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RETIREMENT SAVINGS

Does low cost equal low value?

Some investors might fear that their investment products will not perform well if the costs are on the cheaper side. But it is wise to consider the impact of high total expense ratios on your retirement capital.

Only 6% of South Africans retire comfortably. The other 94% generally depend on some form of societal or familial welfare. Why is this the case and what can retirement savers do to ensure that they fall on the right side of this statistic?

Most companies across the world have shifted from traditional defined benefit (DB) pension schemes to defined contribution (DC) schemes. In the former, the employer calculates a defined pension benefit that the employee will receive upon retirement (the criteria used to determine the actual benefit includes years of service, pension contributions, final salary, etc.). In the latter case, the pension benefit that the employee receives at retirement is predominantly defined by the contributions the employee makes during their years of service. The most important distinction between the traditional DB scheme and the modern DC approaches to pension schemes is that in the traditional case, the investment shortfall is covered by the employer while in the modern case, the employee covers their own investment shortfall.

As someone saving for retirement, you are more likely to be saving within a DC scheme (unless you work for the South African government, in which case you are most likely still in a DB scheme). This places a greater emphasis on the choices you make to ensure that you secure a comfortable retirement.

In this regard, there are broadly four important decision areas that you must be aware of:

1. The choice to start saving toward retirement.

2. The decision to remain invested (instead of withdrawing) when changing jobs.

3. The types of assets your retirement savings will be allocated toward.

4. The fees charged by your default (or individually selected) investment manager.

While all the above are crucial, the focus of this article will be on point number four.

In the default regulations for retirement funds published by National Treasury in August 2017, the high cost of access within the retirement ecosystem was cited as one of the largest contributors to South Africans retiring with inadequate retirement benefits. This cost conversation matters more than most people care to realise.

Anyone who has taken a financial economics or investment management course would have heard of the Efficient Market Hypothesis (EMH). Developed in the 1960s by Nobel Laureate Eugene Fama, it makes the assumption that it is "impossible to beat the market", as financial markets are perfectly efficient and any inefficiencies are eliminated as soon as they arise to ensure that no arbitrage opportunities can persist.

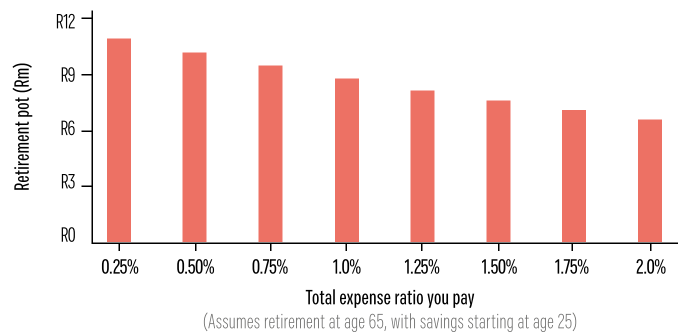
In 2003, the Vanguard Group developed what it called the Cost Matters Hypothesis. Its basic thesis is that whether the Efficient Market Hypothesis is valid or not – whether markets are efficient or not – the costs that you pay in gaining access to the market will always matter. A 2% fee charged on your savings will always reduce in your savings by 2%, regardless of the market environment. So strong is the logical and mathematical grounding of this idea that perhaps a more accurate name for it would be "Cost Matters Fact".

HOW TOTAL EXPENSE RATIOS INFLUENCE RETURNS

Quartile	Average TER	Average return (annualised)			
		10 years	7 years	5 years	3 years
Most expensive	2.44%	7.6%	8.6%	7.6%	3.3%
Least expensive	0.47%	9.6%	9.9%	9.4%	6.1%
Total	**1.49%**	**8.5%**	**9.6%**	**8.5%**	**4.5%**

SOURCE: Morningstar (as at 28 February 2018)

A LOWER FEE PAID FOR RETIREMENT SAVINGS RESULTS IN LONG-TERM BENEFITS



(Assumes retirement at age 65, with savings starting at age 25)

In most industries, people are familiar with the phrase, "You get what you pay for." In the investment management industry, Vanguard founder John Bogle is famous for saying: "You get what you don't pay for." He meant that, as a retirement saver, what you pay your investment manager goes to your investment manager. What you don't pay your manager goes to you.

A simple table illustrates this point. We took the universe of unit trust funds in South Africa's largest and most popular multi-asset category (Association for Savings and Investment South Africa [Asisa] MA High-equity category) and ranked them by the total expense ratios (TER) that they each charge. What is clear from the table is that the more expensive funds tend to have lower net returns compared to the less expensive funds.

According to research from Morningstar, which the firm has also replicated for the SA market, costs are the most important determinant of the success of a fund. This makes the point that the more expensive a fund or retirement solution tends to be, the more the manager gets to keep. And what the manager keeps, the client does not.

Another observation from Morningstar data is that, as a group, investment managers tend to underperform the market (the latest S&P indices versus active (SPIVA) report also provides good evidence of this). This calls for another look at the Cost Matters Hypothesis. Given that there are costs involved in investing in the market (these