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Reveal the 'true cost' of the croupier's take

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Although nobody much believes in the efficient markets hypothesis any more, its lesser known cousin the CMH appears to go from strength to strength. CMH stands for the "costs matter hypothesis", and was first promulgated by Jack Bogle, the combative founder of Vanguard. It asserts that the one certain element in fund performance is the bite that fees and other costs will take out of the returns that the investor's money earns.

Like death and taxes, which are anything but hypothetical, fund costs are one of nature's few sure things. Mr Bogle likes to call them the "croupier's take". As in the casino, they are capable of imposing a serious drag on performance. Costs are irrecoverable and compound over time. In their Global Investment Returns Yearbook, Dimson, Marsh and Staunton estimate the long-run cost of holding equities through funds to be in the region of 3 per cent a year. At that rate costs will eat up 27 per cent of your starting capital over 10 years and almost half the long-run annualised historical equity risk premium.

As certain as fund costs are, the paradox is that measuring exactly how big a bite costs take out of a fund's performance is anything but. Meaningful standardised information on the true cost of fund ownership, as the FT regularly points out, is hard to come by. The current regulatory requirements on funds to publish total expense ratios and deceptively mild reduction in yield figures (whose significance no investor I have ever met seems to understand) fall well short of full transparency.

Mr Bogle and other proponents of the CMH point out that, among other hidden cost items, TERs do not include the impact of direct and indirect transaction costs, an important omission in an era when the portfolio turnover of the typical fund has fallen to less than a year. The "true" cost of owning an actively managed fund can therefore be much higher than its reported TER suggests.

According to Alan Miller, who runs low-cost funds at a boutique firm, SCM Private, the simplest methodology for seeing how far these two effects can combine to rob the investor through needless expense was developed by an American academic, Professor Ross Miller (no relation) and published in 2005. It was designed to arrive at a "true cost" and "true alpha" figure for US mutual funds.

The only three required inputs are a fund's published TER, its r-squared (correlation with the index) and the reported alpha, as calculated by Morningstar. The "true cost" is derived by taking the difference in cost between the TER of any given fund and that of an appropriate low-cost index fund alternative and in effect applying this difference to that small proportion of the fund that the r-squared analysis suggests is the only genuinely actively managed component of the portfolio. By stripping out the passive component from the reported alpha, you can also calculate the "true alpha" of each fund.

The original results were striking in highlighting the difference between apparent and "true" performance. The average large cap mutual fund in the US, Prof Miller found, had an r-squared of 0.96 in the three years to 2004, making it all but impossible for them to produce anything materially different from the performance of an S&P 500 index fund. The "true TER" of this kind of fund was nearly 7 per cent and its "active alpha", on his numbers, a startling minus 9 per cent.

"In essence," he concludes "large-cap funds taken as a whole consume 7 per cent of the assets being managed as expenses and then generate another 2 per cent of losses beyond that". Back in the UK, with all the zeal of a former active fund manager who has since repented, Mr Miller has used the methodology to calculate similar adjusted figures for the TERs and active alphas of mainstream funds in the UK.

Using three-year performance figures, he finds that the "active expense ratio" of the average fund in the UK All Companies Sector is around 6 per cent, or nearly four times the average reported TER of 1.6 per cent, while the "true alpha" is minus 3.8 per cent. Although this methodology is open to criticism, the results are consistent with the known facts. The average equity fund in the All Companies sector, like the average US equity mutual fund, underperforms its benchmark to the extent, more or less, of the industry's average costs. Five-year data produces a similar result.

To be fair, scanning the 233 UK funds in Mr Miller's sample suggests some houses do have a number of funds that score well on both measures. With positive true alphas, even the more expensive ones can at least be said to be doing something to earn their share of the croupier's take. Schroders, Jupiter and Threadneedle are all examples. But there is a much larger number of funds, many with substantial amounts of assets, whose results on this methodology look shockingly poor. They make a compelling case for more meaningful regulatory disclosure (see *www.independent-investor.com*). The CMH in any event stands vindicated once more.