for not doing so'

Charity Commission, CC14

3

Don’t simply focus on measurable outcomes

Value for money – what can we measure?

- Return
- Risk
- Cost

What is less easy to measure?

Provision of safe custody

Provision of good advice

Implementation of effective dealing

Provision of timely, clear and accurate financial reporting

Provision of helpful day-to-day service

4 There is no zero cost option[2]

Active or passive? Self-managed or outsourced?

The answer to these questions will have a material impact on the fees you pay. However, it is important to note that there is no zero cost option. Even the cheapest index trackers will charge a fee and there will be a cost to owning them via a platform, including fees for custody and administration. You will, therefore, achieve market returns, but less a margin.

Typically, the cheapest passive funds will start at about 0.05% p.a. These will usually be replicating very large, liquid, easy to access markets such as the UK FTSE 100 or the US S&P 500.

The more illiquid, bespoke, complicated or obscure, the more expensive passive funds become. This includes emerging markets, commodities and ethical passive funds, which can charge as much as 1.00% p.a.

Passive

Passive management or index tracking is an approach that aims to match closely returns of a specified market index. An index fund may hold all the securities in the particular index or apply a mathematical model to purchase a sample of securities that will perform as closely as possible to the index. The job of the manager is one of replication.

Active

Active management is where an investment manager selects securities that are designed to beat, rather than match, the return from a market index or benchmark. Decisions are actively made by a fund manager, who bases his or her decisions on qualitative and / or quantitative research, often including meetings with company management and analyst recommendations. Given the additional work this involves, active management inevitably comes at a higher price.

Self-managed

In-house or self managed portfolios can be a good option for charities with an experienced board. The benefit is that trustees retain full control of their investments. However, managing a portfolio in-house is time and resource-intensive; for this reason, many charities choose to outsource management to professionals.

Outsourced

Many organisations decide that a discretionary portfolio managed by an external investment manager is the most appropriate route. Investments are continuously monitored and assessed, while trustees also benefit from advice, regular contact, clear reporting and efficient administration. The unique circumstances of each charity is assessed and a portfolio built around its specific requirements. Unsurprisingly, these services come at a cost.

2 For the purposes of this paper we have used the terms 'passive management' and 'index-tracking' interchangeably. We are aware that passive management may also refer to buy-and-hold strategies.

In the complex, competitive world of investing, many charities conclude that pursuing a low-cost passive strategy is the most efficient solution. It is certainly cheaper to implement. In addition, identifying winning active strategies involves not only great skill, but over shorter term periods, a certain amount of luck.

However, passive investing does not solve all of the problems: there is still a cost involved and unwanted differences between the fund performance and the index can further dilute returns.

Importantly, identifying a portfolio that simply meets or beats the market is not enough; managers need to identify investments that generate a return greater than the sum of total costs involved in the investment process. This includes; transaction costs, management fees, custody, advice, reporting, administration as well as market impact. Beating the market means index returns plus costs.

In the table below, we have estimated the range of fees you might expect to pay. We start with the lowest cost option (self-managed using passive funds) moving up to the highest cost (outsourced management using active funds). Interestingly, there is a large dispersion between total fees paid, even within each category.

		Passive	Active
Self-managed	Custody and administration charges via a platform	0.15% – 0.45%	0.15% - 0.45%
	Fees for underlying funds	0.05% – 1.00%	0.50% - 2.00%
	Total fee range	0.20% – 1.45% (expected 0.4%)	0.65% – 2.45% (expected 1.0%)
Outsourced	Portfolio management fees, including custody & administration and other services such as advice, implementation, reporting, training	0.15% – 0.75%	0.15% – 0.75%
	Fees for underlying funds	0.05% – 1.00%	0.10% – 2.00%
	Total fee range	0.20% – 1.75% (expected 0.6%)	0.25% – 2.75% (expected 1.2%)

Note: In our calculations, we assume that passive funds are necessarily accessed via a platform, which charges a fee for custody and administration. We estimate this to be in a range of 0.15% to 0.45%. Our active and passive fund fee figures assume investment in liquid funds, and exclude those with a lock-up period, such as private equity. Such funds will typically carry a higher charge. Figures are based on the universe of funds under Cazenove Capital coverage as at 31st December 2016. Expected fees are based on an average charity portfolio under management. These figures do not consider performance fee arrangements, where fee levels can vary on the basis of relative performance. Performance fee structures are most common in alternative asset classes, such as absolute return or private equity.

5 It is important to know what the costs are

Identifying the costs

The opacity of investment management fees can make it hard to know what you have paid to whom. 2018 sees the introduction of MiFID II which aims to improve transparency on costs, requiring companies providing investment management services to report the fees they charge from next year. However, within portfolios there are many layers of costs, here are some to look out for:

Services	Charge
Investment management	Annual management charge (AMC), plus VAT Fund charges, where held
Implementation	Commissions and stamp duty Front end charges
Custody and administration	Custody fee Cash – foreign exchange charges, transfer costs, interest rate margin Other pooled charges – trustee, safe custody, transaction, audit

6 Know how much you are prepared to pay and what active benefit you are expecting

As there is no zero cost option, trustees will need to debate whether to pay lower fees for passive management or to increase the fee budget in the belief that active management will deliver enhanced returns. Is this realistic?

There is a generally held perception that low cost index funds tend to outperform active funds. However, this idea comes mainly from the US and global equity funds, where active managers have had a more difficult time.

Looking at the five-year rolling monthly performance of active equity managers in the US for the five years leading up to December 2016 (61 months in total), the median manager only outperformed the index net of fees six times.

In the UK and Europe, the picture is markedly better. Using the same analysis, the median UK equity manager outperformed the index after fees 53 times out of 61, and in Europe, every single time.

The following table sets these figures out with further information on other equity markets. The cost of the cheapest passive fund under Cazenove Capital coverage (shown as the 'indicative charge') is taken off index returns figures to allow for a fairer comparison.

Region	Indicative passive charge	% observations where active manager returns have beaten the index 5 year rolling returns vs index	
		Median manager beats the index	Top manager in 2nd quartile beats the index
UK MSCI UK (NDR)	0.05%	87%	100%
Europe ex UK MSCI Eur ex UK (NDR)	0.09%	100%	100%
US FTSE Nth Am (NDR)	0.07%	10%	95%
Japan FTSE Japan (NDR)	0.20%	30%	100%
Asia ex Japan MSCI FE x Jap (NDR)	0.20%	0%	90%
Emerging Markets MSCI EM (NDR)	0.22%	0%	78%

Source: Lipper, MSCI, FTSE, Cazenove Capital.

According to this method of analysis, active managers in Asia and Emerging Markets also appear to have a poor performance record. However, it's worth noting that these markets are even less homogenous than the US or UK, making broad conclusions less helpful.

What the numbers do show is that active management can be worth paying for if you are skilled enough to invest in the right fund. This appears to be an easier task in the UK and Europe, where the chances of identifying a manager who outperforms the index is higher.

If you had chosen the fund at the top of the 2nd quartile (i.e. the 25th centile manager), you would have outperformed the index every time in the UK, Europe and Japan, and 95% of the time in the US over these periods.

It is worth noting the inherent biases of active managers, such as a preference for small and mid cap, which should be accretive to performance over the long term. Risk adjusted performance is also relevant to capture the additional risk taken to achieve any outperformance.

Of course, past performance is not a guide to the future. However, this analysis supports the view that active management in equities can add value, as long as the time and effort is taken to identify the right manager, in the right region, under the right circumstances and over the long term. There will be times when it feels uncomfortable.

"The median UK equity manager outperformed the index after fees 53 times out of 61, and in Europe, every single time."

What should we pay?

Let us assume investment in a UK manager at the top of the 2nd quartile (25th centile manager) over rolling five year periods over the last ten years. The average outperformance over the FTSE All-Share Total Return net of a five basis point passive fund fee is 4.2% per annum, in a range of 0.5% per annum to 7.5% per annum[3].

Assuming the fund manager is entitled to retain 25% of the outperformance, this would indicate a fee take of 1.05%. This compares to the fees charged by our preferred UK equity managers of between 0.5% and 0.75%.

The difficulty is that, by definition, three quarters of all managers fall outside the top quartile. The median manager outperformed by as little as 0.5% per annum, implying a potential fee of just 0.125%, well below the level of average fees. This points to the crux of the problem: fixed fees lead to asymmetric risk and depend on selecting only the best active funds.

In almost all cases, active managers charge an annual fee. What if your fund underperforms its benchmark? This may seem acceptable if you return 6% in comparison with 7% from the market, but what if you lose money? A market loss of 2% could be increased to 3% and you would still be paying for the privilege. In these circumstances, it is hardly surprising that active funds are facing scrutiny; active funds that reduce their annual fee if they underperform are surprisingly rare.

7 Consider the balance between private and public benefit

If managers outperform net of fees does it matter what you pay them?

Public and private benefit

In our research we came across investors holding the belief that as long as the charity was better off net of fees then the absolute level of fees doesn't matter. We would challenge this view, and believe that the Charity Commission would also question the balance between private benefit (to the investment manager) and public benefit (to the charity).

Consider the similarities between investment management and fundraising. Charities pay fundraisers in the hope that they will generate a positive return on that investment to the financial benefit of the charity – as is the case with investment managers. In fundraising, paying a fundraiser £10 in order to raise £11 is unlikely to be seen as an acceptable balance between private and public benefit. Although there is no formal guidance on the acceptable balance, the Code of Fundraising best practice includes the stipulation that 'Payments to fundraisers must not be excessive. For the purposes of this code, an excessive payment should be regarded as one which is considerably more than an ordinary, well-informed person would consider reasonable.'[4] The Fundraising Institute talks about 'ensuring that remuneration of fundraisers is proportionate to the benefit reasonably expected to be obtained.' Fundraising practice suggests that this acceptable balance is somewhere around 25%. That the renumeration of the fundraiser should be around 25% of the benefit that the charity is expecting to receive from the fundraising activity. Perhaps this is also a useful rule of thumb for investment.

What is the right balance between public and private benefit?

3 Source: Lipper, MSCI, CCM. Analysis based on NAV performance, which is net of all costs and is calculated using the 'retail' share class, which typically attracts fees of 1.0% to 1.5%

4 https://www.fundraisingregulator.org.uk/19-0-payment-fundraisers/

8 Diversification comes at a price

What about multi-asset?

Since it's a like-for-like comparison, it is relatively easy to assess the value for money represented by funds in the various equity markets or other single asset classes. It is much more difficult when we consider multi-asset portfolios. Most would agree that a diversified, multi-asset portfolio is more appropriate for long-term charity assets than investing only in a single asset class or region. However, investing in more than one asset class poses its own challenges.

1. Agreeing on an appropriate strategy or asset allocation

This is the first and most important step in implementing an investment policy. Strategic asset class weightings are at the heart of an investment portfolio and a key determinant of long-term risk and return. Agreeing a strategy helps to optimise the balance between risk and return or to target the required level of return, while minimising volatility over the long term. Importantly, it should also consider analysis of the impact of spending and inflation on the portfolio's long-term real value.

The asset allocation decision is demonstrably more important than the active-passive decision to long-term returns. Whether and how much to allocate to different asset classes is therefore a decision of paramount importance. It's also inescapably active: it is impossible to make a passive asset allocation decision. Only once that course has been charted can the investor decide on whether to use active or passive management to gain access to the assets they have chosen.

2. Choice of indices

Whether choosing the active or passive route, there will be a multiplicity of funds and providers to choose from in each asset class and region. You will need to consider the best way to make your selection and how you will accurately assess the cost. This may involve taking advice if you do not have expertise on your investment committee or trustee board.

3. Replicability through passives

There are some parts of multi-asset portfolios that cannot be easily replicated passively. As soon as you move away from traditional asset classes such as equities and bonds, you run into challenges finding passive alternatives. Commercial property indices, for example, are famously tricky to replicate, since they are based on real bricks and mortar. Similarly, infrastructure indices are difficult to mirror convincingly, as it is simply not possible to buy a small share of a series of infrastructure projects. Hedge funds and absolute return funds are designed to provide investors with a level of protection when markets fall and as inherently active strategies, viable passive equivalents are few and far between. Equally, a corporate bond tracker fund will tend to have its highest weighting to the most indebted companies. Often this means that charities adopting an entirely passive approach are restricting their asset classes. Counter-intuitively passive multi-asset portfolios are often less diversified than active portfolios.

4. 'Set and forget' or systematically rebalance?

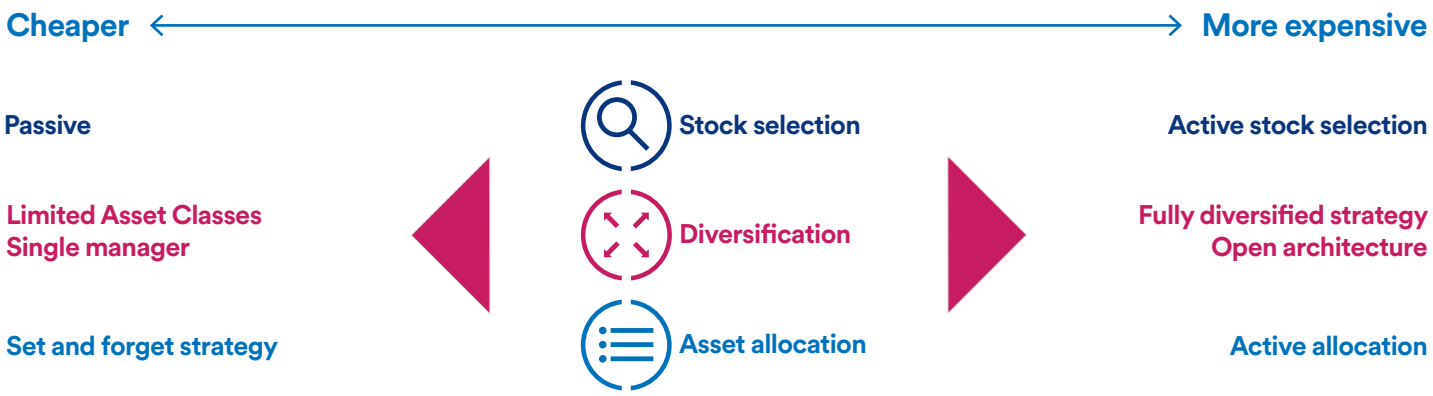
Having chosen to invest in passive funds, how will you run the portfolio once the initial investment is complete? Market performance will cause the allocations to drift away from the target strategy. If the portfolio deviates consistently and substantially from the agreed policy, then the resulting portfolio will no longer reflect the risk and return preferences expressed in the strategy. Rebalancing involves action to ensure that the actual portfolio is close to the targeted one. Who will execute this for you?

Ultimately, all of these are a trade off, as illustrated in the diagram on the next page.

The asset allocation decision is demonstrably more important than the active-passive decision.

It is impossible to make a passive asset allocation decision.

Counter-intuitively passive multi-asset portfolios are often less diversified than active portfolios.



Risk considerations

There is no doubt that there are a huge number of passive investment funds from which to choose. However, as we have discussed, they tend to focus on a narrow range of asset classes (eg. equities and bonds), and within those asset classes, only on the larger and more liquid indices (eg. FTSE, S&P, MSCI). These indices tend to be biased towards developed markets and may be concentrated in larger companies or sectors. In addition, passive vehicles are unlikely to cater to ethical requirements easily and, if they do, tend to come at a higher cost.

Typical indices, such as the MSCI World Index, predominantly cover large cap stocks from developed markets. By adhering to index constraints, investors forego significant opportunities to invest in attractive stocks in emerging markets, and among small- and mid-cap names. There is also concentration at regional level. Investment opportunities are limited to those stocks listed within the 23 countries that constitute the Index, but over half of the total regional exposure lies in US equities. This potentially overstates the importance of the US market compared to the rest of the world particularly against its share of the global economy.

In addition, stock weightings in market cap-weighted indices are a function of the company's past success, with index weightings being skewed towards current market leaders. Consequently, a handful of 'mega-cap' stocks with larger market capitalisations command a greater proportion of the index in percentage terms. We have seen the consequences of this 'concentration risk' all too recently. During the 'tech bubble' of 1999/2000, 36% of the MSCI World Index was comprised of telecom, media and technology (TMT) stocks. In the Japanese stockmarket bubble of the late 1980s, Japan's weighting in the MSCI World Index reached 44% in 1988, when Japan accounted for just 15% of the GDP of the MSCI World constituent. When this bubble deflated it was at enormous cost to most global funds, since even those managers who had a negative view on Japan could not avoid a substantial weighting.

Therefore, when assessing the advantages and disadvantages of each approach, it is important to bear in mind that an active approach allows for diversification beyond just equities and bonds, reducing the overall volatility.

Diversification by asset class is a well-known technique for reducing risk since different asset classes tend not to move in lockstep except in the most extreme circumstances. Investing in a single index tracking fund can prove highly volatile, since there is nothing to offset wide price fluctuations when that particular market is falling.

For trustees considering a purely passive approach, this additional element of risk should not be overlooked.

Given the long-term return characteristics of the various asset classes, a passive strategy would need to have as much as 80% in equities and 20% in bonds to achieve a typical target return of CPI +4%. By contrast, using active strategies and including strategic exposure to alternative asset classes, equity weight might be reduced to as low as 60%, resulting in a lower level of volatility over time.

From a risk perspective, volatility would be as much as 19% higher in a passive strategy of this sort, compared to a more diversified active strategy.[5]

As a consequence, it is important to remember that the additional fees incurred via an active approach are hopefully paying not only for good positive performance but, because of the enhanced diversification, potentially less severe losses when markets turn negative.

5 Based on analysis from Cazenove Capital. Passive strategy based on 40% UK Equities, 40% Dev Ex-UK Equities, and 20% UK Govt Bonds. Active strategy based on 35% UK Equities, 20% Dev Ex-UK Equities, 5% Emerging Market Equities, 5% UK Government Bonds, 5% Investment Grade UK Corporate Bonds, 10% Property, 15% Absolute Return, and 5% Cash.

9 Appraise active value added against a passive portfolio

Additional return to incremental cost

In assessing your various options, it is also worth comparing the cost of active and passive implementation by doing some calculations. In working through this process, you can determine the level of outperformance required to make the additional fees associated with active investing worthwhile. Our example calculations are based on a portfolio of £10 million.

Table 1

ACTIVE (Current Total Cost)	Annual TER (%)	(£)
Hypothetical portfolio management fee	0.50%	£50k
Hypothetical in-house and third party active fund fees	0.50%	£50k
Total (ex VAT)	1.0%	£100k

Assuming a portfolio of £10 million, a portfolio management charge of 0.5% per annum and underlying active fund fees of 0.5%, your total cost would amount to £100,000 per annum, ex VAT. How does this compare with a passive equivalent?

Table 2

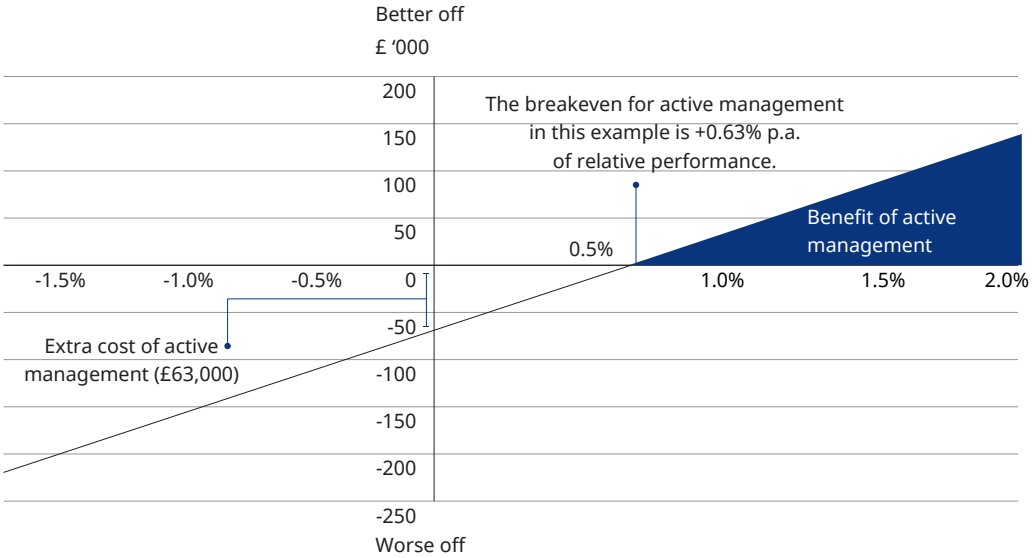
PASSIVE (implementation of strategy/rebalancing)	Annual TER (%)	(£)
Hypothetical custody and implementation fee	0.25%	£25k
Hypothetical third party passive fund fees	0.12%	£12k
Total	0.37%	£37k

In implementing a passive strategy, a small fee is required to cover safe custody of the assets and implementation (custody is included in the 'hypothetical portfolio management fee' in table 1). In our example, custody, implementation and reporting costs 0.25%. In addition, passively managed funds might cost 0.12% per annum to own. This amounts to a total £37,000 per annum, inc VAT (custody is not VATable).

In this example, for a portfolio of £10 million, an active strategy will cost £63,000 more than its passive equivalent. This additional cost pays for asset allocation (portfolio management fees), manager selection (portfolio management fees) and stock selection (fund fees), as well as the ancillary services (advice, custody etc.) provided by your investment manager.

Once you have an idea of the additional expense involved, the next step is to determine whether it is a worthwhile use of your charity's funds.

The chart below aims to determine how much additional return you would need to achieve to make the additional costs associated with active management justifiable. We have based our theoretical numbers on a portfolio value of £10 million and the costs are based on the calculations on the previous page.



For the purposes of this paper we have used the terms 'passive management' and 'index-tracking' interchangeably. We are aware that passive management may also refer to buy-and-hold strategies.

We assume that in order to achieve index or 'market' returns, you need to pay a fee. For a multi-asset strategy invested only in passive funds, we estimate this might cost a total of 0.37%, or £37,000 on £10 million. To implement a multi-asset active strategy, it will cost more; in our example, approximately 1.0%, or £100,000 on £10 million.

Therefore, it might cost the charity £63,000 more to run an active strategy compared to a passive strategy.

If your active investment manager were simply to match his benchmark returns (0.0% outperformance), you would be £63,000 out of pocket on a simple fees basis (disregarding any absolute positive or negative performance) and the benefits from the potential reduction in volatility.

If your manager were skilled enough to outperform the benchmark by 1.0%, you would be £37,000 'in the money' on a fees only basis, representing better value for money.

If your manager were able to beat the benchmark by 2.0%, your net profit would increase to as much as £137,000 (excluding absolute performance). Clearly these figures are highly theoretical, but they show that the value eked out of a successful active strategy grows exponentially with the degree of outperformance. Doubling a 1.0% outperformance to 2.0% will increase the cash returns by almost four times (£37,000 to £137,000). As investors, it is possible to achieve good value for money.

Measuring value for money

Earlier, we established that value comes from more than just the measurable statistics. However, it is useful to consider value for money ratios as part of the overall appraisal of whether the investment management service is meeting the objectives of the charity.

What can we measure?

Cost = passive cost + extra cost of active management

Return = passive return +/- extra return from active management

Risk = passive risk +/- extra risk from active management

We can use these statistics to appraise value for money in three ways

1. Absolute value for money

The amount of extra money generated for the charity per £1 of fees paid.

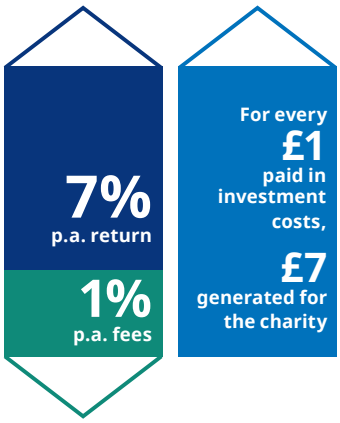
2. Relative value for money – active vs. passive

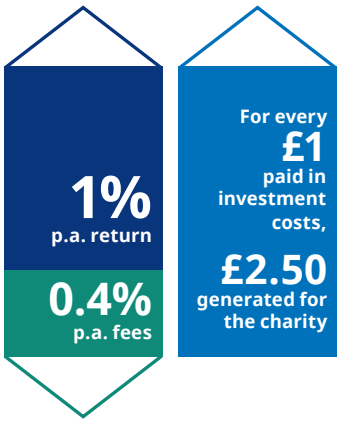
The amount of extra money generated for the charity per £1 of additional fees paid for active management (vs. passive alternative).

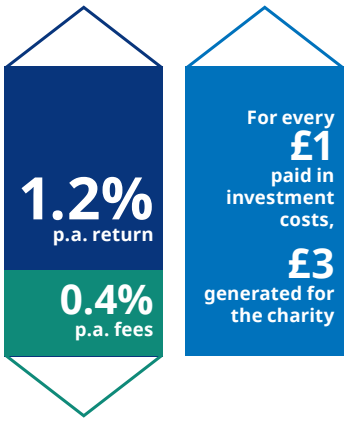
3. Risk-adjusted value for money – active vs. passive

The amount of extra money generated for the charity per £1 of additional fees paid for active management (vs. passive alternative), adjusted for the risk where active approach 20% less volatile.

Please note, examples are fictional.







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