Tuesday, May 15th – Box (BOX) by Jayden Preston

"Human Nature is the Ultimate Hidden Fee"

May 20th, 2018

To Focused Compounding members:

In an interview this week with Barron's, Vanguard founder Jack Bogle cited stats that showed the average investor's annual return from index funds was 8.4% from 2005 to 2017, from actively managed funds it was 7.2%, and from ETFs it was just 5.5%. ETFs and index funds are invested in much the same things. So, investors are charging themselves a 2.9% annual fee in the form of bad timing. The same Barron's article quotes BlackRock's Larry Fink as saying: *"..long-termism is better than short-termism. But people need financial instruments for different reasons."* This is the common argument for the existence of ETFs, long-short hedge funds, etc. But, it's wrong. We're talking about a drag of 3% a year between investors ***staying*** in a representative sample of U.S. public companies and investors trading in and out of those same assets. This past week, Andrew and I announced we'll be handling managed accounts. People who have called in have mostly wanted to talk about the fee. I like a 2.5% fixed fee because the math that matters is easy for me to do in my head. We should only accept money when we feel we can still beat the market by more than 2.5% a year after taking on that sum. Different kinds of investment vehicles have different kinds of hidden fees. These fees often add up to more than the amount you're actually being charged. I spent a good part of last week warning Andrew about the performance drag we'd experience if we either: 1) Held more stocks or 2) Managed more assets. Both would create big performance drags. For ETFs, the hidden fee is bad timing. Investors want the freedom to trade in and out of an ETF. And that freedom costs them 3% a year. For accounts like Andrew and I will be running – the hidden fee is size. I guarantee you you'll be better off when we are running $1 million instead of $10 million or $10 million instead of $100 million. Andrew and I won't be better off. But, you will be. Here's the thing. When money managers charge a percent of profits, they like to say their interests and their clients' interest are aligned. But, the truth is that the manager's interest and the client's interest are never aligned on the one question that matters most: *"Should we gather more assets?"* The bigger a fund gets, the worse its performance will be. The more an investor trades in and out of ETFs, the worse his performance will be. Hidden fees like these often add up to more than the actual fee you're charged. Whatever fees a fund is charging you, it's going to be very hard to overcome the hidden cost of either high turnover or a large amount of assets to actively deploy. Small, active funds can work well. And giant, inactive funds can work well. Everything in between that tends to come with some serious hidden costs.