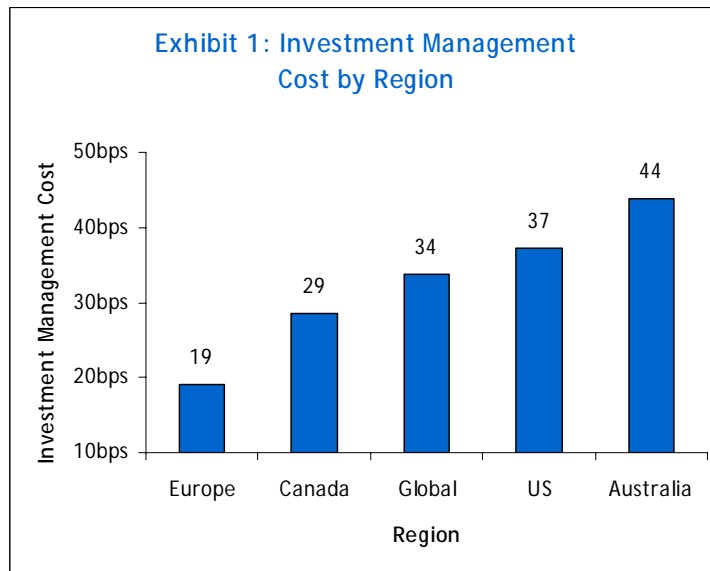


## The World's Lowest Cost Funds

### Apples-to-apples

If we measure the long-term average annual investment management cost incurred by funds from different global regions we find that European funds, at 19 bps, spend the least while Australian funds, at 44 bps, spend the most. This is shown in Exhibit 1. However, before we conclude that European funds are the world's lowest cost funds, we need to consider if the comparison is truly "apples-to-apples."



Funds with more high cost assets, such as real estate or hedge funds and private equity, cost more to manage. Economies of scale drive lower costs in larger funds. Passive management is less costly than active management. The relevant measure to use to assess whether a fund is high or low cost is not a fund's absolute basis point cost number but a fund's basis point cost number adjusted for factors such as asset mix, size and style.

This article will examine the how these three variables impact cost. It will establish how much of the variation in investment management costs and fees is explainable by these three variables. Finally, the article will review the cost of European funds relative to other world funds adjusted for these key factors.

Our consideration begins with an examination of the global investment performance database of CEM Benchmarking Inc. It contains long-term return, cost and risk data from over 700 of the world's largest and most influential funds based in Australia, Canada, Finland, France, Ireland, the Netherlands, Norway, Sweden, and the US. The average fund size in 2005 was US\$10.8 billion. The proportion of corporate versus public or other funds was reasonably balanced at 45% versus 55%.

### Asset mix matters

Much of the variation in cost among funds can be explained by the wide range in asset class costs and by regional differences in asset mix. Exhibit 2 below shows the average costs for asset classes in 2005. The costs range from 15 bps for fixed income to 180 bps for hedge funds and private equity.

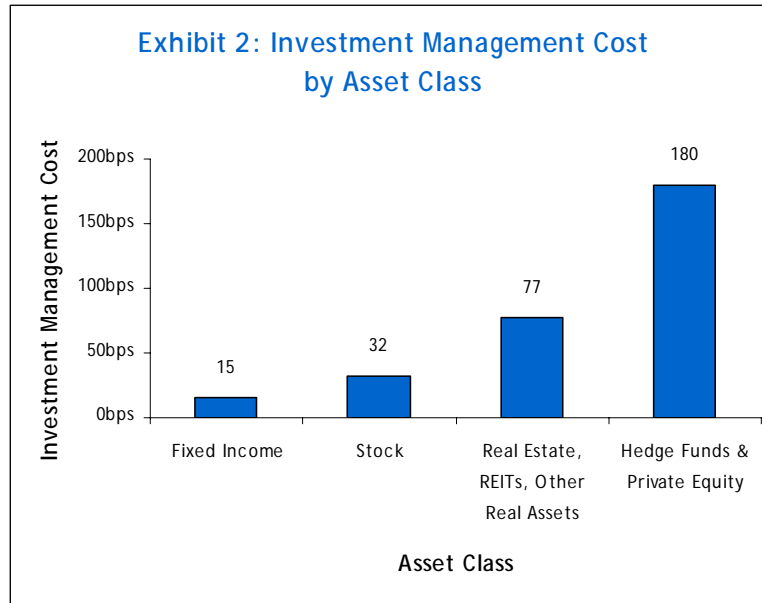
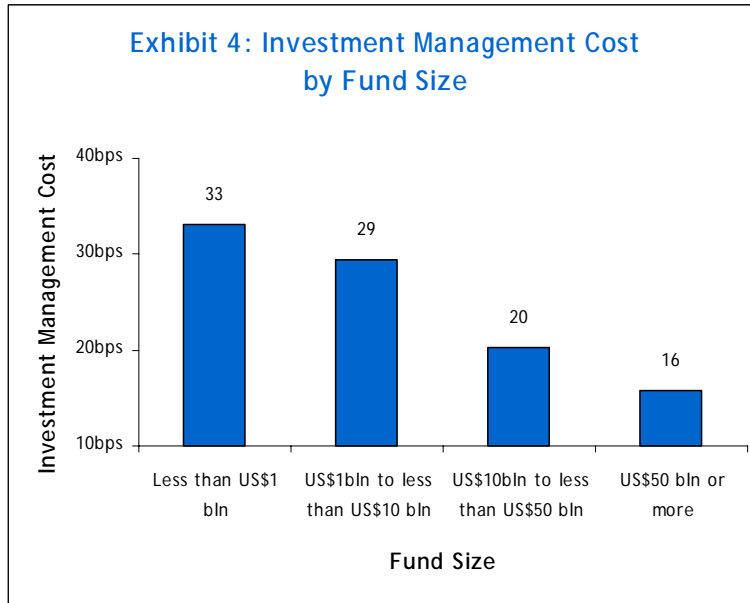


Exhibit 3 shows the regional differences in asset mix for 2005. European funds have the lowest weight (1%) in the highest cost asset classes (hedge funds and private equity) and the highest weight (47%) in the lowest cost asset class (fixed income). By contrast, Australian funds have the highest weight (9%) in the highest cost asset classes (hedge funds and private equity) and the lowest weight (25%) in the lowest cost asset class (fixed income). Given these asset mix differences, it is not surprising that European funds have a significantly lower cost than Australian funds.

Exhibit 3: Asset Mix by Region					
Asset Class	% of Total Asset Mix				
	Australia	US	Global	Canada	Europe
Stock	53	61	58	57	46
Fixed Income	25	30	34	38	47
Real Estate, REITs, Other Real Assets	13	5	5	3	6
Hedge Funds & Private Equity	9	4	3	2	1
Total	100	100	100	100	100

### What is the size impact?

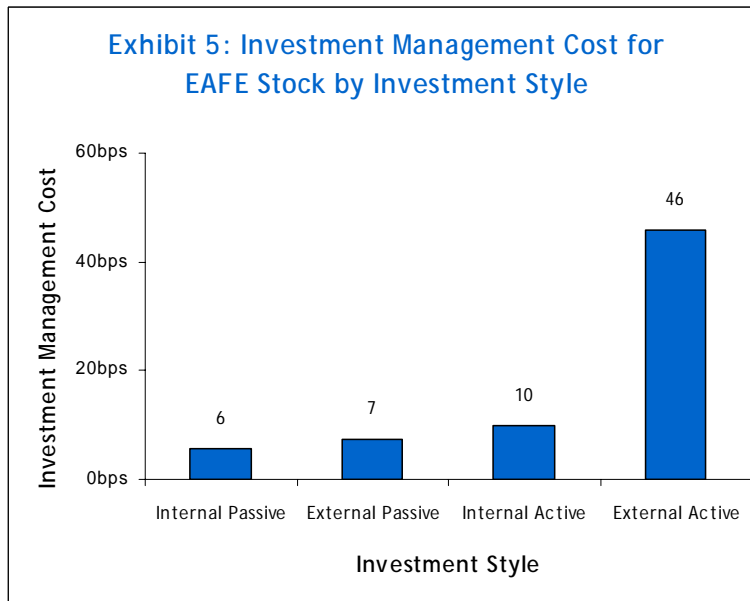
Size matters since economies of scale drive significantly lower costs in larger funds. Exhibit 4 shows that investment management cost declines by over one-half from 33 basis points for funds under US\$1 billion to 16 basis points for funds over US\$50 billion.



Average fund sizes by region in the database for 2005 were as follows: US-US\$14.0 billion, Canada-C\$3.9 billion, Europe-€1.5 billion and Australia-A\$11.4 billion. European funds were the greatest beneficiaries of the size effect.

#### Style impacts cost

Funds with more internal and passive management have lower costs. To illustrate, Exhibit 5 shows that the cost to manage EAFE stock using four distinct styles: internal passive, external passive, internal active and external active. The internal and passive styles group together as low cost styles. Here, the cost ranges from 6 to 10 basis points. The external active style is the high cost style. The cost to manage EAFE stock under an external active style is 46 basis points.



As an indicator of style differences in 2005, European funds, at 47% of total assets, had the lowest proportion of the highest cost external active style compared with Canadian, US and Australian funds at 67%, 73% and 79%, respectively.

### Strong explanatory power

What is the collective impact of our key variables—asset mix, size and style—on cost? Our variables account for 61.6% of the variation in investment management costs. The result, shown in Exhibit 6, is based on the regression of investment management cost against asset mix (per cent holdings of private equity and hedge funds, real estate and stock), fund size (log 10), and style (per cent external active management). The T-values indicate that the coefficients for our variables are significant at a confidence level in excess of 99%. The regression equation has good explanatory power.

Exhibit 6: Impact of Asset Mix, Size and Style on Cost						
Investment Management Cost =	Constant	+% Private Equity & Hedge Funds	+% Real Estate	+% External Active Mgt	+% Stock	+Log Fund Size
Coefficient	+14.7	+161.7	+62.9	+27.1	+22.2	-6.3
T-value	+4.0	+21.4	+4.9	+15.8	+5.3	-8.8
R <sup>2</sup>	61.6%					

### The world's lowest cost funds

The above equation will allow us to determine if European funds are indeed the world's lowest cost funds. To make this determination, we add variables to represent European and Canadian funds. The resulting regression equation shows the cost of European and Canadian funds relative to US funds. The analysis is restricted to the three lowest cost regions.

Exhibit 7 shows that Canadian funds have investment management costs that are 6.9 basis points below US funds. European funds have costs that are virtually identical to US funds. The T-values in excess of 2.0 indicate that the coefficients for our variables have a high degree of significance. The T-value for European funds at 0.0 indicates a cost that is statistically indistinguishable from the cost of US funds. Overall the equation explains 64.2% of the variation in investment management costs. In conclusion, adjusting for asset mix, size and style, Canadian funds are the world's lowest cost funds.

Exhibit 7: The World's Lowest Cost Funds								
Investment Management Cost =	Constant	+% Private Equity & Hedge Funds	+% Real Estate	+% External Active Mgt	+% Stock	+Log Fund Size	+Can Funds	+Euro Funds
Coefficient	+26.7	+155.8	+58.8	+25.6	+18.0	-8.2	-6.9	-0.0
T-value	+6.5	+20.8	+4.7	+15.2	+4.1	-10.8	-6.8	0.0
R <sup>2</sup>	64.2%							

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