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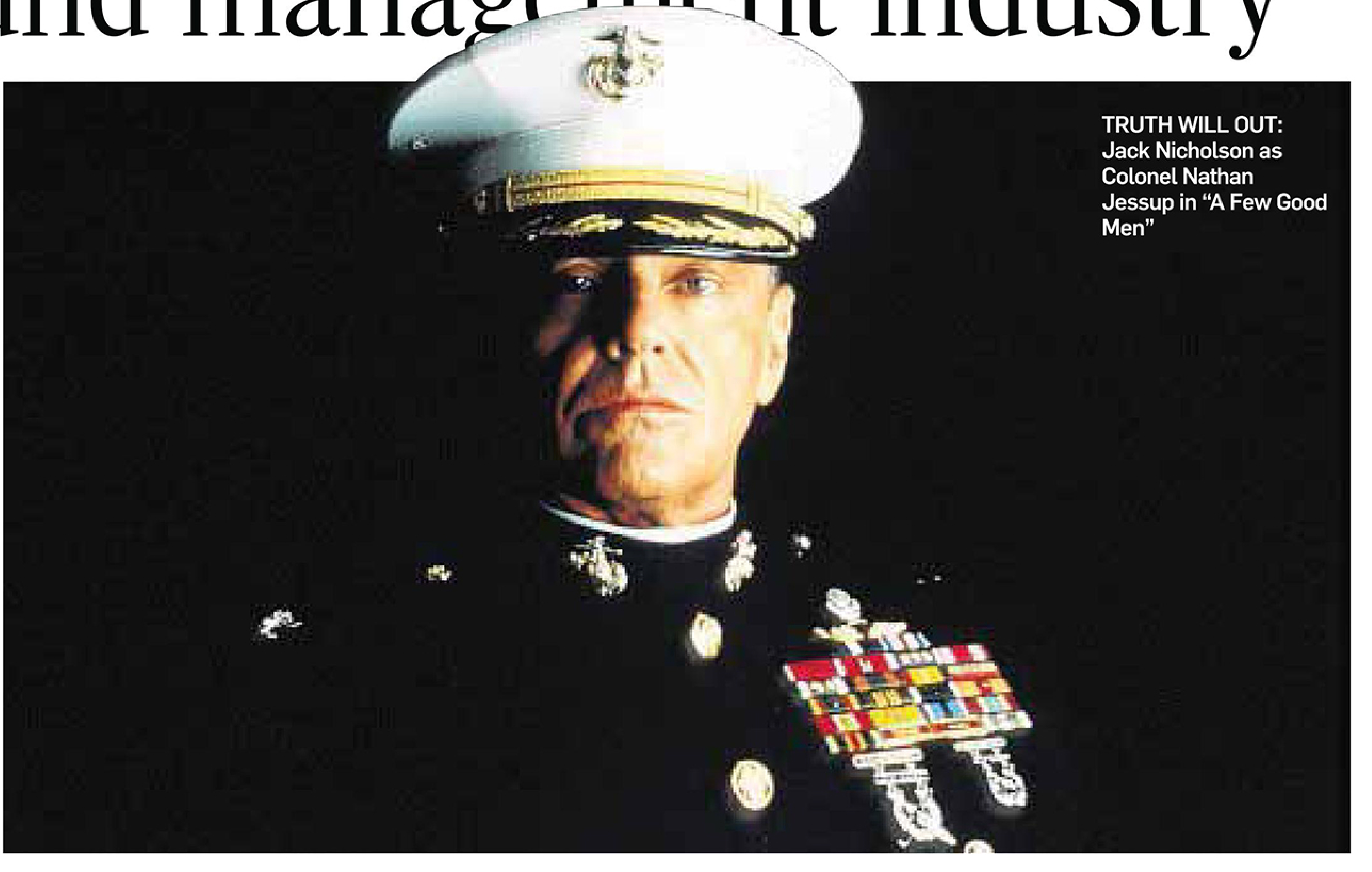
An uncomfortable truth facing the fund management industry



TRUTH WILL OUT: Jack Nicholson as Colonel Nathan Jessup in "A Few Good Men"

Hidden fund management fees can leave savers in the dark about the cost of their investments. Barry O'Neill, an investment director with financial planning, investment and pensions advice firm Carbon Financial Partners in Aberdeen, says some fund managers may want to keep it that way

Transparency, clarity and honesty – all attributes we hold in high regard in our daily lives.

Why then, should we lower our expectations when it comes to investing?

Pressure has been mounting on the active fund management industry to disclose all of the costs investors pay.

Indeed, the former chief executive of industry body the Investment Association tried to introduce greater transparency and was ousted from his position for his troubles.

Perhaps his members were in agreement with Jack Nicholson's character in A Few Good Men, Colonel Nathan R. Jessup, when he said "You can't handle the truth".

David Cameron weighed in to the discussion recently during Prime Minister's Questions when MP Tom Tugendhat raised the issue of the lack of transparency of investment fund fees.

Mr Tugendhat claimed to have discovered his own investment costs were more than 5% a year.

The prime minister acknowledged the lack of clarity was off-putting for investors and a barrier to saving.

The 5% figure, if correct, would be extraordinary. We do regularly see total annual fees in excess of 2.75%.

In the long run, after inflation return from shares is in the region of 4.5% a year, losing over 60% of this in fees means you are taking all of the risks of being a shareholder for only 40% of the return – hardly a sensible trade-off.

Large fees might be acceptable if net of those fees the active management world delivered superior, index-beating performance over an investment lifetime.

However, this is an area where clarity does exist. Both Morningstar and Standard and Poor's (financial services firms) publish reports on how active managers perform when compared to the indices of the markets they invest in. The results are routinely damning. The most up to date report from Standard and Poor's confirms that although the short-term performance of actively managed UK equity funds was reasonable, 71.82% of funds delivered less than the index over 10 years.

Barry O'Neill

Curiously, one of the areas that active fund firms insist is their strength, investing in small companies, faired even worse. More than 80% of them failed to beat the small companies index over 10 years.

If, after fees, the overwhelming majority of actively managed funds lag the simple index return of the market they invest in, surely it would be in their own best interests to reduce costs as this has been proven to be the biggest single determinant of investment success over the longer-term? This seems to be the uncomfortable truth for the industry. Hopefully, active fund management groups will wake up in time to steer away from the cliff-edge they are currently sleepwalking towards. Time will tell.