

Getting Better Returns From Your Existing Funds

By Wilfred Ling

FOR THE PAST 5 years, Emerging Market equity funds had a whopping return of 32.73 per cent per annum or 312 per cent in absolute return. This is based on MSCI Emerging Market Net (USD). Those who had invested in emerging market funds should be overjoyed by such fantastic returns. However, do not be too happy. If you check your latest statement, your funds' returns are far below this figure.

We compiled a table of emerging market funds and computed its relative performance to its benchmark. It was

discovered that these group of funds have been giving dismal performance.

In the table shown, the figures were derived by subtracting the performance of the fund from its benchmark. For example, First State GEM Leaders had a return of 25.6 per cent per annum over 3 years. Its benchmark returned 33.22 per cent per annum. Therefore, the relative performance of the fund compared with the benchmark was $25.6 - 33.22 = -7.62$ per annum. We use the MSCI Emerging Market Net index as the benchmark returns for all the funds.

Emerging Market funds relative performance against its benchmark

	1 Year	3 Years	5 Years
*Aberdeen Global Emerging Market Equity (USD)	(6.46)	(3.51)	-
Fidelity Funds - Emerging Markets Fund - A Share USD	(0.63)	4.47	(0.75)
First State GEM Leaders (SGD)	(7.12)	(7.62)	-
HSBC GIF Global Emerging Markets Equity Freestyle (USD)	(11.22)	-	-
ING (L) Invest Emerging Markets (USD)	(3.58)	(2.05)	(4.53)
Schroder ISF Emerging Markets (USD)	(4.03)	(2.76)	(2.53)
ABN Ambro Global Emerging Market Equity A (USD)	(4.23)	(3.26)	(3.93)
Franklin Templeton F-Emerging Market (SGD)	(13.22)	(9.23)	(5.97)
Aviva Morley - Emerging Market Fund (USD)	(5.47)	(1.33)	(1.43)

All data as at 31 Aug 2007 except for ING(L) Invest Emerging Market as at 31 July 2007

*Refers to the underlying mother fund. Available in Singapore is the feeder fund.

It can be seen from the table that all funds are underperforming its benchmark. Interestingly, Fidelity Emerging Market Fund A-Share seems to be the best having underperformed only 0.76 per cent per annum over a 5-year period. Yet a closer look at its performance since launch revealed something extraordinary. This fund was launched in October 1993. Since inception, the fund returned a cumulative performance of 127.6 per cent. Sounds good? Actually its



benchmark returned 237.9 per cent over the same period. This fund suffered a cumulative 110.3 percentage points of underperformance!

To be fair, the underperformance of emerging market funds is not a peculiar phenomenon in Singapore's unit trust industry. If we look at the United States, we observed similar problem. According to Morningstar's Diversified Emerging Markets category, the majority of the emerging market mutual funds domiciled in United

States underperformed the Vanguard Emerging Market fund. The Vanguard Emerging Market fund is merely a passive managed fund that does nothing other than to replicate the performance of the emerging market index.

While there is already enough evidence documented that shows mutual funds investing in American stocks underperform the market average, fund managers should not have problems outperforming in less efficient markets such as in emerging markets. Yet the

To be fair, the underperformance of emerging market funds is **not a peculiar phenomenon** in Singapore's unit trust industry.

How many emerging market funds underperformed the Vanguard Emerging Market?

	1 Year	3 Years	5 Years	10 Years
Number of funds underperformed the index fund	71%	55%	63%	73%

Source: Morningstar based on US domicile emerging market equity funds

evidence as shown by the Morningstar database revealed that fund managers are also not competent in inefficient markets. To understand the real reasons behind such underperformance, we will need to tap the brains of academics.

Professor William F. Sharpe, the noble prize winner in Economic Sciences 1990 published a short article in *The Financial Analysts' Journal* Vol. 47, No. 1, January/February 1991, entitled "The Arithmetic of Active Management." He demonstrated a stark truth about investing. Consider a case of two groups of investors - one group invests passively tracking the market returns while another group invests in active managed dollar. Because both groups invest in the same market, the returns of the active managed dollar as a group must be equal to the returns of the passive managed dollar before cost. Since investing is never costless, the group of the active managed dollar must underperform the passive managed dollar because the former's cost is always higher than the latter.

What is important here is that the "market" can be any market and asset classes including equities (developed or emerging), bonds and even "alternative" asset classes. It is also interesting to note that the "market" can be inefficient yet active managed dollars as a group must still underperform the group of passive managed dollar.

With this simple reasoning, it is a no wonder that active managed unit trusts have been performing so badly! However, there must be other reasons to explain the widespread magnitude of underperformance. We need to tap

another brain - a retired neurologist turned financial theorist, Dr William Bernstein. The author of a widely acclaimed book "The Intelligent Asset Allocator" and principal officer at Efficient Frontier Advisors - a boutique investment-advisory firm catering to institutions and high networth individuals having a minimum size of US\$25 million portfolio - explains three additional expenses that are not captured by the expense ratio of the fund. These are: brokerage cost, bid-ask spread and impact costs.

It is common to see funds that have turnover rate of 100 per cent or even 400 per cent. Such high level of trading activity increases the cost of brokerage fees. The bid-ask spread represents the price difference between the buyers and the sellers at the stock exchanges. A high volume trader suffers substantial bid-ask cost because he has to buy at a higher price and when he sells, he has to sell at a lower price. Impact costs are normally associated with trading large chunk of shares. A fund manager who buys large chunk of shares on the same counter could potentially cause the market price of the

share to increase so much that the last share purchased is significantly more costly than the first share purchased. Similarly, a fund manager who sells a large chunk of shares on the same counter could potentially drive down the market price of the share so much that the price sold by the last share is significantly lower than the price of the first share bought. As Dr William Bernstein puts it, "Impact costs are not a problem for small investors buying shares of individual companies, but they are a real headache for large mutual funds. Obviously, the magnitude of impact costs depends on the size of the fund, the size of the company, and the total amount transacted." He then goes on to provide some estimates of the true annual cost of owning funds.

We modified Dr William Bernstein estimates for Singapore's context. From the estimates, an active global equity fund is 3.55 per cent per annum more expensive than a passive counterpart. Similarly, an active managed emerging market equity fund cost 7.65 per cent per annum more expensive than a passive counterpart! It is no wonder fund managers find it hard to outperform passive funds.

While the reader may think that the solution is to purchase passive funds, it is not as simple as that. The first hurdle is that there is a lack of choice in the industry. Exchange Traded Funds

Impact costs are not a problem for small investors buying shares of individual companies, but they are a real headache for large mutual funds.

(ETFs) listed on the Singapore Stock Exchange have hardly any liquidity. Who dares to buy a security with no trading volume? The lack of liquidity means high bid-ask spread and potential difficulty in liquidating a large position. Secondly, there is a lack of interest for fund managers to promote it as the management fee is low. For example, the Vanguard Total Stock Index listed in US has an expense ratio of merely 0.07%! Can any fund manager survive based on that kind of fee? Thirdly, passive funds are unexciting. Many investors invest based on sentiment and impulse rather than on a risk-adjusted long-term returns. It is much easier for a salesperson to sell a thematic fund with a nice story to tell to the investor than a passive fund that does nothing other than track the index. Fourthly, financial advisers do not promote passive funds. The most common reason is due to the lack of choice. This is especially so for financial advisory firms that only uses iFast Financial Pte Ltd and Aviva's Navigator as their unit trust platforms. Another reason is due to the misconception that advisers cannot survive by recommending such portfolios. From the table shown, the advantage of passive funds over active managed equivalent ranges from 2.07 per cent to 7.65 per cent annually in cost. A financial adviser can still charge an on-going retainer fee of say 1.5 per cent per annum and yet still leave a significant cost advantage to the client.

Finally, good passive funds are only found in places of foreign domicile such as in the United States, Ireland and United Kingdom. The need to open multiple trading accounts with foreign brokerages is daunting. Investors prefer a centralized and consolidated holding through a single investment account for administrative convenience and ease of rebalancing. Moreover, unfamiliarity with foreign estate duty can bring disastrous consequences. For example, United States imposes a whopping 55

per cent estate duty on foreigners' assets in US with an exemption limit of merely US\$60,000. Surely nobody wants to donate more than half of his assets to the foreign taxman! Some countries such as Hong Kong do not have any estate duty. As nothing is ever cast hard in stone, investors must continually keep abreast with foreign estate laws if he wishes to invest in a foreign land. Many high networth individuals use a trust structure for such estate planning

are solutions to these hurdles. At Promiseland, we are able to help accredited investors invest in a portfolio of a globally diversified and widely acclaimed passive managed funds – like Vanguard, Barclay's iShares series and Dimension Fund Advisers – all these domiciled in foreign jurisdictions with no fear of being subjected to foreign estate duties. These are done through a single consolidated investment account. Of course, there is no necessity

Active Managed Fund Expenses in Singapore

	US large cap	International Equities	Emerging Markets
Expense Ratio *	1.60% **	1.95% ***	2.20%
Brokerage	0.30%	0.50%	1.00%
Bid-ask spread	0.30%	1.00%	3.00%
Impact costs	0.30%	1.00%	3.00%
TOTAL	2.50%	4.45%	9.20%

INDEX FUND EXPENSES

	S&P 500 Index Fund	Global Equities Stock Index Fund	Emerging Markets Index Fund
Expense Ratio	0.38%	0.50%	0.65%
Brokerage	0.01%	0.10%	0.10%
Bid-ask spread	0.02%	0.15%	0.40%
Impact costs	0.02%	0.15%	0.40%
TOTAL	0.43%	0.90%	1.55%

Advantage of index fund over active managed funds

	2.07%	3.55%	7.65%
--	-------	-------	-------

* Arithmetic average of the expense ratio (if available) of Singapore's US unit trust fund from IMAS 18 Sept 07
 ** Median expense ratio under CPFIS for equity funds
 *** Arithmetic average of the expense ratio (if available) of Singapore's emerging equity market fund from IMAS 18 Sept 07
 Source: Modified from Dr William Bernstein's "The Intelligent Asset Allocator"

purposes. However, the usage of a trust has its own set of problems such as the necessity to setup an irrevocable trust. If the trust is revocable, estate duty still applies because of the continuing vested interest. For clarification, we are not too worried about Singapore's estate duty since tax rates here are rather low. But we are more concerned with estate duty imposed by foreign jurisdictions.

The good news is that there

to setup a trust and yet investors can continue to enjoy ownership of these investments – and earn a higher investments return. **Q**

Wilfred Ling is an investment adviser with Promiseland Independent. He is licensed by the Monetary Authority of Singapore to provide investment advice. For consultation, prior appointment at telephone 6294-2461 is required. A consultation fee may be charged.