FINANCIAL POST

Wednesday, May 13, 2009

Canadian funds get an F for fees

Canada ranks last among 16 countries

Jonathan Chevreau, Financial Post

A worldwide study by Chicago-based investment research firm Morningstar Inc. gives Canada's mutual fund industry a failing grade for its high fees.

The study of the global fund investor experience in 16 countries found Canada placed last for its high management expense ratios, earning it a failing grade of F.

The study, by three Morningstar research analysts, gives Canada an A on transparency and investor protection. But Canada's overall ranking was seventh, giving it a B minus. The only country to get an overall A grade was the United States. At the bottom were New Zealand, with a D minus, and Spain at D.

The composite scoring system has six components, says Morningstar Canada managing editor Rudy Luukko: also addressed were sales practices and media coverage, taxation and distribution.

Ironically, Morningstar views Canadian prospectuses as being "among the world's most comprehensive in their disclosure of the costs of investing." Canada is among the minority of countries whose regulators require a prospectus to include a numerical example of the total costs of funds, Mr. Luukko said.

In other words, while our MERs may be sky high -- as famously disclosed in an earlier worldwide study by Harvard's Peter Tufano et al -- at least our fund companies are required to disclose it.

Never mind the fact that most investors ignore prospectuses, viewing them as unreadable legalese. "It's unfortunate most investors don't pay attention to fees and expenses because they're one of the few things you can control," said Mike Bayer, a Mississauga-based financial advisor with Raymond James,

"The majority of investors would be better off with low-fee exchange-traded funds and enhanced index funds."

Mr. Bayer, who started his investment career selling mutual funds, says he finds the Morningstar results "kind of depressing. Unfortunately, Canadian investors are not demanding lower fees, so they're not getting them."

One reason Canada's fees are so high is the embedded compensation system for the advisors who sell mutual funds. Typically, they receive an annual "trailer fee" of 0.5% to 1% for each year they keep a client invested in a particular fund. Mr. Luukko says the study recognizes Canadian MERs include trailers, which are "fairly specific to the Canadian market."

In a damning indictment of the integrity of advice under the Canadian distribution system, Morningstar concluded some advisors direct clients to funds that pay out higher trailer fees; a practice Canada's vocal investor advocate community has long complained about. Because the cost of the trailer is embedded in the MER, the funds Canadians end up purchasing tend to be the higher-cost funds, and in the long run higher costs mean lower investment returns.

Even so, Canada got a Bplus on distribution and choice, placing it second in that category. Canada also got an A for transparency in sales practices and media.

The Investment Funds Institute of Canada says our higher MERs occur because of taxes that do not apply in the United States.

Dennis Yanchus, IFIC manager of statistics and research, says there are also cross-country differences in the fees included in a MER. In some countries, trailers and legal costs are charged outside MERs. In other countries, fund companies are only required to post the fund-of-fund fee for the top fund but in Canada, fund-of-fund MERs must also include all fees charged to underlying funds.

Countries also differ in the holding period of the average investor and tax treatment varies by country, Mr. Yanchus said.

jchevreau@nationalpost.com - Chevreau is the author of Findependence Day and blogs at www.wealthyboomer.ca.