RESEARCH CAPITAL CORPORATION

Understanding Fee-Based Investment Accounts

Fee-based accounts have become increasingly popular in Canada as investors seek more transparent fee structures from their advisors. In Canada, these accounts typically charge a percentage of assets under management (AUM) annually and pro-rated on monthly or quarterly basis. This fee structure is designed to align the advisor's interests with the client's, as the advisor's compensation grows with the client's portfolio.

Fee Structure Example

For this analysis, we'll use the fee structure for my investment clients:

- 1.25% annually for combined accounts under $1 million
- 0.85% annually for accounts over $1 million

Asset Allocation Example

We'll examine a portfolio with the following allocation purely as an example:

- 70% ETFs
- 20% F-series Mutual Funds
- 10% Stocks

Costs Breakdown

<u>ETFs (70% of portfolio)</u>

Exchange-Traded Funds (ETFs) are known for their low costs. The management expense ratio (MER) for a more active managed ETFs can range from 0.5 % to 1 %, depending on the complexity and focus of the fund. As I primarily use more higher yielding active managed ETFs for generating retirement investment income, let's assume an average MER of 0.65% for the ETF portion of the portfolio. Investment returns on ETFs are reported net after MER.

F-Series Mutual Funds (20% of portfolio)

F-series mutual funds are designed for fee-based accounts and typically have lower MERs compared to their A-series counterparts. The MER for F-series funds can range from 0.50% to 1.50%. For this example, we'll use an average MER of 1.00% for the F-series mutual fund portion. Investment returns on mutual funds are reported net after MER.

Stocks (10% of portfolio)

Individual stocks don't have ongoing management fees like ETFs or mutual funds. However, there may be trading commissions when buying or selling stocks. Many brokerages now offer commission-free stock trading, so we'll assume no additional costs for the stock portion of the portfolio.

Cost Scenarios

Let's examine two scenarios: one for an account under $1 million and another for an account over $1 million.

Scenario 1: Account under $1 million

Assume a portfolio value of $500,000.

1. Fee-based account charge: 1.25% of $500,000 = $6,250 per year
2. Actively Managed ETF costs: 0.65% of $350,000 (70% of portfolio) = $2,275 per year
3. F-series Mutual Fund costs: 1.00% of $100,000 (20% of portfolio) = $1,000 per year
4. Stock costs: $0 (included in account fee)

Total annual cost: $9,525 (1.905% of total portfolio value)

Scenario 2: Account over $1 million

Assume a portfolio value of $1,500,000.

1. Fee-based account charge: 0.85% of $1,500,000 = $12,750 per year
2. Actively Managed ETF costs: 0.65% of $1,050,000 (70% of portfolio) = $6,825 per year
3. F-series Mutual Fund costs: 1.00% of $300,000 (20% of portfolio) = $3,000 per year

4. Stock costs: $0 (included in account fee)

Total annual cost: $22,575 (1.505% of total portfolio value)

Impact of Market Conditions

It's important to note that the fee-based account charge is calculated based on the total portfolio value, regardless of market conditions. This means that in both ‘up’ and ‘down’ markets, the percentage fee remains constant, but the dollar amount will fluctuate with the portfolio value.

In Up Markets

When markets are performing well and the portfolio value increases, the dollar amount of fees will also increase. For example, if the $500,000 portfolio grows to $550,000, the fee-based account charge would increase to $6,875 (1.25% of $550,000).

In Down Markets

Conversely, when markets are down and the portfolio value decreases, the dollar amount of fees will decrease. If the $500,000 portfolio drops to $450,000, the fee-based account charge would decrease to $5,625 (1.25% of $450,000).

Dividend Considerations

My fee-based portfolios for many of my retired clients are based on generating investment income, although every individual investor has unique goals and circumstances. Some clients primarily just seek growth. Dividends received from stocks and distributions from ETFs and mutual funds can help provide for retirees' monthly financial needs. If not needed, these payments are typically reinvested in the portfolio, increasing the overall asset base. This growth can lead to slightly higher fees as the portfolio value continues to increase. However, dividends, regardless of whether they are reinvested or withdrawn, help offset some of the costs by providing additional returns.

Advantages of Fee-Based Accounts

1. Transparency: Clients have a clear understanding of the fees they're paying.
2. Alignment of interests: Advisors are incentivized to grow the client's portfolio, as their compensation is tied to the portfolio's value.
3. Potential for lower overall costs.

4. Access to lower-cost investment products: F-series mutual funds and ETFs.
5. Tax deductibility: The account fee may be tax-deductible in taxable investment accounts as it is charged directly to investors to cover the cost of advice, access, and service.
6. Covers the cost of a set number of transactions for the year (normally enough for the client) as part of the fee paid.

Considerations for Investors

1. Portfolio size: As demonstrated in our scenarios, larger portfolios can benefit from lower percentage fees, potentially leading to significant savings over time. Typically, many financial institutions such as the major banks charge more as a percentage of your assets, the smaller your portfolio is.
2. Asset allocation: The mix of investments can impact overall costs. A higher allocation to lower-cost ETFs may result in lower total expenses.
3. Service level: Consider the value of the advice and services provided by your advisor in relation to the fees paid.
4. Performance: While costs are important, they should be viewed in the context of overall portfolio performance and the value of professional management.

In conclusion, fee-based accounts offer a transparent and potentially cost-effective way to manage investments, especially for larger portfolios. By understanding the fee structure and considering factors such as asset allocation and market conditions, investors can make informed decisions about the fees they pay. It is crucial to regularly review and understand all costs associated with investments, including both advisor fees and product-related expenses, to ensure they align with the value received and overall financial objectives. High-quality financial advice and portfolio management can provide significant value that helps offset the costs in a fee-based investment account.

If you want to explore your pre- and post-retirement goals aimed at creating healthy and balanced financial strategies, please contact me at wwoo@researchcapital.com.

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