

Understanding managed fund costs

Vanguard INVESTMENTS™

The Plain Talk Library



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Unless otherwise stated, the source for fees and charges information is the IFSA Retail Registered Schemes Fees and Charges Report - August 2001.

Introduction

It is easy to ignore costs when investment markets are performing well. But, when markets are down, the impact of costs are much more obvious. Even minor cost differences between funds can have a significant effect on your investment returns.

It can be very difficult to determine, then compare, all the fees that different managed funds charge. This Plain Talk brochure explains the basics of managed fund costs and offers you several useful tips on cost-conscious investing.

Why it's important to consider costs

All funds have fees, some are much more expensive than others, but there is no evidence to suggest that higher fees result in higher returns. Since investors buy managed funds for their returns and fund costs come off investment returns, costs matter. What most people don't realise is just how much a difference they can make over time.

You cannot control future returns, but you can control what fees you are prepared to pay. When you invest in a managed fund, high sales commissions, excessive management expenses, and other fees can significantly erode your investment.

Consider the cost differences in the following two hypothetical funds. Both funds are exactly the same, except that total fees for fund A are 1% more than fund B.

The following table assumes a return of 8% per year and shows how cost differences can affect total returns over time. Fund A has an annual management expense ratio (MER) of 1.75% and fund B has an annual MER of 0.75%.

Value of \$20,000 invested for 20 years in 2 hypothetical funds*

	Fund A	Fund B
	MER 1.75%	MER 0.75%
Initial investment	\$20,000	\$20,000
5 years	\$27,082	\$28,380
10 years	\$36,671	\$40,272
15 years	\$49,655	\$57,146
20 years	\$67,237	\$81,092
Difference		\$13,855

Source: Vanguard

*This is an example only, for illustrative purposes. It does not imply these returns are available on any particular investment. The fees do not relate to any particular funds.

Defining managed fund costs

Fund managers charge fees for their services and recover expenses incurred in the marketing, promotion and administration of funds. Funds have different fee structures. However, managed fund costs typically fall into four broad categories.

1. Management Expense Ratio (MER)

The investment management fee and associated expenses are known as the management expense ratio. The MER generally includes the fee for managing your money as well as marketing the fund. It also covers operating expenses such as legal, accounting and audit fees, custodian fees, the costs of preparing the product disclosure document or prospectus and administrative expenses.

The MER is typically expressed as a percentage of your investment account balance and is deducted from the fund's assets or investment earnings. For instance, a MER of 1% results in a charge of \$10 per \$1,000 of investment per year. The MER for retail managed funds, can range from around 0.70% per annum of the balance of your investment account to more than 2% per annum. Wholesale managed funds with lower MERs, are also available for investors with typically more than \$500,000 to invest.

Many funds also have a **trail (ongoing) commission** payable to the adviser which is charged to the investor's account on an ongoing basis. Typically a trail commission can range from nil to 0.60% annually and is included in the management expense ratio.

The MER can differ depending on the type of fund selected. The table below indicates the average retail MER for each category, ranging from a low of around 1% for cash funds to 2% for international share funds.

Asset Class	Average MER (%) p.a.
Australian shares	1.85
International shares	2.00
Cash	1.04
Australian bonds/fixed interest	1.55
International bonds/fixed interest	1.80
Property securities	1.89

Source: Vanguard using ASSIRT data as at November 2002

Actively managed funds tend to charge higher MERs than index funds. The MER for a Vanguard retail index fund ranges from 0.70% to 0.90%, with substantial discounts for large investments. While the difference in percentages charged might seem small, they can have a dramatic impact over time.

2. Entry fee

This fee is levied when the initial investment is made (effectively reducing the amount invested). The entry fee can range from nil to 5%. A fund with a nil entry fee will typically have a higher MER than those that charge an entry fee. Some low fee funds - like Vanguard funds - are the exception.

An **upfront commission** is often included in the entry fee and is essentially a fee charged to pay for a financial adviser's services. Some advisers rebate this commission back to the client as part of the arrangement they have with their client and instead charge a fee for service. Where this occurs a fee for service is usually paid to the adviser in place of the upfront commission.

3. Exit or withdrawal fee

A fee may be charged when you withdraw your investment. The amount charged is often assessed on the length of time you have held your investment. The exit fee can vary significantly between funds and can range from nil to 4%.

Most managed funds charge either an entry or an exit fee and typically not both. Some funds, such as the Vanguard Investor Funds charge neither an entry nor an exit fee.

If you are **switching funds**, withdrawing from one fund and investing in another, you might incur an exit and or entry fee and a buy/sell spread, described below.

4. Buy/sell spread

Generally, the buy/sell spread is a transaction cost charged when you invest or withdraw your investment and is usually incorporated in the fund's unit price. This fee is normally paid to the fund to recover its costs and not to the fund manager.

When monies are invested or redeemed, the fund manager purchases or sells securities in order to satisfy unit holder requests. As a result of these transactions, costs such as brokerage are incurred which are recouped through the buy/sell spread. In general, the purpose of the buy/sell spread is to protect long-term investors from the costs associated with those who come and go in the fund. Costs not passed on in this manner would impact on the fund's performance and affect all unit holders, not just those transacting.

The buy/sell spread can range from nil to 0.50%, depending on the type of fund.

Fees and charges that you might encounter

Entering the fund

1. Entry fee which usually includes an upfront sales commission.

Can range from nil to 5%.

2. Buy spread charged to cover transaction costs and is usually included in the unit price.

Total buy/sell spread can range from nil to 0.50%.

Ongoing management

3. Management Expense Ratio (MER)

covers the cost of managing the fund.

May include a trail commission.

Total MER can range from 0.70% to more than 2.0% per annum.

Leaving the fund

4. The amount of exit fee charged is usually assessed on the length of time invested in the fund.

Can range from nil to 4%*.

5. Sell spread charged to cover transaction costs and is usually included in the unit price. (see 2. Buy spread)

*Source: ASSIRT May 2001.

If you are not sure about the fees and charges payable on a particular fund, don't forget to ask your fund manager or financial adviser.

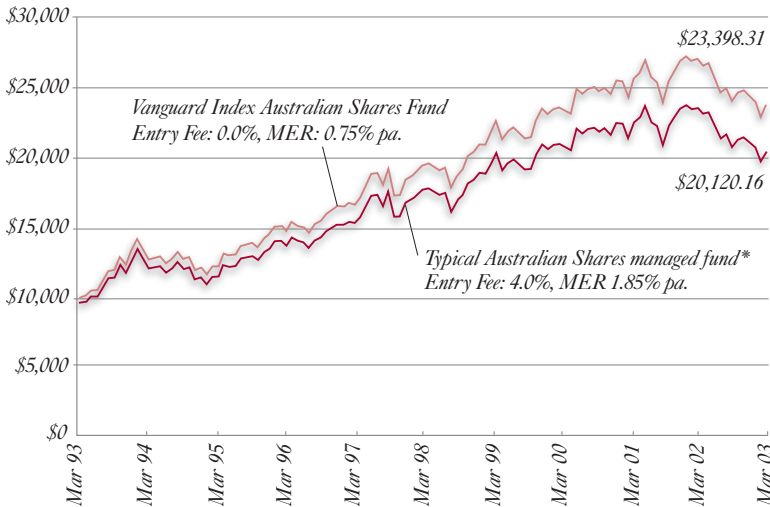
Comparing managed fund costs

Many investors compare the past returns of managed funds before making an investment decision. Past returns are not a guarantee of future returns. In fact, the best performing fund in any one year often cannot maintain an above average performance the following year.

The costs of managed funds are easier to compare and it is important to carefully consider these costs. Fund managers are required to disclose all fees and expenses in the prospectus/product disclosure document. This assures your ability to compare fund costs before you invest.

Example of the impact of fees on two Australian shares funds

*Investment value of \$10,000 after fees (assuming S&P/ASX300 Index Returns)
Initial Investment 31 March 1993*



*Source: Vanguard using ASSIRT data.

This is an example only for illustrative purposes. The fees, charges and expenses do not relate to any particular funds.

While it is important to compare costs, your investment decision should not be based on costs alone. The fund that you select should match your goals, risk tolerance and time horizon. Before you invest, remember to read the prospectus/disclosure document carefully.

When comparing fund costs, you should be aware that some of those costs may be used to pay an adviser for providing you with financial planning or fund selection advice. The cost of this service may be reflected in an entry fee, or in a trail commission, or both. If you need advice, a commission may be an appropriate way to pay for it.

If you are a “do-it-yourself” investor, you may prefer funds that do not charge fees for these services. The Vanguard Investor Funds do not pay sales commissions and so are most appropriate for investors who make their own decisions or who use financial advisers who charge a “fee for service”. Vanguard funds are also available through many master trust and wrap services, which charge a fee for administration and advice.

Assessing the impact of costs

It can be difficult to determine the total cost of a fund at first glance. A quick review of the fees charged by a managed fund - before you commit your investment dollars - can save you money later on. Consider the example of John Brown who invests \$10,000 in a managed fund on 1 March 2003 and withdraws his investment two years later. John's fund has charged him the following fees:

Type of Fee/Charge/Expense*	Amount of Fee/Charge/Expense over 2 years
Entry fee 4%	\$400
Buy Spread 0.25%	\$24
Management expense ratio 1.85% per annum	\$359
Sell spread 0.25%	\$23
Total Fees, Charges and Expenses	\$806

*This is an example only for illustrative purposes. The fees, charges and expenses do not relate to any particular funds.

Before investment income and capital growth is even considered, John has had his investment buying dollars reduced by \$806 or 8% of the \$10,000 invested. So this fund needs to earn 8% over 2 years for him to cover his costs.

Tax - the hidden cost

Often a forgotten part of the investing equation, taxes can severely impact your bottom line returns. An investor in a managed fund can incur income and capital gains taxes when:

- The fund distributes its net income;
- The fund distributes realised capital gains;
- You realise a capital gain as a result of a withdrawal, switch or transfer of units in the fund.

A fund manager who throughout the year has been actively buying and selling (turning over) securities within a fund, is likely to produce a higher capital gains tax liability for an investor, than a manager who adopts a buy and hold approach.

For instance, an index fund investing in Australian shares, would have an expected turnover rate of 5% or less, compared to an actively managed fund which generally turns over 30% or more of its portfolio throughout the course of a year.

A buy and hold approach such as indexing can be a tax effective strategy for share investing that offers two key benefits:

- Most if not all gains will qualify for the capital gains tax concessions* because most securities would have been held for more than a year; and
- Investors can defer paying taxes and earn a return on the deferred amount by keeping gains (unrealised) within the portfolio.

It is important to keep in mind a fund's turnover rate, and its potential impact on your returns. For many investors a buy and hold approach can minimise capital gains tax.

*Only half the gain is taxed for long-term capital gains on assets held for more than 12 months. For short-term gains (on assets held for less than 12 months), the entire gain is taxed.

The Vanguard advantage

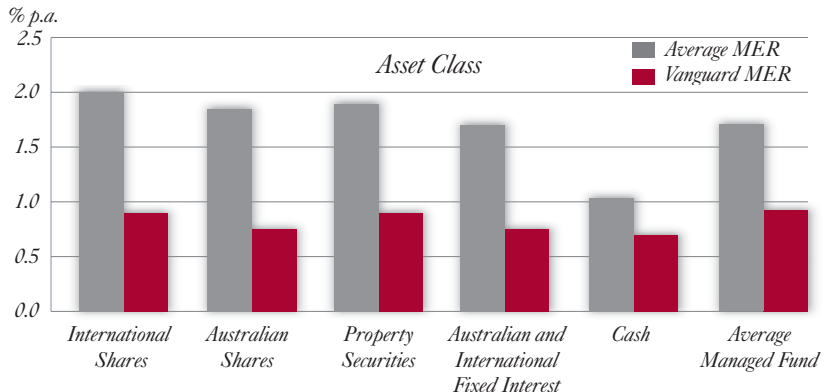
At Vanguard we are committed to providing the highest quality services at the lowest reasonable cost. The indexing approach we use to manage our funds has an inherent cost advantage.

Our funds have:

- **Low management fees.** An index fund typically has a much lower management expense ratio than an actively managed fund. The MER for a Vanguard retail index fund is less than 1%, which is substantially less than the industry average*.
- **Low transaction costs.** An index fund tends to buy and hold securities and does not regularly trade in order to outperform the market. In contrast, an actively managed fund will typically trade securities regularly, incurring higher brokerage, stamp duty and other such costs.
- **Lower taxes.** Indexing's buy and hold approach may also reduce capital gains tax liabilities compared to most actively managed funds.
- **No sales commissions.** Our funds do not have sales commissions. If however, you obtain advice from a financial adviser, your adviser may charge you a fee.

The low cost advantages of indexing provide investors with a larger share of investment returns - and a competitive edge over time. The MER advantage is shown below.

*Comparison of retail management expense ratios (MERs)**



* The MERs analysed are based upon an investment of up to \$50,000.

Source: Vanguard using ASSIRT data as at November 2002

Summary of fees and charges for Vanguard Investor Funds

Fund	Entry, Exit & Switching Fee	MER**			Buy Spread*	Sell Spread*
		For amounts up to \$50,000	\$50,001 to \$100,000	For amounts over \$100,000		
Cash Plus	Nil	0.70%pa	0.50%pa	0.35%pa	Nil	Nil
Diversified Bond	Nil	0.75%pa	0.50%pa	0.35%pa	0.15%	0.15%
Property Securities	Nil	0.90%pa	0.60%pa	0.35%pa	0.20%	0.20%
Australian Shares	Nil	0.75%pa	0.50%pa	0.35%pa	0.20%	0.10%
International Shares	Nil	0.90%pa	0.60%pa	0.35%pa	0.30%	0.10%
Hedged International Shares	Nil	0.90%pa	0.60%pa	0.35%pa	0.35%	0.15%
LifeStrategy Conservative	Nil	0.90%pa	0.60%pa	0.35%pa	0.15%	0.10%
LifeStrategy Balanced	Nil	0.90%pa	0.60%pa	0.35%pa	0.20%	0.15%
LifeStrategy Growth	Nil	0.90%pa	0.60%pa	0.35%pa	0.25%	0.15%
LifeStrategy High Growth	Nil	0.90%pa	0.60%pa	0.35%pa	0.30%	0.20%

* The buy and sell spreads are paid to the fund, not to Vanguard.

**MERs are capped until at least 16 February 2004

Take charge with Vanguard

Vanguard Investments Australia Ltd is a wholly owned subsidiary of The Vanguard Group, Inc., based in the US. It combines the skills of its team of Australian investment professionals, with the strength and expertise of its international parent.

The Vanguard Group manages approximately \$1 trillion for individual and institutional investors.

Vanguard in Australia has established a strong reputation as the index specialist, managing approximately \$17 billion in index funds, primarily for large institutional investors.

Vanguard Investor Funds

If you are looking to access low cost investments, we have a range of asset sector and diversified index funds. You can invest in our funds by contacting us directly or through your financial adviser.

Asset sector index funds

International Shares

Hedged International Shares

Australian Shares

Property Securities

Diversified Bond

Cash Plus

Diversified index funds

High Growth

Growth

Balanced

Conservative

Vanguard Personal Superannuation Plan

Our low cost Personal Superannuation plan offers a range of asset sector and diversified investment options to choose from.

Why Plain Talk?

At Vanguard, we believe that one of the keys to investment success is being an informed, knowledgeable investor.

Our growing Plain Talk Library covers a number of aspects regarding investing for success. Our aim, through this library, is to offer candid, concise and easy to understand information on a variety of topics.

Currently our Plain Talk Library includes:

- Understanding Indexing
- Asset allocation
- Understanding bonds
- International shares
- Realistic expectations for share market returns
- Understanding managed fund costs
- Maximising your Super
- Managing your investment portfolio

Like more information or to give us your feedback?

We would be happy to provide you with more information about our Investor Funds or Personal Superannuation Plan. We also value your feedback.

Please contact Vanguard Client Services on **1300 655 101** or access our website through **www.vanguard.com.au** or contact your financial adviser.

Contacting Vanguard

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