Financial Disruption Begins to Take Root

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By **Barry Elias**

The financial industry is feeling the effects of technological disruption, competition and regulation. This portends well for the investing public and a **financial sector** that has grown to unsustainable proportions.

In recent years, the U.K. increased financial transparency by unbundling the fee for investment advice and asset management. A decade ago, a fund manager might not have known the fees and a commission-based adviser might have been evasive.

As expected, with more transparency, the cost of these services has begun to fall.

Fund manager fees have fallen below 1 percent of assets, down from 2 or 3 percent several decades ago. Online stockbroker platforms are beginning to charge less than ½ of 1 percent on four-figure balances, and a new fund recently introduced a performance fee-only product. Peer-to-peer lending and crowdfunding provide additional technological alternatives that further competition and place downward pressure on the cost of investing.

Unfortunately, this type of unbundling has not yet occurred in the U.S. and might take several more years.

Mutual funds typically do not advertise the transaction costs associated with fund trading, which the client is responsible for paying. These costs can average 1.44 percent annually, more than the management fees and operational expenses combined, according to Roger Edelen of the University of California, Davis; Richard Evans of the University of Virginia; and Gregory Kadlec of Virginia Tech. Small-cap funds fared much worse, with trading costs of 3.17 percent.

Some passive index funds, which do not trade shares often, offer expense ratios that are 1/10 of those for actively managed mutual funds, which can range from 1.5 percent to 2.0 percent annually.

The research indicates that the greater the trading, the lower the net return to the investor. The annual return for mutual funds with trading in the top 20 percent lagged those in the bottom 20 percent by 1.78 percent.

The average investor might pay a total of 3 percent in management and trading expenses, nearly 1/3 of the annual return of 9.6 percent for the S&P 500 during the past 86 years.

Mutual fund investors and fund advisors pay broker-dealers $8.88 billion annually for account maintenance, shareholder servicing and revenue-sharing, according to a letter from Niels Holch, executive director at the Coalition of Mutual Fund Investors, to Mary Miller, undersecretary of domestic finance at the U.S. Treasury Department, dated Nov. 14, 2014.

Holch claims these payments are not warranted based on Section 120 of the Dodd-Frank Act, which would require the Financial Stability Oversight Council to issue recommendations to the Securities and Exchange Commission that would heighten standards that lower systemic risk to the financial system.

Notwithstanding this legislative requirement, technological disruption and competition could undermine demand for these investment vehicles and encourage more transparent reporting of the true transaction costs associated with their purchase, thereby lowering investor expense.

Technology might inspire greater competition, transparency and responsible regulation that levels the financial playing field for the many.