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Higher Fees Mean Lower Returns

THE results are in: the more you pay fund managers, the less you get in returns.

In a damning finding on the benefits of "active" fund managers, research from the Australian Prudential Regulation Authority shows superannuation investors would be better off on average with their money invested in "passive" low-fee index funds.

In the largest, most detailed study of the performance of active fund managers in Australia, two authority researchers, Wilson Sy and Kevin Liu, used commercially sensitive data obtained by the regulator to measure the performance of 115 superannuation fund managers.

The researchers found in the five years to 2006 the average actively managed superannuation fund underperformed a passive benchmark index by 0.9 per cent each year. The result was based on the net return to an investor, after a fund manager's fees and tax were taken into account.

"On average, value adding from active management appears statistically to be unable to overcome higher costs associated with attempts to exploit market inefficiencies," the authors say.

To underline this point, the report assesses the average cost of active management was about 0.9 per cent a year, the same amount as the annual underperformance.

The authors also warn the higher the fees, the less returns investors can expect: "Higher management expenses leads to poorer net investment performance of the firms."

The results follow US research showing most active US fund managers underperformed relevant market indexes, including a study by Lipper Analytical Services showing 53 per cent of active managers underperformed the market between 1999 and last year.

To make matters worse, the Australian Prudential Regulation Authority paper finds fund underperformance was worse during a bear market.

But there is also strong evidence some active fund managers outperform the market, and about half the 115 superannuation funds outperformed the benchmark index - with the highest firm returning 18 per cent a year.

The problem for investors is finding which half of superannuation funds to choose.

The research does not publish the performance of individual superannuation funds over the period. But the researchers say they have developed a performance measurement tool allowing them to predict which funds are likely to have higher performance in the future.

The authority is collecting and publishing standardised results from superannuation funds in an attempt to allow consumers to better understand their fund's performance.

The report authors are calling for their performance measurement tool, which they have dubbed RAVA, or risk-adjusted, value added, to be used by investors to select a better-performing superannuation fund. "Our approach should serve at least as a reliable initial filter," they say.