

Canadian Financial Planner

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As an investor, are you paying for “alpha,” but receiving “beta,” or less? If this statement is true, are there steps that can be taken to eliminate this issue? As an investor, it is important to understand the concepts of “alpha” and “beta.” Although these terms have very technical definitions among investment professionals, in layman’s terms they can be defined as follows:

Alpha – It measures the investment return in excess of the target benchmark used by a fund manager. From a technical perspective, it must also be adjusted for risk

Beta – Beta measures performance against a pre-determined benchmark. If an investment has a beta measure of “1,” it can be expected to increase or decrease by the same amount as the benchmark. If the beta is less than “1,” the investment is less sensitive to movements in the market

At the risk of oversimplification, if investors purchase an index fund, they are purchasing “beta.” Alpha is the value that the fund managers can add by using their expertise. They attempt to beat the index by overweighting sectors they believe will outperform the market and underweighting those they expect to lag. Many investors are questioning

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whether or not investment professionals are earning their fees. In this edition of the Canadian Financial Planner, we shall review mutual fund fees charged by the investment industry and outline a number of factors that allow investors to determine if they are receiving value for fees paid.

Many investors generated an excellent return on equity investments in 2006, although some owners of income trusts had a difficult fourth quarter. When mutual funds generate double digit returns, there appears to be less focus on the level of fees charged by mutual funds. However, if we return to the single digit rates of returns posted earlier in the decade, the magnitude of the management expense ratio may be challenged by more investors.

Observations on the Investment Industry

Given that investors have access to professional money managers by purchasing mutual funds; this should result in a superior level of return. However, consider the following:

- a paper written by three academics – Peter Tufano of the Harvard Business School, Ajay Khorana of the Georgian Institute of Technology and Henri Servaes of the London Business School, studied just under 50,000 mutual funds in 18 countries. For each fund, they established the total shareholder cost which was equal to the management expense ratio, plus commissions paid by the seller of the fund. Their findings indicate the average cost is 1.9% for all countries, but Canada had the highest expense at 4.7%. Ireland was a distant second at 2.7%. The average cost in the United States was 1.7%.
- approximately 15% of Canadian equity fund managers have beat their index over the past five years. In the United States, approximately 25% of fund managers outperformed the S&P 500

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