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Do Fees Help Identify Good Managers?

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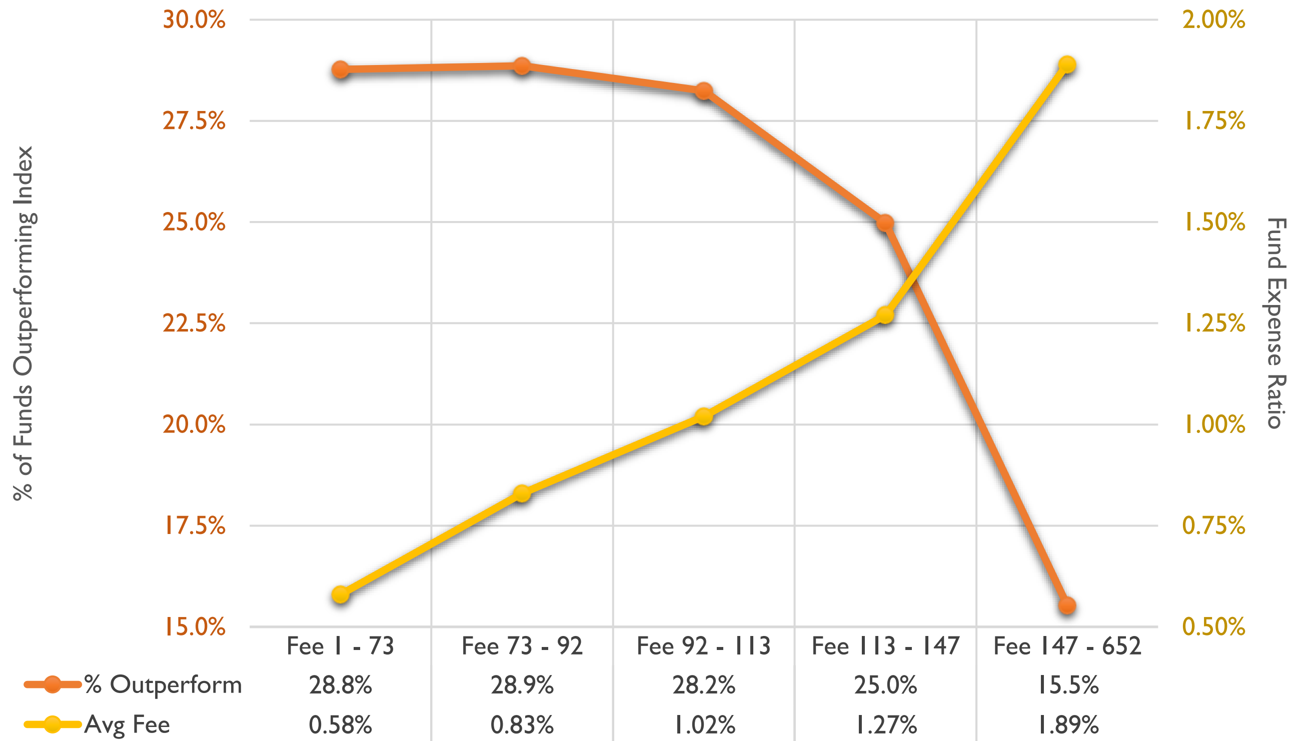
Mutual fund investors tend to focus on fees in order to find active equity managers that can outperform over the long run. While it is true that higher fees lead to lower performance on average, the data indicate you have an above-average chance of selecting an outperforming manager by simply picking from funds that have an annual expense ratio less than 1.5%.

PERCENT OF OUTPERFORMING MUTUAL FUNDS VERSUS FUND EXPENSE RATIO (10 YEARS ENDED MAY 31, 2023)



	Fee 1 - 73	Fee 73 - 92	Fee 92 - 113	Fee 113 - 147	Fee 147 - 652
% Outperform	28.8%	28.9%	28.2%	25.0%	15.5%
Avg Fee	0.58%	0.83%	1.02%	1.27%	1.89%

Source: Morningstar, Inc.

The chart above shows what percentage of active US equity managers have outperformed their best-fit index over the last 10 years at various fee levels. 25% of the 5,665 funds in this sample outperformed. Only at the highest fee quintile, over 1.5%, does the probability drop significantly to 15.5%. This indicates you should avoid the highest fee managers and, after that, fees don't offer much value in identifying good managers. Other criteria such as strategy, consistency, and conviction are much more likely to produce better manager selection.

The industry is myopically focused on scale and cost in a race to maximize commoditized volume at the expense of investor outcomes. Fees are an explicitly stated cost which can easily be understood and controlled by intermediaries and accepted by investors. Reframing fees with some appropriate and relevant context can be helpful. Rarely do we start out a significant purchase decision by eliminating all but the cheapest choice. We usually have other more important criteria and want to understand the value we get for the price we pay. For perspective, annual management fees can easily be less than daily market volatility. Just because we know with certainty what fee is being charged doesn't necessarily make it useful for identifying good managers. It may be better to focus on quality and not wholly on cost.

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From the Behavioral Viewpoint

What is going on?

1. Expenses and costs are tangible, accessible, and easy to understand, while the long-term value of selecting good managers is more abstract and harder to grasp. This creates an **availability bias** and **fallacy of control** that causes us to focus on immediate costs which we can easily understand and control.

2. Investors are overwhelmed by the complexity associated with investments and managing them. **Substitution** is a natural response, where we substitute a simpler problem or solution for a complex one. In this case, looking for the lowest cost investment. The large asset managers and platforms are happy to provide low-cost solutions and deliver average results to everyone.

3. Marketing and distribution efforts, reinforced by the regulators, trigger **herding instincts** and **social validation**. The government says it's good for us, the advertisements say it's good for us, everyone says it's good for us. It must be good for us!

What can we do?

1. Move beyond cost when selecting active equity managers.

2. Focus on other criteria such a Strategy, Consistency and Conviction when selecting managers.

3. Work with a financial advisor as a trusted resource and coach. Gain from their experience, process, perspective, and insights. Building wealth is a long-term endeavor that requires time and discipline.

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