

## Expense Ratios: Analysis of Trends

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From time to time, attention is given in the media to the expense ratios that are applicable for unit trusts and investment-linked insurance products (“ILPs”) in Singapore. Mercer has been monitoring expense ratios for some time and we have carried out an analysis of the trends of average expense ratios over time. The results of this analysis are presented in this article. We also put the expense ratios in Singapore into context by making some global comparisons of the typical levels of expense ratios that apply in some other countries.

### What is an Expense Ratio?

There are basically two types of expenses that an investor incurs when investing in a retail investment product, such as a unit trust. There are ongoing expenses, such as investment management fees, that are already accounted for in the returns that are shown in Mercer’s Performance and Risk Monitoring Reports on investment products included under the CPF Investment Scheme. These are generally deducted from the net asset value (“NAV”) of the fund on a daily basis, at the time the unit price is determined for that day.

In addition, there are expenses that aren’t included in the returns – these are the costs associated with buying or selling units in a particular fund.

The expense ratio that Mercer shows in its reports relates to the ongoing expenses. The methodology that is used by Mercer is consistent with that outlined in “Guidelines for the Disclosure of Expense Ratios”, issued by the Investment Managers Association of Singapore (“IMAS”). Specifically, the guidelines state the following expenses should be included:

- Investment management fee;
- Trustee fee;
- Administration fee;
- Accounting and valuation fees;
- Custodian, sub-custodian and depository fees;
- Registrar fees;
- Legal and professional fees;
- Printing and distribution costs;
- Audit fee;
- Amortised expenses; and
- GST on expenses.

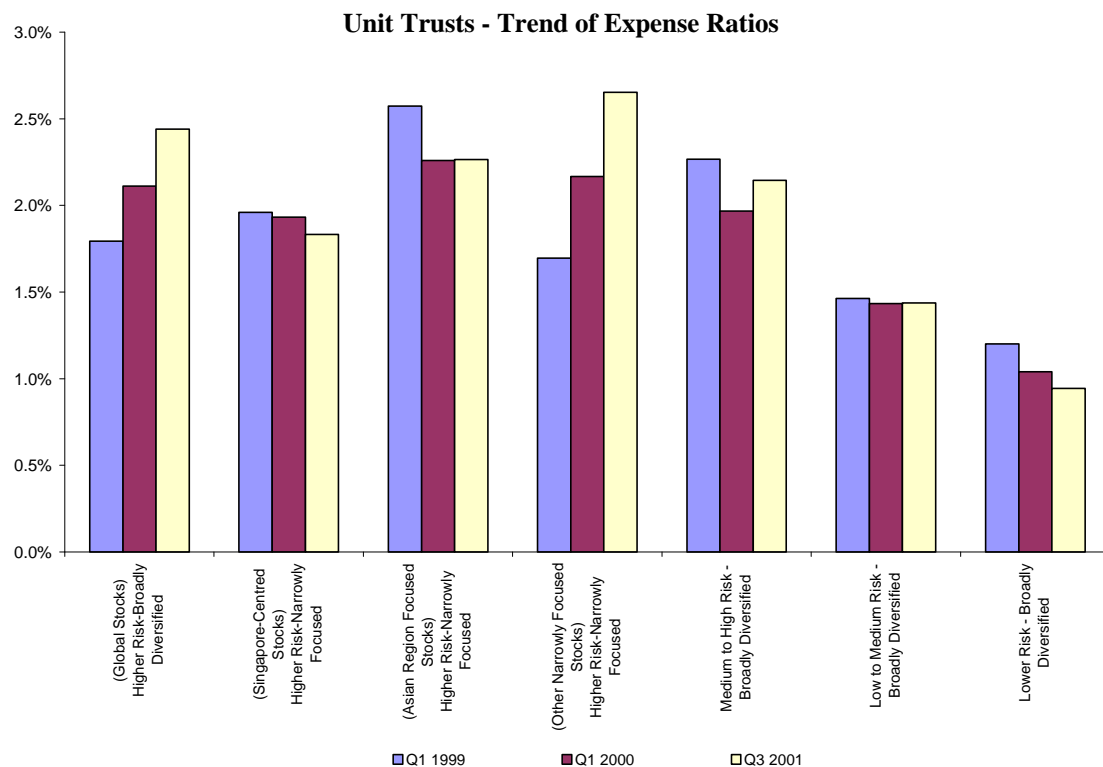
The expense ratio does not include brokerage and other transaction costs, which are charges against the performance of the fund. Some unit trusts in Singapore have a feeder fund structure in that the Singapore unit trust will invest into a foreign unit trust. The determination of the expenses for the Singapore unit trust will include all expenses incurred at both the Singapore level and at the foreign fund level.

In accordance with IMAS guidelines, the expense ratio is calculated on a six monthly basis. The expenses for the six-month period are annualised and then divided by the average NAV over the period – the average NAV is to be calculated as the average of the six month end NAV balances. The annual expense ratio is then calculated by taking the average of the annualised expense ratios for the last two six month periods.

### Trends in Expense Ratios

Mercer has carried out an analysis of the trends of average expense ratios for unit trusts across three different time periods, namely Q1 1999 (the first quarter when Mercer collected the expense ratio data), Q1 2000, and Q3 2001 for the different risk classifications. The results are based on a simple arithmetic average of the funds in each risk classification.

The results are shown in the following chart:



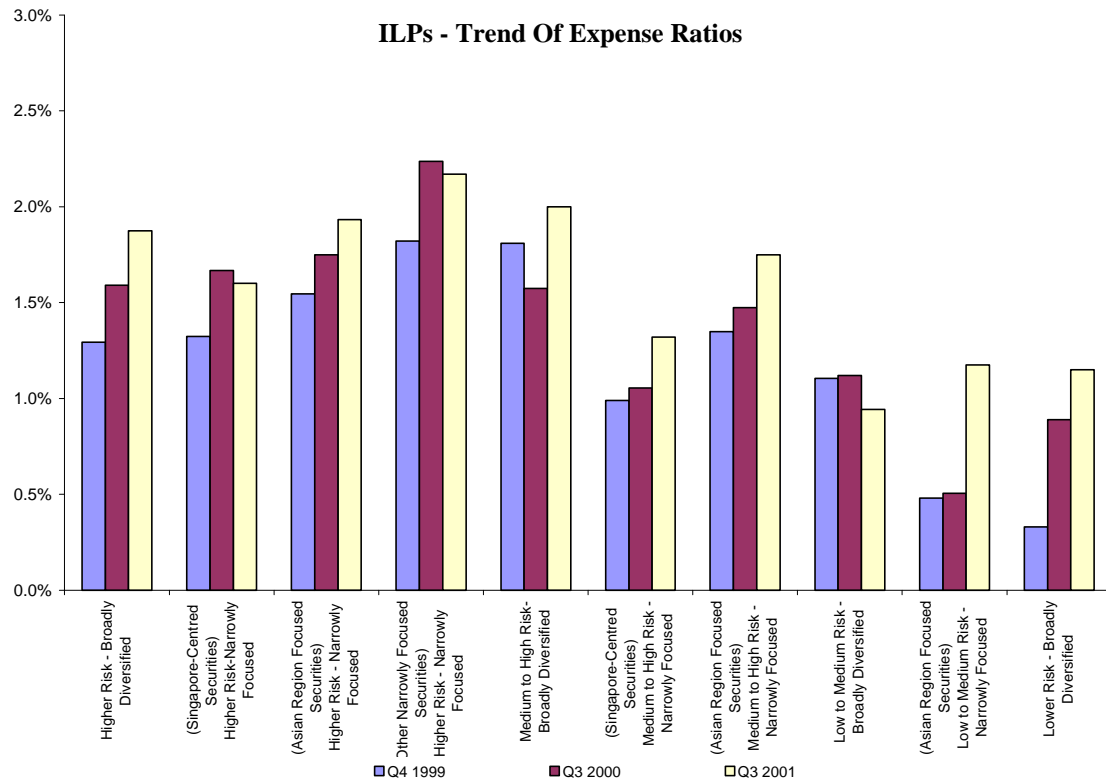
The results, in Mercer's view are largely inconclusive. In some risk classifications, the average expense ratio seems to have increased whereas for others, expense ratios seem to have gone down. One reason behind the increasing expense ratios will be increases over time in the number of feeder fund structures – this is particularly the

case in the Higher Risk: Broadly Diversified and Higher Risk: Other Narrowly Focused categories.

As we expected, the expense ratios trend downward as we move from the Higher Risk classifications to the Lower Risk classifications. This will reflect the fact that investment management fees for equity management tend to be higher than those for bond management.

We have also undertaken this analysis for ILPs. In this case, the three time periods we have used are Q4 1999 (the first quarter when Mercer collected the expense ratio data for ILPs), Q3 2000, and Q3 2001.

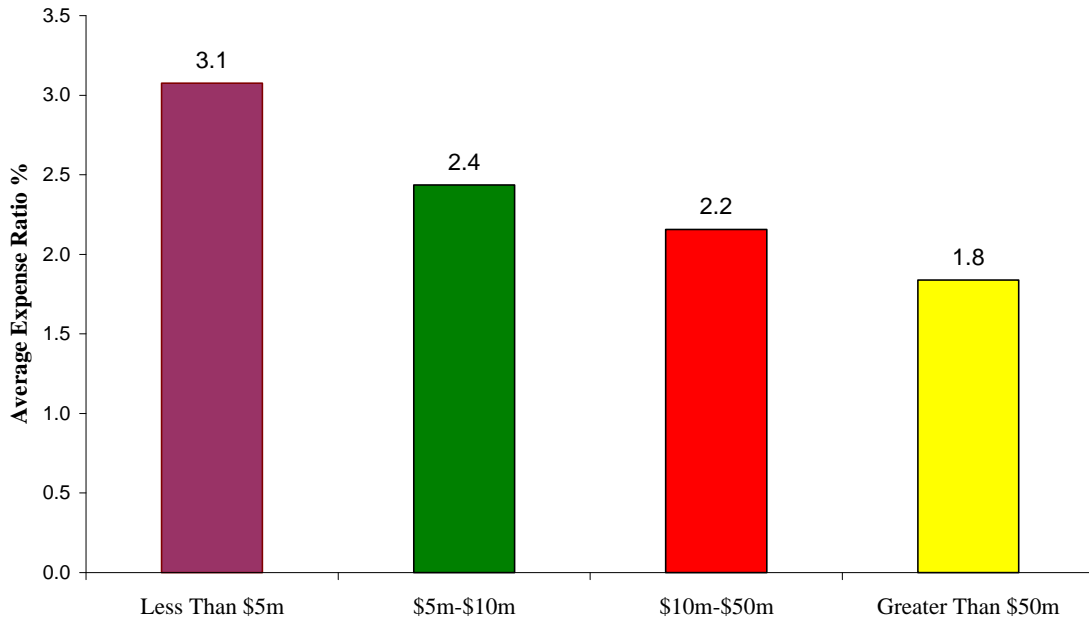
The results for ILPs are shown in the following chart:



The increasing trend for ILPS to feed into unit trusts, thus potentially creating another level of fees, is the main reason for the upward trend in expense ratios for ILPs shown in the above chart.

From our observations, in most cases, funds with high expense ratios tend to be either those with feeder fund structures or those with small fund sizes. To illustrate this latter point, a breakdown of the average expense ratio by fund size for unit trusts is shown on the next page:

**Unit Trusts - Expense Ratios Related To Size Of Funds  
at 30 September 2001**



Investment management fees, which will normally represent the major component of an expense ratio are charged as a percentage of a fund's assets and, as such, do not tend to reduce in percentage terms as fund size increases. However, many of the other expenses that are incurred are fixed dollar amounts independent of the size of the fund. Therefore, the main reason for the reduction in expense ratios shown in the above chart is that as the fund size increases, these fixed dollar expense amounts are spread over more assets, thus reducing the expense ratio as a percentage of assets. For example, if an expense of \$10,000 per annum were both incurred, for say accounting fees, by a fund of \$1 million and by a fund of \$100 million – the expense ratios based on just this one expense would be 1.00% and 0.01% respectively.

**Global Comparisons**

In relation to global comparisons, we have looked to the Australian, UK and US retail fund management markets. All three markets have considerably more mature retail markets than Singapore and, as a result are much larger.

The typical expense ratios in these markets for retail funds are shown in the following table, along with those in Singapore:

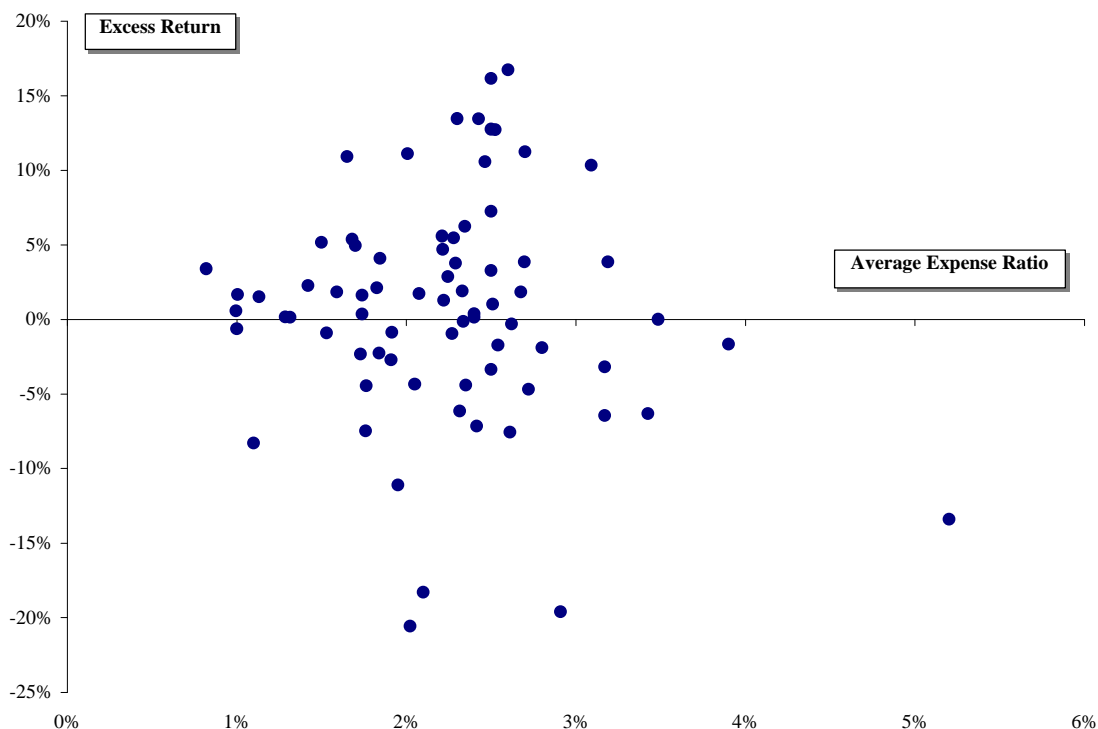
<b>Fund Type</b>	<b>Singapore Typical Range</b>	<b>Singapore Average</b>	<b>US Typical Range</b>	<b>US Average</b>	<b>UK Typical Range</b>	<b>Australia Average</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Equity	1.6 to 3.3	2.4	0.2 to 4.0	1.4	1.3 to 2.0	1.9
Balanced	1.4 to 2.9	2.1	0.1 to 2.6	1.4	1.3 to 2.0	2.0
Bond	1.0 to 2.2	1.4	0.1 to 2.1	1.0	1.0 to 1.5	1.6

The table above shows that for Equity Funds and Balanced Funds the Singapore market has higher average expense ratios as compared with the other markets. This will partly be attributed to the presence of feeder fund structures in Singapore, but perhaps more importantly to the fact that these other markets will tend to consist of much larger sized funds.

For Bond Funds, the expense ratios in the Singapore market appear to be slightly lower than the Australian market, yet more expensive than the US as would be expected.

## Expense Ratios and Fund Performance

We have also examined the degree to which there is a relationship between the performance achieved by a particular fund and its expense ratio. This is shown in the following chart.



Each point on the chart represents a particular unit trust. The vertical axis represents the annualised excess return achieved over the two years to September 2001 by those unit trusts included in the CPF Investment Scheme with at least a two-year track record. The horizontal axis represents the average expense ratio of these unit trusts over the two-year period. The excess return shown in the above chart for a particular unit trust is the actual return (net of expenses) achieved less the return on the benchmark index nominated by the unit trust manager for that fund.

It will be noted that, in general, unit trusts with expense ratios greater than 3% per annum are generally underperforming their respective benchmarks, with the extent of the underperformance increasing in line with the increasing expense ratio. However,

with a few exceptions, for funds with expense ratios below 3% per annum, there is no clear relationship.

The lowest expense ratios in the chart will tend to correspond with lower risk products in which the scope for performance to deviate significantly from the benchmark is not that high. As the expense ratio increases from around 1.5% per annum through to 3% per annum, the unit trusts tend to be much more equity oriented, thus increasing the potential for greater variation between the return of the unit trust and that of its benchmark.

## Summary

The analysis we have undertaken in this article tends to indicate an increasing tendency for expense ratios in Singapore to be rising. This mainly reflects the increased use of feeder fund structures, both in terms of Singapore unit trusts feeding into foreign unit trusts and of ILPs feeding into Singapore unit trusts. The analysis also shows that expense ratios tend to reduce as the risk classification moves from Higher Risk to Lower Risk, but then so should the expected return over the longer-term. Expense ratios also tend to reduce as the fund size increases. The fact that expense ratios in Singapore are higher than in the other countries we have examined should not be an unexpected outcome, given the substantially greater size of the retail fund markets in those countries.

However, while expense ratios are important, the key consideration for any investor should be on the actual return achieved net of expenses. The analysis we have undertaken of the relationship between expense ratios and excess returns shows no clearly defined relationship, at least for expense ratios below 3% per annum.

Based on analyses that Mercer has undertaken of the performance of a large number of managers globally, the performance differential *before* fees over a reasonable time frame between a good manager and a poor manager can be as much as 6% to 7% per annum for equity management and around 1% per annum for bond management. In this context, particularly for equity management, a difference in expense ratios of 0.5% per annum may be relatively minor. To us, this tends to highlight the importance of selecting a good product as opposed to simply buying the cheapest product. If there are two equally good products available, then it may be appropriate to select the one with the lower expense ratio.

One final comment that we believe should be made in relation to the higher expense ratios associated with feeder fund structures is that these expense ratios could potentially be reduced if the Singapore fund were buying units in the foreign fund at institutional prices, rather than at retail prices as seems to be common practice. While it is unlikely that all foreign funds will have this pricing flexibility, some will. In addition, some of the larger Singapore feeder fund structures are of sufficient size that they could potentially be managed as individual portfolios, with lower overall management fees and therefore reduced expense ratios.