MER Misleads Investors When Choosing Mutual Funds

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Articles in the media often recommend that investors avoid mutual funds with high Management Expense Ratios (MER), which they frequently confuse with the management fee.

The management fee is often used as the key determinant when making an investment decision, but the MER is an even broader measure of all the costs of the fund to the investor. Using MER to select mutual funds is misleading advice that will not yield the best results for investors. Since all performance is measured net of MER, it is best to simply choose funds that have the best performance regardless of the MER.

MER represents the combined cost of both the administration of the fund, including the total of operating expenses, taxes and management fees, and the distribution costs paid to dealers divided by the fund's average net assets for that year. This ratio is magnified if the fund has declining assets under management (AUM) growth, resulting in higher MERs, than one that has positive AUM growth. Using MER as an indicator for choosing mutual funds can be misleading because a fund with a lower MER, as a result of high AUM, could underperform a fund with higher MER because the AUM is lower. Since performance must be measured net of MER, a more accurate analysis would be to select funds based on performance and not MER.

Most of the expense categories of a mutual fund are requirements mandated by the securities regulators. These include portfolio management fees, security reporting costs, audit costs, investment review committee fees, sales taxes, legal costs, filing fees, translation costs and printing and distribution costs. Fund managers have little discretion over these costs. The average MER in Canada of all funds is 2.53%.

The simplified prospectuses of all mutual funds must disclose management fees, administration fees, trailing commissions paid to advisors and trading costs. All mutual funds must also report performance data after deducting MER and Trading Expense Ratio (TER).

Most mutual funds have a TER, which is a measure of a fund's trading costs. The trading costs are expenses that aren't included in the MER, including brokerage fees, exchange fees, redemption fees, trading costs, switch fees and sales commissions.

These expenses do not form part of the expenses of the fund, but rather reduce the returns generated by the investments. You can have a fund with low MER but high TER because of frequent portfolio turnover. Again, the important criteria is performance, which is net of both MER and TER. The sum of MER and TER should be used to get an accurate cost estimate.

In typical Class A retail units of a mutual fund, the Management Fee includes a trailer fee paid to the advisor’s dealer. Trailer fees typically range from 0.25% to 1.5% of the value of your investment each year. Therefore, in a fund with a 2.5% MER and a 1.0% trailer fee, about 40% of the MER is attributable to payments to the dealer. Trailer fees can be avoided if investors do not need investment advice and can make their own investment decisions by purchasing Class D units through a discount brokerage account. Class D units typically have an MER that is 1% lower than retail Class A units.

Investors who use a fee-based advisor will typically pay the advisor a fee between 0.5% and 1.5%, depending on the size of their portfolio. However, because these advisors tend to have more assets under management, they are able to negotiate reduced management fees for the mutual funds they use. Fee-based advisors are usually qualified portfolio managers and are more knowledgeable and experienced than a commission based advisor. As a result, they are often able to generate higher returns for their clients.

Not only does past performance of mutual funds not predict future performance, but expense ratios, portfolio turnover and trading costs can have a negative effect on a fund's performance. Based on some studies, the average reduction in annual return per 100% turnover was -0.87 for international stock funds. This may also cause additional taxable events for investors, even when they continue to hold their units.

Higher turnover results in higher costs. Of course, there are the obvious transaction costs. (It’s not free to buy or sell a stock.) But there are other, less obvious, costs as well.

For instance, if a fund wanted to sell all of its shares of a given stock, it’s likely (especially if it’s a particularly large fund) that such a large liquidation would move the price of the shares slightly downward. As such, the fund is likely to receive a lower price for the last shares liquidated than it received for the first shares liquidated. Let’s say that this hidden cost amounts to a 0.5% loss of value.

Then, in most cases, the fund will choose to invest the cash in another security. In this case, the opposite will occur: Purchasing a large amount of a given stock will cause the share price to move upward, however slightly. This again results in a hidden cost. Let’s assume that the cost is a 0.5% loss of value.

In all, this results in a 1% loss of value for the portion of the portfolio that was liquidated and reinvested. With the fund industry's average annual turnover of 92%, this is going to result in an annual hidden transaction cost totaling 0.92% of assets.

Further to MER and TER, investors may also incur a front-end sales charge from the advisor. A back-end load on the sale of the mutual fund may also be applicable; this is known as a deferred sales charge. These charges will have a direct, negative impact on the net returns received by the investor.

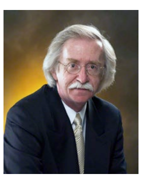
Also, MER comparisons may be meaningful when comparing funds with similar investment objectives. Balanced funds and equity funds, for example, have all of the underlying securities kept in the fund's brokerage account at little or no cost. However, when comparing an equity fund or a balanced fund to a physical bullion fund, MER comparisons are meaningless. Precious metals bullion funds with allocated storage will have storage and insurance costs that don't occur in paper-based funds. Some precious metals funds may have lower MERs because they eliminate storage and insurance costs by buying precious metals proxies like bank certificates, unallocated accounts and futures contracts. In the final analysis, investors may be lured by lower MERs when in fact they don't own any bullion.

Precious metals ETFs appear attractive to some investors because they typically have lower MERs than precious metals mutual funds and mislead investors into thinking they actually own bullion. These ETFs are simply vehicles that track prices. However, when you carefully read the Prospectus and the Authorized Participant Agreement, it becomes clear that the Authorized Participants lease the bullion that they contribute to the ETF. As a result, legal title to the bullion remains with the Lessor. (*The Illusion of Owning Gold*)

In addition, precious metals ETFs typically do not insure their bullion, and the company has no right to inspect the bullion stored with sub custodians.

The largest ETF is SPDR Gold Shares (GLD), the Prospectus of which clearly states, "***The investment objective of the Trust is for the shares to reflect the performance of the price of gold bullion***." No disclosure is made about bullion ownership. Without actually owning the bullion, investors are subject to numerous risks that could occur exactly when they may need to own bullion the most.

BMG Funds have a higher MER because they hold physical bullion on an allocated and insured basis. Most equity funds or balanced funds, as well as some precious metals funds, do not hold any physical bullion and as a result will not have the same expenses. This is due to the costs of storage and insurance that safeguard the investment and preserve wealth in the long term. BMG Funds buy bullion at wholesale prices without any commission, and they do not have a TER because they don't trade or rebalance the bullion holdings. BMG Funds have an exemption from requiring a portfolio manager because of their fixed investment policy of investing 95% in physical bullion, and therefore avoid the costs of a portfolio manager. BMG does not use any derivatives or hedges and does not lease the bullion. While this may not be appreciated in today's environment, in the future, when physical bullion is in short supply, it will become critically important to own fully insured and allocated physical bullion.



Nick Barisheff *is the founder, president and CEO of BMG Group Inc., a company dedicated to providing investors with a secure, cost-effective, transparent way to purchase and hold physical bullion. BMG is an Affiliate Member of the London Bullion Market Association (LBMA) as well signatory to the Six Principles of Responsible Investments (United Nations endorsed Principles for Responsible Investment – PRI).*

Widely recognized as international bullion expert, Nick has written numerous articles on bullion and current market trends that have been published on various news and business websites. Nick has appeared on BNN, CBC, CNBC and Sun Media, and has been interviewed for countless articles by leading business publications across North America, Europe and Asia. His first book, $10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven, was published in the spring of 2013. Every investor who seeks the safety of sound money will benefit from Nick's insights into the portfolio-preserving power of gold. www.bmg-group.com