March 20, 2017 Pionline.com CRAIN

Pensions&Investments

THE INTERNATIONAL NEWSPAPER OF MONEY MANAGEMENT

Industry Voices

The S&P 500's hidden $828 billion annual expenses

By Elizabeth Cohernour

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Introduced just over 40 years ago, index funds are now firmly middle-aged, but still growing like an adolescent. Both index funds and their cousins, exchange-traded funds, have been marketed as inexpensive and partly as a result garnered huge asset inflows over the past 10 years. According to Morningstar, in 2016 alone, these passive index funds and ETFs attracted more than $504 billion in new assets, while actively managed funds posted withdrawals of $340 billion

Index funds and ETFS do have low expense ratios, but are these costs paid to the sponsors of these funds to manage the investments the only expenses paid by investors?

Our research strongly suggests institutional investors are unaware of significant hidden costs embedded in the reporting of the results of passive investments, particularly those made up of Standard & Poor's 500 stock index companies. Investors and money managers crowding into these vehicles aren't clearly presented with two ongoing, long-term costs that affect total returns.

Our research into the dilutive costs of equity stock buyback programs and stock-based compensation found they add an average of 4.1% annually to the costs of owning an index fund built to mimic the S&P 500. Collectively we refer to the costs of equity stock buyback programs and stock-based compensation as "look-through expenses."

Our research into the S&P 500 examined two factors:

1. The average annual dilution from each company's executive equity compensation plan. To arrive at this, we calculated the dilution from executive compensation plans by averaging it over the typical three- to five-year year vesting period. On average for the index, it amounted to 2.5% in 2015.

2. The average annual buyback for each company. We found that, on average, 53% of the shares purchased in stock buyback programs for S&P 500 companies were used to offset the dilution from executive equity bonus plans. This amounts to average annual buyback being used to offset dilution from equity compensation plans of 1.6% in 2015.

The market values at play are huge: The equity market capitalization of the S&P 500 was over $20.2 trillion at year-end 2016, and 4.1% of this amount exceeds $828 billion. That's right — S&P 500 investors are paying more than $828 billion in murky expenses.

Equity-based compensation and corporate equity buybacks aren't reported as index fund expenses although they clearly affect investors' returns. They are only reported separately in the annual reports and proxy statements of the index fund constituent companies, and even then without much clarity. However, if you owned each of these stocks individually, a thoughtful shareholder would likely consider these expenses for what they are: costs to be evaluated as part of the investment. Effectively, every company has its own expense ratio, with some very high and others much lower.

"Highest cost" examples of Look-Through Expenses in the S&P 500

Company	Average annual dilution from executive compensation plans	Average annual buyback used to offset compensation dilution	"Look-Through Expense to shareholder" (average dilution [Column C] + average buyback to offset dilution [Column D])*
Goldman Sachs Group (GS)	10.1%	7.9%	18.0%
Ameriprise Financial	6.0%	6.0%	12.0%
Citrix Systems	5.6%	5.6%	11.2%
Regeneron Pharmaceuticals	10.7%	0.0%	10.7%
Teradata Corp.	5.1%	5.1%	10.3%

Distinct company expenses

We view stock-based compensation and shareholder buyback programs as company expenses, not merely as executive rewards. While we strongly believe in motivating executives appropriately, we must be on guard against casual overpayment or rubber-stamping compensation that is intended to be discretionary.

Total compensation is not falling. According to the non-partisan Economic Policy Institute, total CEO compensation is up more than 46% since 2009 and 941% since 1978. We shareholders must have a clear presentation to evaluate proxy proposals for executive compensation.

While it's mandatory for companies to disclose these expenses, there's no standard format for presentation. To create an industry standard, we recommend they be disclosed in the "say on pay" section of the proxy statement. That way, investors would know where to look within documents that sometimes run more than 200 pages long. We believe the number of shares used to offset equity bonus plans and shares issued under these plans should also be clearly disclosed in proxies.

Considering the volume of material presented, it would be easy for companies to show these expenses as a percentage of the total value of the company. Shareholders and fiduciaries could then easily see how much their interest in the company was being diluted annually, or how shareholder assets were being spent to hide or offset this dilution.

Currently the share buyback information is only in the annual report, and nowhere is it easy to find how much of the share buybacks are used to offset executive equity compensation plans. We believe this is potentially misleading to investors and can seriously overstate the returns of index funds.

The effect of compounding

In describing his early insights, Vanguard founder John C. Bogle, said in a recent interview that "over 50 years, 7% turns $1 into $30, and 5% turns $1 into $10 ..."

The effect of compounding on investment returns is well-known. It also led us to think about the long-term effect of compounding on the two expenses we're tracking. The results are staggering — and dangerous.

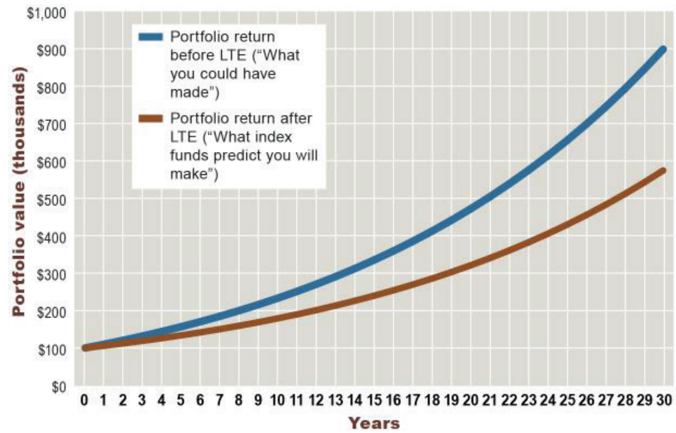
The accompanying hypothetical chart tells a story of what could happen to $100,000 invested over 30 years. The orange line shows the predicted return of the portfolio, assuming a 6% annual growth rate, which is based on an S&P 500 index fund's sales material. The blue line shows what returns could have been, if look-through expenses of an average of 4.1% — which will also compound at 6%, according to Economic Policy Institute — had not been deducted from the investor's investment return.

Effect of Look-Through Expenses on returns

If markets compound at 6% annually, which is a common prediction of leading index funds, the added effect of Look-Through Expenses over the long term can be staggering. As suggested by the Economic Policy Institute*, Look-Through Expenses are also expected to compound at 6%.

This example shows that if Look-Through Expenses did not exist, investor returns would have been much higher.

Each year's hypothetical return has been calculated based on 6% market growth, which is based on an S&P 500 index fund's sales material. "What you could have made" shows what you could have made if the compounding Look-Through Expenses had not been deducted from each year's return.



*Look-Through Expense of 4.1% in 2015 compounding at 6% (Economic Policy Institute, "CEO Pay Rises as Typical Workers Are Less," Issue Brief #380, June 2014. Washington, DC.)

Over time the look-through expenses unchecked likely will continue to grow, which could make the returns of the S&P 500 index even more compromised.

A clearer disclosure of these costs would make the total returns less opaque, allowing institutional managers working for pension funds and other clients to compare both costs and returns across multiple vehicles.

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