

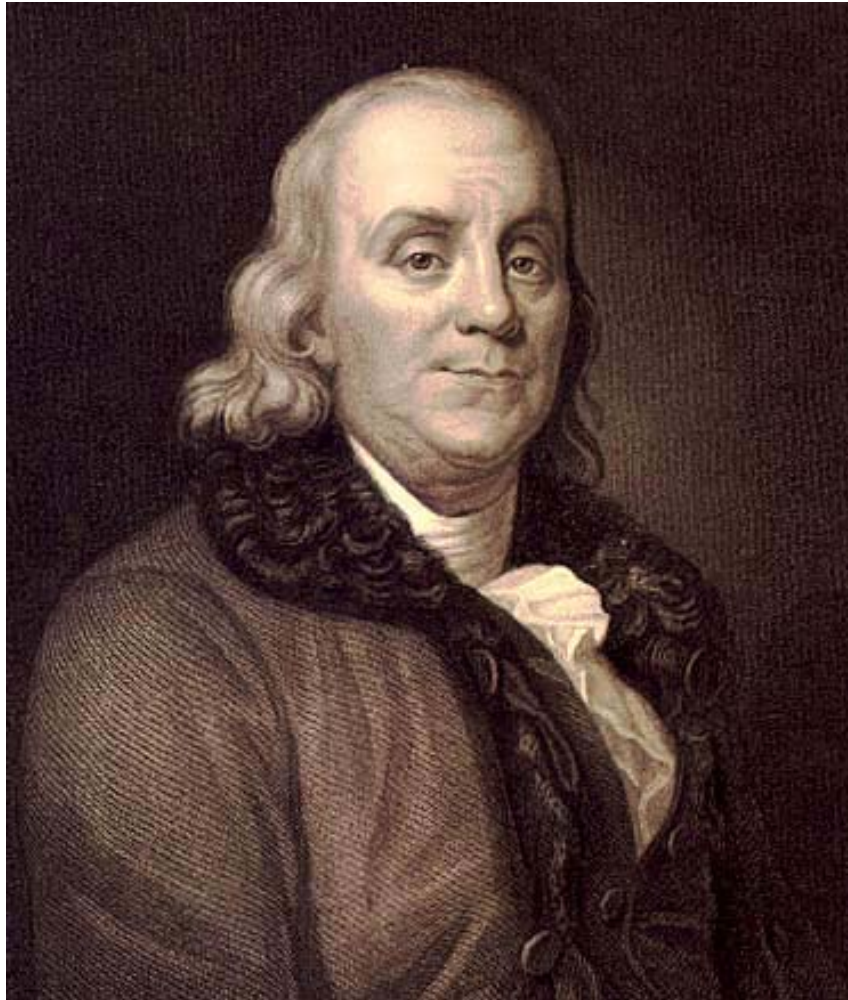
# Why is looking at costs so important?

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Dr. Diego Liechi, Investment Consultant  
PPCmetrics AG  
Financial Consulting, Controlling & Research  
[www.ppcmetrics.ch](http://www.ppcmetrics.ch)

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# Why is looking at costs so important?



A penny saved  
is a penny earned

*Benjamin Franklin*

**But who cares?  
It is just a penny!**

# Structure of the talk

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- Introduction
- Some experiments
  - Under certainty and uncertainty
- Is active portfolio management worth the additional costs?
  - Some arguments
  - Academic literature
  - PPCmetrics experience
- Conclusion

# Introduction (1)

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- What is the definition of costs?
  - “The amount or equivalent paid or charged for something”  
(Merriam-Webster Dictionary)
- In many industries costs are a big issue!
  - Examples: car industry, airline industry
- Are there any reasons why costs are not such a big issue in the asset management industry?

- There are many kind of costs for pension funds
  - Obvious costs
    - Management fees, performance fees
    - Custody costs
    - Brokerage fees
    - Own operational costs
    - Fees for consultants
    - Taxes
  - Hidden costs
    - Bid-ask spreads and other transaction costs
    - Retrocession, soft dollars, etc.
    - ...
- Example: structured products

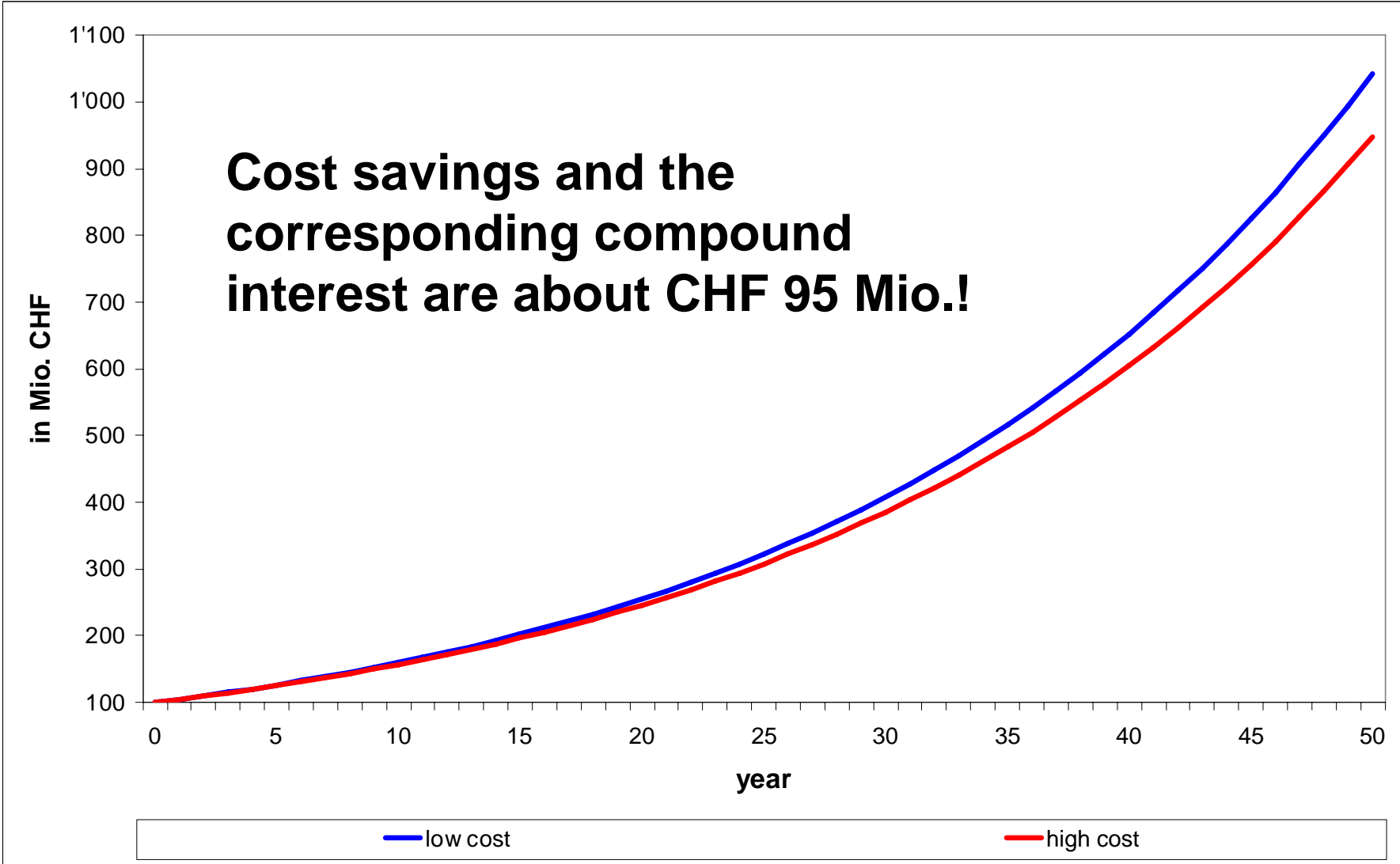
- Cost-benefit analysis
- Cost analysis: Examine and monitor your costs
  - Total costs = fixed cost + variable costs
- Fixed vs. variable costs
  - If problems arise, variable costs are easier to cut
  - Flexibility: Keep your fixed costs low
  - However, cutting fixed costs too much can cause (operational) problems
  - Importance: matter of size
- How important is it really to reduce these costs?

# Some experiments (1) – setup

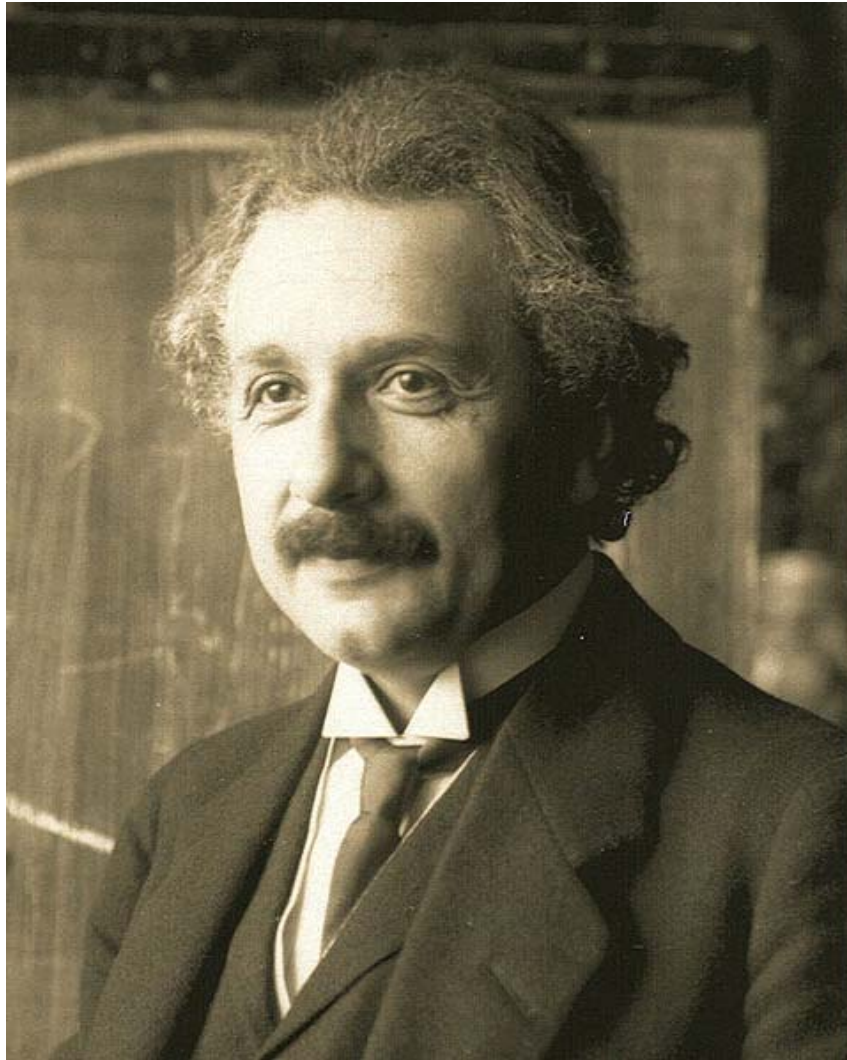
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- Example:
  - Fund size: CHF 100 Mio.
  - Expected return of a pension fund: 5.00%
- What is the impact of additional 20 basis points costs on the value of fund? (e.g. costs rise from 20 bp to 40 bp)?
- „Not that much“: CHF 200'000 per year
- Cost savings in 50 years are CHF 10 Mio.

# Some experiments (2) – value of the fund



# Compound interest



Compound interest  
is the world's  
greatest discovery

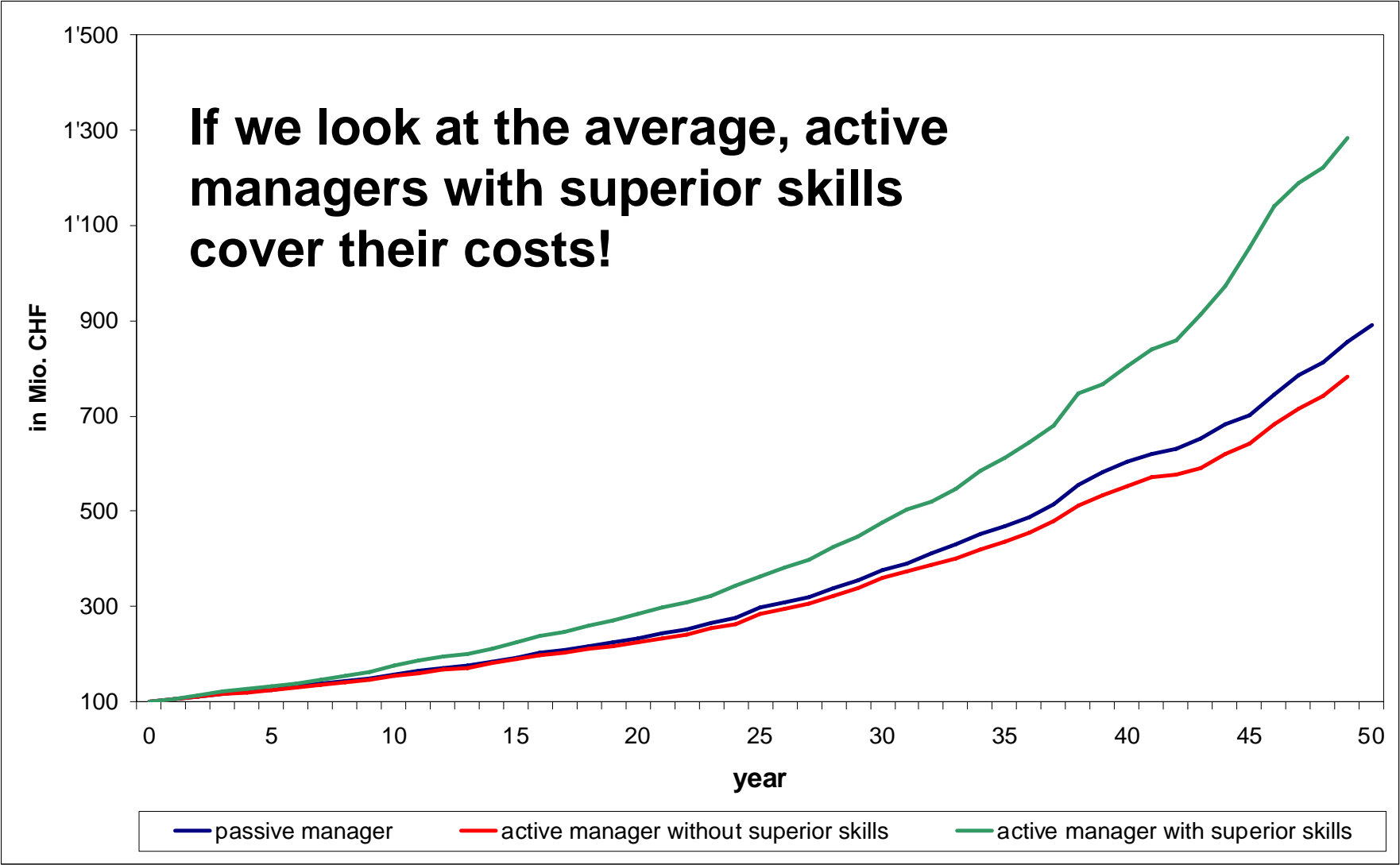
Albert Einstein

## Some experiments (3) – new setup

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- But probably the fund with the higher costs has a higher alpha?!
- So, what if we have three possibilities?
  1. Passive manager: Market (low beta)  $\sim N(5\%, 15\%)$ , costs 20 bp
  2. Active manager without superior skills: same market component as passive product, alpha component  $\sim N(0\%, 5\%)$ , costs 40 bp
  3. Active manager with superior skills: same market component as passive product, alpha component  $\sim N(1\%, 10\%)$ , costs 40 bp
- If we run some simulations, what happens?
  - 200 random draws

# Some experiments (4) – value of the fund



# Some experiments (5) – value of the fund



## Some experiments (6) - takeaways

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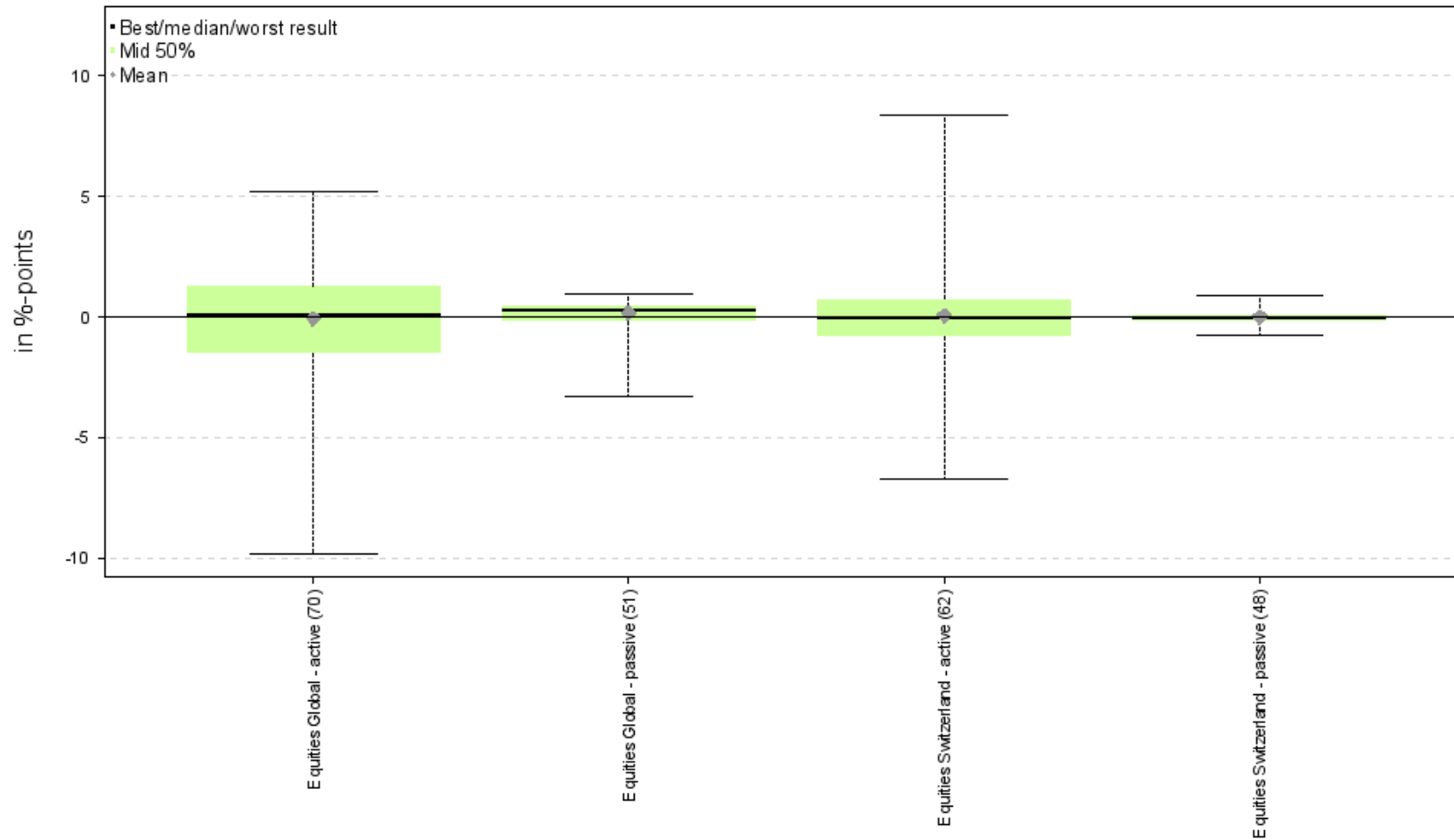
- Saving costs is per se a good idea.
- Active managers with superior skills, i.e. managers with higher costs on average, are possibly worth their money.
- However, are active managers really able to outperform the market on a risk-adjusted basis?
  - Are there any skilled managers?
  - How easy can we distinguish between luck and skills (are they easy to select)?

- Pro:
  - There are many active asset managers with historical outperformance!
  - Markets are not always efficient?!
  
- Contra:
  - Head you win, tail you loose:
    - If a 1'000 people toss a coin 5 times, there will be on average 30 people which always have head.
    - There are millions of asset managers!
  - Sharpe's argument
  - Financial markets are competitive
    - Life cycle in other industries

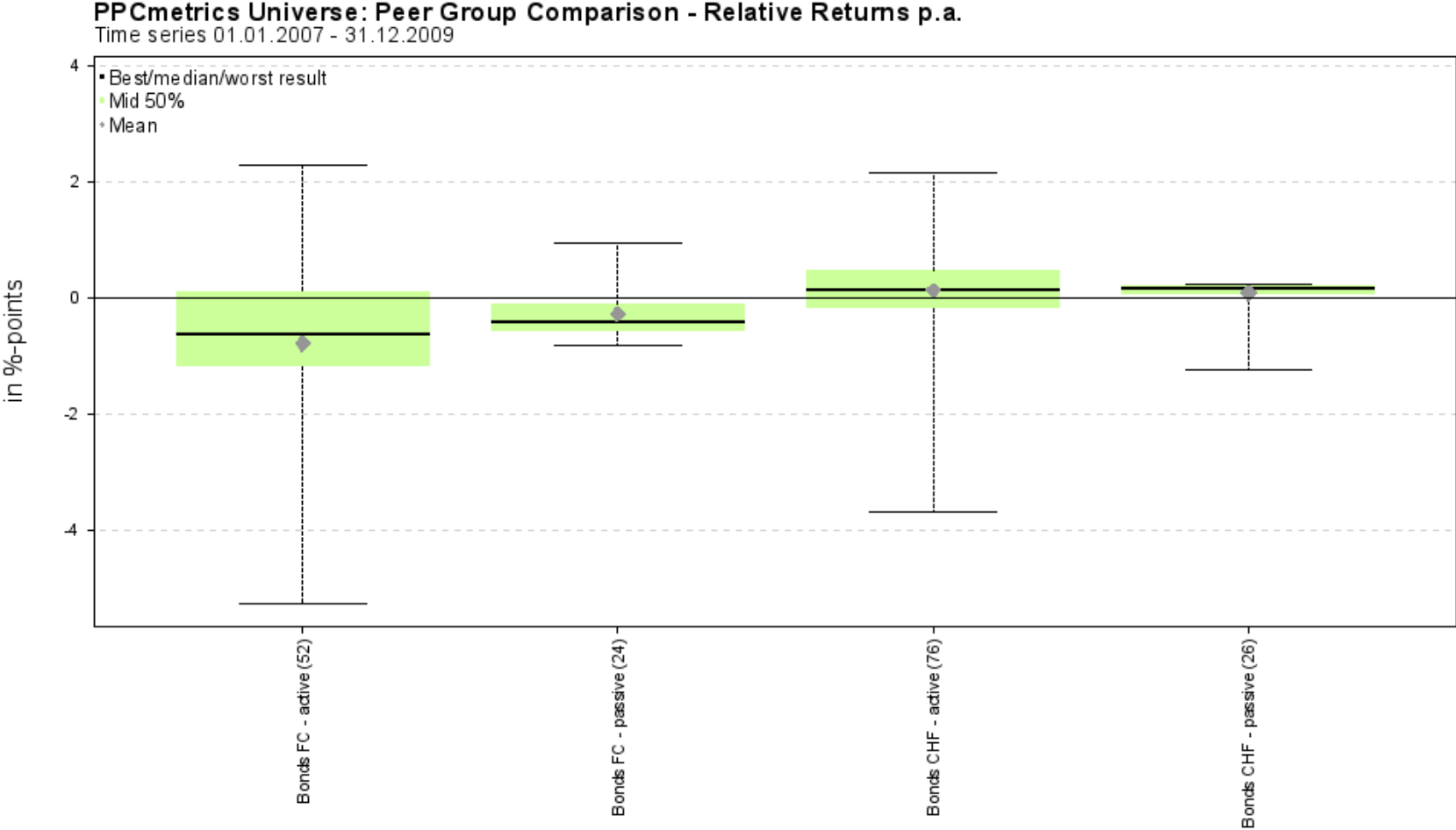
- Academic literature tells us:
  - No alpha in retail mutual funds
  - No alpha in private equity or venture capital funds
  - Data problems with hedge funds (i.e., survivorship bias)
  - Pension fund does not have a superior selection ability
  - Most so called outperformance is the exploitation of risk factors
- Bottom-line:
  - Outperforming of the market happens, but not in a systematic way.
  - Looking, investing in risk factors is important!
- But they are just academics! They know nothing about the reality!

# PPCmetrics experience: Equity (gross returns – benchmark return)

PPCmetrics Universe: Peer Group Comparison - Relative Returns p.a.  
Time series 01.01.2007 - 31.12.2009



# PPCmetrics experience: Bonds (gross returns – benchmark return)



# Necessary conditions to distinguish between luck and skill

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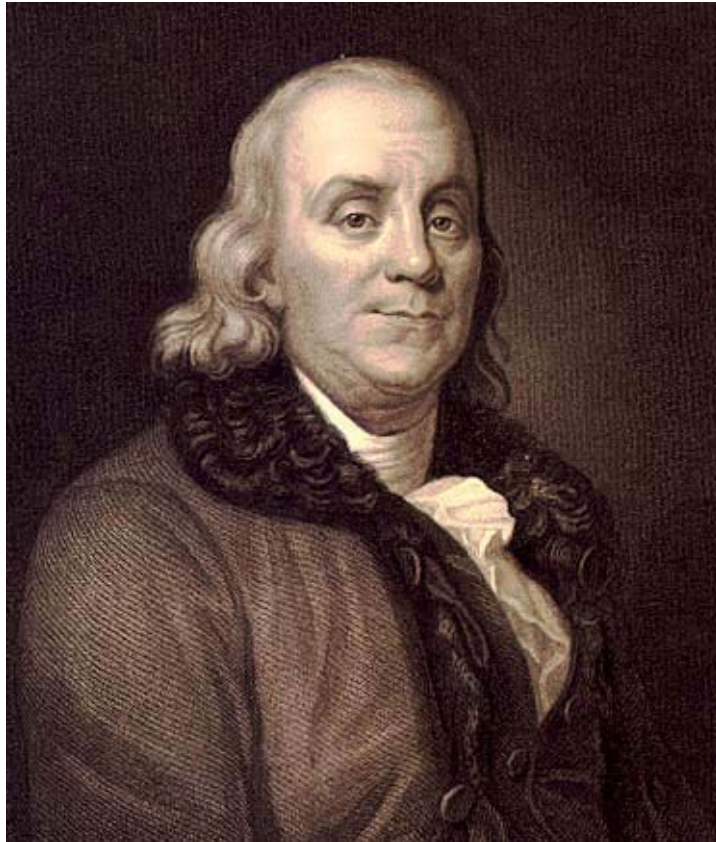
- Long track record (>11 years)
- Adequate benchmark
- Control for (non-traditional) risk factors
  - Equity: Value-growth, size, momentum, liquidity
  - Bonds: Term spread, credit, fxcarry, liquidity
- However, there are still problems with asymmetric risks (e.g. hedge funds).

# Conclusions

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- Looking at costs is really important
  - Especially from a long-term perspective
  - Lowering costs is like getting more return for sure!
- It is at least questionable that active portfolio management is worth its costs!
- Consequences for pension funds
  - Costs, especially fixed costs, have to be a big issue
  - Need for good arguments for active management
  - Look at, evaluate, and invest in risk factors
  - If necessary renegotiate your costs!

**Thank you for your attention!**



**A penny saved is a penny earned**



**That's two pennies we can tax!**

## **PPCmetrics AG**

### **Financial Consulting, Controlling & Research**

Badenerstrasse 6  
Postfach  
8021 Zürich

23, route de Saint-Cergue  
1260 Nyon

Tel. +41 44 204 31 11  
Fax +41 44 204 31 10

Tel. +41 22 704 03 11  
Fax +41 22 704 03 10