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Opinion

Vanguard's low fees no match for ours

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U.S. indexing fund giant Vanguard Group is escalating its infiltration into Canada, which will inevitably force the bloated domestic mutual fund industry to cut its world-beating high fees.

It's clear something has to give when the world's lowest-cost investment manager collides with the cost of the developed world's highest expense ratios (according to a famous study by Harvard University's Peter F. Lynch and his academics)

Because of its unique ownership structure -- unit-holders of Valley Forge, Pa.-based Vanguard are also investors -- Vanguard's fees are almost impossible to undercut. Since its 1975 founding by the legendary John Bogle, Vanguard has grown to over \$1 trillion in assets, using the increased economies of scale to dramatically lower fees.

Thus average expense ratios for Vanguard funds have fallen from 0.89% at inception to 0.20% today, while the mutual fund industry as a whole rose from 1.08% to 1.19% over the same period. Canadian mutual fund fees average about 2.5%, which makes the fee disparity with Vanguard almost laughable.

Fortunately for the Investment Funds Institute of Canada -- which yesterday tried to blame the GST and the Tax for further bloating its high fees -- Canadians can't yet buy Vanguard's index mutual funds. It's a niche market. Vanguard is also a major player in exchange-traded funds and Canadians can easily buy its ETFs on Air Canada.

Vanguard's image revolves around these low-cost investments for retail investors, but it's equally an image built almost as much in actively managed funds.

Rather than launch a direct assault on the local retail market, Vanguard is building credibility with Canadian investors. While sources say it was already in that market here, yesterday it held its first ever "Investment Forum" in Toronto.

Except for media, retail investors were not present. Instead, I saw executives and financial advisors from Wood Gundy, Desjardins Financial, Burgeonvest Securities, Capgemini Canada, Pro-Financial Asset Management and high-net-worth boutique Tacita Capital Inc.

Only a small fraction of Vanguard's assets comes from outside the United States. Going global is "a real challenge for Vanguard," said Dennis Duffy, Vanguard director of business development ex-America. The US\$100-billion mutual fund industry in the United States is only 8% of the US\$1.25-trillion total but "it's a fairly significant business," he said.

Most investors are surprised to learn the firm is almost as big in active management as in passive: assets under management are split fairly evenly across major asset classes: 49% equity, 32% bonds, and 19% cash.

Fran Kinniry, principal with the Vanguard Investment Strategy Group, reviewed several myths about the firm's performance.

passive management. In the short term, some active managers may outperform but over the longer term on mutual fund performance.

One myth is that active managers outperform index funds in bear markets. In seven bear markets between 1980 and 2009, active managers beat active managers in four of those periods, and active managers the other three. From October 2000 to March 2009, index funds beat actively managed U. S equity funds by 1.4%, Vanguard estimates. However, once markets bottom reached in March 2009, active managers started to outperform.

Kinniry told the audience that in the last few days Vanguard has flashed a "yellow warning sign on the fact several of its funds are up 60% year to date.

It's not unusual for Vanguard's research department to throw cold water on its product sales: it did the same for REITs six months before they imploded in 2008.

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