Lower fees - much ado about nothing?

End-investor costs are still under the spotlight despite efforts by firms like Vanguard announcing a 50% reduction in its UK closed-platform fee structure for online clients, says Paul Gambles of MBMG Group in Thailand.

Vanguard UK recently announced a 50% reduction in its UK closed-platform fee structure for online clients. This has been heralded as "throwing down the gauntlet to high-charging rivals and financial advisers by slashing fees to less than half the UK average".

While that may be true, the offer in itself is perhaps less attractive than Vanguard's marketing may suggest, according to Paul Gambles of MBMG Investment Advisory, and a co-founder of MBMG Group.

Plus, he adds, it leaves unanswered many key fundamental questions about end-user costs for clients.

"Coincidentally, just before the announcement in the UK, I was talking to a new client about the fund giant's offering. Since then, I seem to have been asked about it on a daily basis," he says. "My view is that the reality of Vanguard's announcement fell some way short of the hype."

Still, he believes that it has at least generated discussion on how the wealth management industry generates its income from clients.

DIFFERENT CLIENT TYPES

Gambles breaks down the investor universe into three broad types.

"DIY clients" typically make all the decisions themselves. They may pay fees for specific expertise in related areas and also pay subscriptions or fees for research. Many might also want to execute transactions online; some may prefer to use a broker, RM or adviser.

"Collaborators", meanwhile, want to be involved in the decision-making process but tend to place a higher value on external input. Collaborators might generally be less inclined to execute transactions themselves online.

Thirdly, "delegators" are generally investors who prefer to have a high-level overview of setting strategy but little

PAUL GAMBLES
MBMG Group

or no ongoing day to day involvement. "The best approach is very much a client's own decision and can change over time," says Gambles. "It impacts greatly on the services that are provided and the fees charged for the delivery of the complete wealth service."

However, this is frequently misunderstood and far from clear for a variety of reasons, he adds.

One major factor is the complexity of intermediation and disintermediation relationships, which appears to be changing faster today, as the role of technology increases. "All clients face similar challenges trying to identify the most cost-effective solutions," says Gambles. "The visible fees, that in many cases have been unbundled, are the tip of the iceberg. The majority of financial-institution profit may lurk below the surface."

SOURCES OF INCOME

He believes that financial institutions have been able to benefit from multiple income streams, mainly: their own (or affiliated) product or service fees; transaction fees and profits; and incomes received from third parties. "Each of these have visible and hidden facets," says Gambles. "Once having apparently 'unbundled' their services and fees, banks (and other financial institutions) have rather furtively buried many of them again."

Broadly, the essential links in an investment service chain comprise of the custody of the assets, the transaction of assets and ultimately the asset allocation/selection decision-making process, when investors, or their delegated agents, have to choose what assets to hold, buy and sell etc.

Visible transaction fees might amount to only a fraction of a percentage, or a flat fee per trade. But, says Gambles, these might also be just the thin end of a much fatter wedge. "Hidden fees can be much higher. In addition to the fees received from genuinely third party providers, institutions frequently promote the funds of their affiliated fund management company, thus capturing, for their parent company or group, the entire up-front and ongoing fees."

There has also been a significant trend for private banks to promote structured and other products created by their investment banking division, in which structuring has in many cases now become a major activity. Structured products typically pay explicit fees – to private banks and also to advisers or brokers – which, in markets where generally such distribution fees have to be disclosed, have averaged around 2%. "They may be higher in less regulated markets," adds Gambles. "These products also generate further fees for the investment banks involved in structuring them, which can be many times greater than this."

Brokerage accounts are generally focused primarily on market-traded assets (stocks, ETFs and mutual funds, etc). But, he says, brokers also have promoted structured products too. "Within market-traded assets, there can also be additional opaque opportunities for banks and brokerages to generate significant extra income. With the volume of US and European stock-trading taking place off-exchange and the volumes in dark pools each now approaching 50%, hidden income generation at the clients' expense is on the increase," he explains.

A wide range of choices exists to provide the most suitable services for each client's given situation. "The opaqueness surrounding these makes it difficult for clients to fully assess the best option for them. Conflicts of interest lead to hidden or embedded fees, making the comparison of visible fees at best only a partial view and, at worst, downright misleading," says Gambles.

MAKING PROGRESS

He believes that Vanguard's initiative is definitely a move in the right direction, but adds that the firm's reduced offering is far from cheap for a closed investment universe, offering access to only Vanguard funds. And, like any closed or restricted universe, it inevitably compromises client outcomes in most foreseeable situations. "Therefore, the extent of savings compared with more open-architecture alternatives is the most significant metric to assess here," says Gambles. "Vanguard remains more expensive than the most competitive restricted architecture solutions available and not sufficiently cheaper than the best value open-architecture solutions. Overall, Vanguard's UK solution also remains short of the kind of value-added extras many clients require."

As a low-cost index funds provider, Vanguard has outstanding marketing, he adds, even though there are often cheaper ETFs in most categories. "But building a portfolio exclusively of these, though, is too limited for most HNW or family office investors," adds Gambles. "Sadly, Vanguard's new price structure is therefore unlikely to have any direct impact on our business."

Yet, just as the fund house's original indexing business forced change on the US and global investment landscape, it may be that the furore surrounding this latest fee cut will see reductions in custody and transaction costs.

Ideally, says Gambles, it will start a broader discussion about how conflicts, that still pervade the investment profession to the detriment of end-users, can be addressed and lead to transparency regarding all fees. "Otherwise, at least we'll have cheaper explicit fees and have to continue doing our best at hunting down hidden costs." ■