Mutual Fund Fees

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I. Review of Mutual Fund Fees

A. Introduction

Despite the economies of scale that must accompany the phenomenal influx of assets into the mutual fund industry, mutual funds are not passing those savings to investors in the form of lower fees. So say many industry observers, in response to two sets of data. First, the mutual fund industry has indeed grown phenomenally. In 1990, mutual funds were the fifth-largest category of financial intermediary in terms of balance-sheet assets, but by the end of 1996 held balance sheet assets second in size only to commercial banks.\(^1\) Over the same period, mutual fund assets grew at an annual rate of approximately 20 percent per year, as compared to slightly over 10 percent for private pension funds and under 6 percent for commercial banks.\(^2\) This growth has resulted in an enormous sum of mutual fund assets in absolute terms: the total assets of mutual funds stood at more than $3.5 trillion dollars at the end of 1996.\(^3\)

Second, the average fee charged investors by mutual fund companies has increased during recent years. In 1980, the average mutual fund fee was 0.71 percent of assets.\(^4\) In 1995, the average


\(^{2}\) See id.

\(^{3}\) See id. at 1.

was 0.99 percent. Industry researchers have also calculated the average expense of mutual funds after first weighting funds according to size. This asset-weighted expense ratio has also risen during the past decade.

Although there is some external regulation of these charges, both by the federal government and through self-regulatory organizations, some have argued that fees have been higher than they ought to have been, given the dramatic influx of assets into the mutual fund industry. Stated one observer,

[the general wisdom has been that the growing mountain of [mutual fund] assets in [retirement] plans would lower costs, thanks to economies of scale. Similarly, growing competition among the 'vendors'--or mutual-fund companies, insurers, banks and brokerage firms that set up and run retirement plans--should lead them to slash costs in order to win new business. But that hasn't happened.]

Perhaps more importantly, the Securities and Exchange Commission (SEC) has also taken notice. Barry Barbash, head of the Division of Investment Management at the SEC has stated that the growth in assets under management by mutual funds "might have been expected to lead to lower fees" through economies of scale. Furthermore, Barbash has expressed his opinion that the "increase in advisory

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5 See id.
fees is hard to justify and ultimately would not seem to be sustainable."

On the other hand, an influx of assets is not the only factor that may have had some influence on mutual fund fees during recent years. An evaluation of trends in mutual fund fees must be grounded in a more complex account of the factors affecting those fees, including, for example, shifts in the way expenses are recouped and reported, the proliferation of funds, the growth of equity funds as a proportion of all mutual funds, the shift towards third-party distribution channels (such as "supermarkets") and the rapid expansion in ownership of mutual funds, with the concomitant potential for a segmented market. An examination of such factors produces an evaluation that includes conflicting trends, instances of investor savvy as well as investor ignorance, and a conclusion that much of the reported increase in fees does not actually impose any additional costs on investors.

This paper will review the component parts and types of fees imposed by mutual fund companies in Part I.B. In Part II, several hypotheses potentially explaining the persistence of high fees despite the growth of mutual fund assets are offered and evaluated. Part III offers by way of conclusion a few observations on the complexity and difficulty of ascertaining the "reasonableness" of mutual fund fees.

9 Id.
B. Fees

1. Advisory fee

The typical mutual fund is organized as an investment company, a form which serves as a shell to hold the assets of the fund. Each investment company, through its board of directors, negotiates a contract with an adviser to manage the assets of the company.

The advisory fee reflects this core expense of mutual fund management, that is, compensation of the adviser to the fund for operating expenses and advisory expertise. This compensation expense is passed on to the shareholders of the fund in the form of an “advisory” or “management” fee.

2. Performance fee

Performance fees are a subset of advisory fees that may have special relevance to the issue of fees, particularly in years during which the overall market value of financial assets rises significantly. Performance fees reward an investment adviser for good performance through a contract provision that ties the investment adviser’s compensation to the performance of the fund against some benchmark, usually an index such as the Standard & Poor’s 500. These performance fees are a matter for contract negotiation, but are regulated by the 1940 Act.\(^\text{10}\) Although performance fees must be granted according to performance against a benchmark, these fees are especially likely to increase total

expenses during bullish years, thereby contributing to an overall rise in fees.

3. 12b-1 fee

As authorized by the SEC in 1985, investment companies may charge their shareholders a fee for the costs of distribution of shares, including the costs of distribution to new shareholders. The costs of distribution are understood to include the costs of advertising.

These 12b-1 fees are often a source of concern, as it has seemed to many industry observers that they may operate as hidden fees, or even be unnecessary fees. For example, several funds have continued to impose 12b-1 fees after closing to new investors. Because 12b-1 fees are supposed to be justified by the costs of distribution to new investors, the absence of those investors seems to many to make the imposition of a fee in this circumstance without justification. Mutual fund executives responsible for the continuance of the 12b-1 fees may defend their decision by arguing that closed funds do continue to receive new investment by current shareholders, and that this investment incurs brokerage costs.

11 17 C.F.R. 270.12b-1.
12 See Michael Siconolfi, Fund Track: Mutual-Fund Ad Fees Studied by Regulators, Wall St. J., Oct. 3, 1996, at C1. Morningstar counted 36 such funds in 1996. One fund had charged the maximum 12b-1 fee of 0.75 percent of assets allowed by the NASD despite having been closed since 1992. See id.
13 See id.
14 See id.
4. Loads

The term "load" traditionally referred to a fee paid when shares were purchased. However, the term has expanded to include some types of fees paid when shares are sold, or even fees paid while shares are held. Regardless of when a load is imposed, however, it is related to the transaction costs of buying and selling fund shares.

The terms "sales load" and "front-end load" refer to the difference, if any, between the price paid by shareholders per share and the current net asset value per share received by the fund.\textsuperscript{15} The front-end load comprises the underwriter's profit, the selling broker-dealer's commission, and any other sales and promotional expenses.\textsuperscript{16}

In recent years, deferred sales loads, also called "back-end" loads, have become more common.\textsuperscript{17} Generally, deferred loads are paid by the investor as a percentage of the proceeds of shares that are redeemed within a specified period after purchase.\textsuperscript{18}

\textsuperscript{16} See id. at 291.
\textsuperscript{17} See Are Mutual Fund Fees Reasonable? at 10. As a proportion of all funds, deferred load funds increased from 9.6 percent to 35.5 percent during the period 1986 to 1996, while front-end load funds decreased from 40.0 percent to 30.7 percent over the same period. Id.
\textsuperscript{18} See Protecting Investors at 294. Back-end loads were authorized by the SEC in 1982. See 24 SEC Docket 647.
 Deferred loads are often used in combination with 12b-1 fees\textsuperscript{19} to create what is effectively a "spread load," that is, a load paid by the shareholder over a period of time rather than all at once. This arrangement is designed to allow investors to buy shares of a fund without paying all of the costs of distribution at the time of purchase, while protecting the fund from the relatively higher costs of distribution to short-term investors by assessing a deferred load on those investors.\textsuperscript{20}

Many funds are offered with no load. No-load funds were, until recent years, sold primarily by the investment company directly to the public.\textsuperscript{21} More recently, no-load funds have also become available through alternative distribution channels, such as "supermarkets."\textsuperscript{22} The expenses of a direct sale (which, in the case of direct sales, are typically lower than the expenses of transactions effected by broker-dealers) are paid either by the investment adviser or by the principal underwriter out of its own profits.\textsuperscript{23}


\textsuperscript{20} \textit{See} Protecting Investors, at 294.

\textsuperscript{21} \textit{See id.} at 292.

\textsuperscript{22} \textit{See Want To Raise Your Rate of Return? Be a Skinflint About Expenses, Houston Chronicle}, Dec. 11, 1995, at 7.

\textsuperscript{23} \textit{See Protecting Investors}, at 292.
5. **Wrap account fee**

As an additional layer of advice on top of the investment advice provided by an individual fund adviser, many investors also pay for advice and services relating to the choice between investment companies and advisers. “Wrap accounts” are managed by an adviser whose role it is to choose and purchase mutual funds on behalf of individual investors. Investors also gain in terms of simplicity—rather than dealing with several funds or even fund complexes, the investor deals with a single report from his wrap account manager. For this service, investors typically pay a single fee of between 1 percent and 3 percent of assets in the wrap account.24

**C. Distribution**

Mutual funds are sold to the public through several different channels. The distribution channels themselves may have characteristics that add to the cost of selling and maintaining a fund, and may therefore be relevant to the fees charged investors. This section surveys the distribution channels through which mutual funds are sold to the public and suggests some ways in which these channels are relevant to fees.

1. **Direct**

A significant portion of mutual shares are sold by fund companies directly to investors at the initiative of the investors. This method of selling shares avoids some of the transaction costs present in other methods of selling, and

therefore ought to allow lower transaction-related fees relative to other methods of selling. In 1995, this distribution channel accounted for 37.7 percent of the value of shares sold.²⁵

2. Sales force

Mutual fund shares are often sold through third party sales forces, such as banks,²⁶ brokers and financial planners.²⁷ In 1995, 53.6 percent of the value of mutual fund shares sold was sold through sales forces.²⁸ Two important components of the sales force channel are the wrap accounts described above,²⁹ and "supermarkets."³⁰ Supermarkets are distinguished from wrap accounts in that, whereas wrap accounts are individual accounts managed with some discretion by a broker for a fee paid by the investor, supermarkets provide omnibus accounts for customers choosing to invest in particular funds.³¹ Rather than charging their customers for their services, supermarkets typically receive a distribution fee from fund complexes for shares sold through the

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²⁶ See infra, I.F.3.
²⁸ See id. at 53.
supermarket of 0.25 to 0.35 percent per year. The fee is paid either directly by the mutual fund through 12b-1 fees or indirectly by the fund’s investment adviser. It seems unavoidable that payment through the latter method should be reflected in the management fees charged to the fund. This fee is not necessarily borne only by customers shopping at supermarkets—many fund companies spread the cost of supermarket distribution to all shareholders equally, including those that buy shares directly from the investment company.

The benefits to a mutual fund of distribution through a supermarket are great enough that supermarkets may require concessions from funds that hope to be distributed through the supermarket, in addition to the distribution fee already mentioned. Supermarkets may refuse to make available to customers any funds other than those for which high demand has already been demonstrated. Other supermarkets may offer a fund for which demand is high without an initial charge, but may charge small or relatively unknown funds a fee for the privilege of being offered

through the supermarket. Funds may also be charged an annual
maintenance fee based on the funds' assets. Finally, super-
marts may examine the creditworthiness and financial
soundness of the fund company before agreeing to act as a
distributor. These additional requirements necessarily increase
expenses at funds complying with them, and may increase pressure
to raise fees.

Management of funds and fund complexes often justify the
added expense of using sales forces, and the concomitant 12b-1
fees by arguing that no-load funds that rely on direct marketing
are at a competitive disadvantage. If a fund does not sell well,
so the argument goes, fees for current shareholders will remain
high indefinitely because of the relatively high expense of
managing a small pool of assets.

Brokerage firms are another sales force distribution channel.
Traditionally, brokers sold funds to investors and were
compensated out of the load attached to the sale. However,
brokers (though, for example, the use of wrap accounts) have begun
to take on some characteristics of supermarkets that blur
distinctions between the types of sales forces. For example,
brokers may sell no-load funds, and in at least one case, have
attempted to charge for making funds available to their customers,
in much the same way some supermarkets do. Dean Witter, in

36 See id.
37 See id.
38 See id.
39 See id. at 1, 12.
response to complaints by fund companies that its brokers emphasized Dean Witter's own funds in advice to customers to the exclusion of other funds, proposed that fund companies pay Dean Witter a fee of 15 cents out of every $100 of fund assets sold by Dean Witter in exchange for being emphasized in sales efforts at the same level as Dean Witter's own funds.40

3. Banks

Banks are a relatively new entrant into the mutual fund sales business, as banks were prohibited from participating in many aspects of the mutual fund business until relatively recently.41 Participation by banks in mutual fund distribution continues to be heavily regulated.42 Currently, banks may act as brokers for nonproprietary funds, and may serve as advisors and administrators43 for proprietary funds.44 However, the Glass-

Steagall Act continues to be interpreted generally to prevent banks or their affiliates from acting as distributors of funds. Given a high level of regulation on the use of the banking channel as a means of distributing mutual fund shares, and the relative inexperience of banks in the mutual fund industry, we might expect that banks are not the most efficient supplier of mutual fund shares. Furthermore, we might expect that costs are added to mutual fund ownership through purchasing those funds through a bank. When these additional costs are multiplied by the potential growth of the banking distribution channel, a significant effect on the fees charged owners of mutual funds may appear.

4. Fund of funds

A fund of funds is a mutual fund that invests in other mutual funds. Until the enactment of the National Securities Markets Improvement Act of 1996, the 1940 Act prohibited mutual funds from investing in the shares of other mutual funds. With the repeal of that prohibition, many financial companies have begun to offer such funds of funds. These funds of funds remain a

relatively new phenomenon, and account for a relatively small share of the total assets invested in mutual funds. 49

The rationale behind the existence of funds of funds is as follows: Picking a portfolio of individual mutual funds appropriate for an investor's goals is time-consuming and difficult. Furthermore, given the minimum required investment for each individual fund the fund of funds holds, an investor with little to invest can gain greater diversification among funds than he would otherwise enjoy. 50

There are two types of funds of funds. The first is an "in-house" fund of funds run by a fund company. T. Rowe Price's Spectrum Growth fund and Vanguard's LifeStrategy Portfolios are examples. These funds spread investors' money across several funds run by the company. 51 These in-house funds of funds do not charge any fees in addition to the fees charged by the underlying funds held by the funds of funds. However, the additional layer of management necessary to operate a fund of funds must result in higher costs, which must in turn result in higher fees, spread more or less equally among the funds held by the fund of funds or among all the funds in a fund complex.

The second type is an "independent" fund of funds. These funds are not operated by a large fund complex. Rather, these

49 See Christopher C. Oster, Funds of Funds Multiply Quickly, Offer "In-House" or "Independent" Investments, Wall St. J., Mar. 31, 1997.
51 See Christopher C. Oster, Funds of Funds Multiply Quickly, Offer "In-House" or "Independent" Investments, Wall St. J., Mar. 31, 1997.
funds invest in funds offered by various investment companies, based on the independent operator's assessment of the best funds available to meet the fund's goals. These funds of funds do charge a fee in addition to the fees charged by the underlying funds, justified by the "active management" of the fund portfolio.

Funds of funds are probably both too new and too small to have had much impact on average fees. Nevertheless, because they require an additional layer of management and produce an additional service to consumers, growth in this area may produce contribute to increases in fees in years to come.

5. Retirement plans

There are two types of retirement plans, only one of which seems to have particular relevance to the topic of mutual fund fees as a distribution mechanism. The first is the Individual Retirement Account, or IRA. IRA's are important mainly for their tax deferral benefits, and for their concomitant incentive to save money for retirement. Because these plans are individual and no less under the control of the individual investor than are other mutual fund investments, this distribution mechanism probably has

52 See id.
53 See id.
little effect on fees independent of other mechanisms and effects
described elsewhere in this paper.

More directly relevant to the question of mutual fund fees
may be the employer-sponsored pension plan. The bulk of employer-
sponsored pension plans are defined contribution plans, a category
which includes 401(k)\textsuperscript{56} plans. A 401(k) plan allows employees to
make contributions to their pension fund through pay deductions.\textsuperscript{57}
Like IRA contributions, these contributions are not taxed until
withdrawal.\textsuperscript{58} Because the employer may limit the range of choices
available to the individual investor-employee regarding the
management of the pension fund, it may be the case that defined
contribution plans create mismatched incentives between the
individual investor’s desire for high overall return and low fees,
and the employer’s desire for ease of management. The effect of
defined contribution plans is discussed further below.\textsuperscript{59}

If pension plans generally and defined contribution plans in
particular do have an effect on mutual fund fees, that effect is
likely to be growing. Mutual funds accounted for about one
percent of the assets held in retirement plans in 1981.\textsuperscript{60} In 1996,

\textsuperscript{56} 26 U.S.C. 401(k) (1997).
\textsuperscript{57} See Fidelity: Nuts and Bolts: 401(k) Basics, http://www.401k.com/401k/
\textsuperscript{58} Internal Revenue Service, Publication 17, Your Federal Income Tax; Chapter
11 - Retirement Plans, Pensions, and Annuities, Employee Pensions and
\textsuperscript{59} See infra, II.F.3 and II.F.4.
\textsuperscript{60} See Brias Reid and Jean Crumrine, Retirement Plan Holdings of
mutual funds accounted for 15 percent of the total retirement plan assets,\textsuperscript{61} and 38.7 percent of 401(k) assets.\textsuperscript{62}

6. Variable annuities

Insurance companies have traditionally offered a fixed contingent payment in exchange for periodic payments, or premiums. Variable annuities are distinct from these fixed annuities in that the contingent payment is variable according the performance of the investments funded by the premiums. These variable annuities have the advantage of deferred tax treatment, as well as protection against loss in the case of the investor's death.\textsuperscript{63} In the words of the Wall Street Journal, "[v]ariable annuities are essentially baskets of mutual funds in a tax-deferred insurance wrapper."\textsuperscript{64}

Until recently, variable annuities carried the insurance company's own mutual funds, managed by insurance company advisers.\textsuperscript{65} However, insurance companies have recently begun to offer external mutual funds to policyholders through variable annuities, a move that has led to comparisons between variable annuities and supermarkets.\textsuperscript{66}

\textsuperscript{61} See id.
\textsuperscript{62} See Brian K. Reid, Mutual Fund Developments in 1996, 3 Perspective 9 (March, 1997).
\textsuperscript{65} See id.
\textsuperscript{66} See id.
In 1995, variable annuities accounted for 9.7 percent of the value of mutual fund shares sold to the public.67

II. Explanation of High Fees

Part II of this paper offers several possible explanations for the rise in average industry fees. Each hypothesis is followed by an evaluation of the hypothesis according to available evidence. Some evaluations are necessarily more complete than others, reflecting the varying levels of information available to support or refute each hypothesis.

A. Proliferation hypothesis

1. The rise in average expenses reflects the entry of numerous smaller funds into the market.

Observers looking for economies of scale in the mutual fund industry argue that as the ratio of costs to assets drops, so should the fees charged as a percentage of assets. However, as has already been noted, not only have assets risen, but so have the number of funds. It is possible that the proliferation of funds is preventing the creation of economies of scale by increasing the costs of management.

2. Evaluation

The proliferation hypothesis is difficult to evaluate because of the presence of apparently conflicting data regarding the trend in the average size of mutual funds over the past decade or so. This data might be reconcilable, but without such a

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reconciliation, it is difficult to draw conclusions about the effect of mutual fund proliferation on average fees.

According to data compiled by Lipper Analytical Services, the total number of funds has increased at roughly the same rate as the total assets invested in mutual funds. Mutual funds held approximately $0.7 trillion in assets in 1986, $1.1 trillion in assets in 1990 and $3.5 trillion in assets in 1996.68 There were approximately 1,500 open-end mutual funds in 1986, 2,800 in 1990 and 10,500 in 1996.69 Thus, both the number of funds and the total assets invested in those funds nearly doubled from 1986 to 1990, and increased almost exactly five-fold from 1986 to 1996. Over the period 1986 to 1996, the average fund increased from $325.9 million to $488.3 million, proportionally a much smaller increase than the increase in the size of the entire mutual fund industry.70

On the other hand, according to the Investment Company Institute (the "ICI"), the average size of mutual funds has increased rather dramatically. The ICI reports the trend in average mutual fund size according to type of fund: equity/mixed, money market and bond. According to the ICI, the average size of equity and mixed open-end mutual funds increased from under $200 million in January 1984 to approximately $650 million in 1996.71 Growth in the average size of such funds was especially

69 See Are Mutual Fund Fees Reasonable? at 8.
70 See id. at 13.
rapid after 1990. The average size of a money market fund
increased from approximately $500 million to approximately $910
million over the same period, with the period of most rapid growth
occurring from 1994 to the present. The average size of bond
funds increased very rapidly in the mid-1980s, but decreased in
later years. Over the period, the average size of bond funds
increased from approximately $150 million to approximately $290
million.

The apparent conflict in the data might be reconciled by
comparing the universe of funds that the two reports used.
Lipper’s sample is larger, and appears to include all known
funds. The ICI’s sample consists of funds submitting data to the
ICI. It is possible that the differences in average fund size
trends reported are explained by the type of fund that is not
included in the ICI sample. If small funds, or new funds, which
tend to be small, are for some reason less likely to submit data
to the ICI, the ICI’s fund size average would be skewed, and would
reflect the growth trends of older, more established funds.
Lipper’s own data shows that older funds have experienced a very
large increase in average size.

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72 See id.
73 See id.
74 See Are Mutual Fund Fees Reasonable? at 8.
75 See Peter Fortune, Mutual Funds, Part I: Reshaping the American Financial
76 See Are Mutual Fund Fees Reasonable? at 13. Funds that began before
1987 had an average size of $325.9 million in 1986. These same funds had an
average size of $1.188 billion in 1996. See id.
If Lipper's data is accurate, then the proliferation hypothesis has merit. The economies of scale expected throughout the mutual fund industry due to increasing assets would be thwarted by a similarly increasing use of resources to manage the assets. However, even according to Lipper's data, we might still expect to see economies of scale among older, larger funds. Evidence confirming this expectation is found infra at II.C.2.

B. Preference for international equity funds hypothesis

1. The rise in average expenses reflects a shift in mutual fund assets to more expensive categories of funds.

Some types of funds, such as equity funds or funds that hold primarily foreign assets, are more expensive to administer than others, such as money market funds. If the proportion of funds in relatively expensive categories to funds in relatively inexpensive categories increased, we would expect to see a rise in average fund expenses. Similarly, if investors shifted assets to relatively expensive funds, we would expect to see a rise in asset-weighted expenses.

2. Evaluation

Lipper reports that the proportion of world equity and world debt funds, fund types that have high management and custodial expenses, has risen significantly over the past decade. In 1986, world equity and world debt funds accounted for 5.9 percent of a universe of funds containing all world equity and world debt

77 See id. at 9, 11.
funds, all retail money market funds, all debt funds, and all general equity, sector equity and balanced/mixed funds. By 1996, world equity and world debt funds accounted for 13.4 percent of the total funds in the same four categories. Over the same period, the cheaper retail money market funds declined from 22.3 percent to 13.8 percent of the total.

Lipper also reports that assets in equity funds have grown relative to assets in money market funds and debt funds. In 1986, money market funds held 46 percent of the assets invested in the three classes of funds. Debt funds held 23 percent and equity funds held 31 percent. By 1996, money market funds held 26 percent of the assets held by the three fund classes, debt funds held 17 percent, and equity funds held 57 percent. Because equity funds are more expensive to operate, this shift from money market and debt funds to equity funds should have an expense-increasing effect on asset-weighted averages.

C. Accounting hypothesis

1. The rise in average expenses reflects a shift from loads to 12b-1 fees.

Fund companies' methods of recouping sales costs has evolved over the past decade. Traditional front-end load funds have been

78 See id. at 9.
79 See id.
80 See id.
81 See id. at 11.
82 See id.
83 See id.
84 See supra I.B.3-5.
replaced to varying extents by deferred-, level- or no-load funds, and by 12b-1 fees. Front-end loads have become so unpopular that at least one Wall Street firm elected to open a mutual fund supermarket for the stated purpose of allowing its broker-dealers the ability to sell load and no-load funds without transaction fees. Because 12b-1 fees are included in the calculation of fund expenses while loads are not, a shift toward paying for transaction costs through 12b-1 fees instead of through front-end loads should increase reported average expenses. Such an increase in reported expenses is an accounting accident; the investor is not paying more to own the fund, but is merely moving a cost from time of purchase to the time of holding the fund.

2. Evaluation

The shift from front-end loads to 12b-1 fees probably has some effect. Funds sold with front-end loads accounted for 40.0 percent of all funds in 1986, but only accounted for 30.7 percent by 1996. It is unclear from the evidence available, however, how much effect the shift has, or how much of the increase in reported expenses is explained by it. The best study available does not disaggregate the effect of a shift from front-end loads to fees from other factors such as the proliferation of funds or the shift towards expensive funds.

86 See Are Mutual Fund Fees Reasonable? at 10. Deferred- and level-load funds increased from 9.6 percent of the total to 35.5 percent, and no-load funds decreased from 50.4 percent to 33.8 percent over the same period. See id.
This study, performed by Lipper Analytical Services, attempted to determine the overall reasonableness of fees by looking at the combined effects of factors similar to those identified supra in II.A.1, II.B.1, and II.C.1. Lipper's method consisted of looking only at funds in existence before 1987 to control for the increased number of funds in expensive categories such as international, using median expense ratios instead of asset-weighted averages to control for the shift in assets toward equity funds, and deducting 12b-1 charges that were imposed concurrently with a reduction in front-end loads from the reported expenses of funds.\textsuperscript{87} The result of this study is a reported decline in average fund expenses of 2.7 basis points from 1986 to 1996.\textsuperscript{88} If all funds (as opposed to funds in existence before 1987) are included in the calculation, a increase of 2.6 basis points in average expenses is observed.\textsuperscript{89}

D. Service hypothesis

1. The rise in average expenses reflects the greater use by investors of indirect distribution channels.

The financial press has commented extensively on the changing character of retail financial services. For example:

Many brokers who used to sell mutual funds with sales fees attached, or load funds, have become fee-based financial planners who get paid a percentage of the money they manage. Many individuals who used to buy load funds from brokers or no-load shares direct from

\textsuperscript{87} See Are Mutual Fund Fees Reasonable? at 11.

\textsuperscript{88} See id. at 12.

\textsuperscript{89} See id.
fund companies now buy and sell through supermarkets instead.\textsuperscript{90}

Along with this shift has come concern that the use of channels such as supermarkets to sell funds may raise fund fees. As already noted, funds typically pay shelf costs of 0.25 to 0.35 percent of shares sold through the supermarket. Brokers have also begun to take advantage of their position as advisor in the crowded mutual fund marketplace, where many mutual funds are dependent on brokers for sales, by increasing their fees for selling funds.\textsuperscript{91}

2. Evaluation

Existing evidence does tend to support the hypothesis. In 1995, the Wall Street Journal has reported that fees for funds distributed through the three largest no-load mutual fund supermarkets were approximately 50 percent higher than fees for other no-load funds.\textsuperscript{92} Data compiled by Strategic Insight Mutual Fund Research and Consulting, Inc. and reported by Peter Fortune indicates that distribution channels do affect the expenses charged to investors, and that they do so in the manner the hypothesis would suggest. Funds marketed through nonproprietary sales forces have higher total expenses than funds marketed by


\textsuperscript{91} See Mike Garrity, Proliferation of Funds Increases Broker/Dealers' Worth, \textit{Mutual Fund Market News}, Jan. 27, 1997, at 3.

banks. Funds marketed by banks, in turn, have higher expenses than those marketed directly by the fund. The advisory and administrative expenses do not vary widely by distribution channel, although bank-distributed funds are a little more expensive than others. However, bank proprietary funds and sales-force funds do have much higher 12b-1 fees than do direct-marketed funds. Higher 12b-1 fees appear to be the single largest contributing factor to the disparity in expense between direct-marketed funds and other funds. This is what we would expect according to the hypothesis, as 12b-1 fees are meant to compensate for the costs of distribution.

E. Soft-dollar and directed brokerage hypothesis

1. Reported expenses are lower than they would be without the use of soft-dollar and directed brokerage arrangements.

Unlike other sections of this paper, this section addresses practices that would tend to explain lower reported fees. The

93 See Peter Fortune, Mutual Funds, Part I: Reshaping the American Financial System, New England Economic Review, July/August 1997, at 55. For example, total average expenses for sales-force marketed capital appreciation funds were 1.25 percent in 1995, while average expenses for the same type of funds marketed through banks were 1.05 percent. See id.
94 See id. Total average expenses for direct-marketed capital appreciation funds were 0.96 percent in 1995. See id.
95 See id. Total advisory and administrative expenses for capital appreciation funds marketed by sales-force, bank, and direct channels were 0.68 percent, 0.89 percent and 0.68 percent, respectively. For total return funds, the respective advisory and administrative expenses were 0.49 percent, 0.65 percent and 0.50 percent. For international and global funds, the respective advisory and administrative expenses were 0.86 percent, 0.72 percent and 0.77 percent. See id.
96 See id. Total 12b-1 fees for capital appreciation funds marketed by sales-force, bank, and direct channels were 0.36 percent, 0.08 percent and 0.0 percent, respectively. See id.
potential problem with the practices is that the reported fees may be misleading, as costs are shifted rather than eliminated.

The term "soft-dollar" refers to arrangements between investment companies and broker-dealers under which investment companies receive products or services other than trade execution, such as market research, from broker-dealers in exchange for commission-generating trades. These arrangements reduce the investment company’s reported out-of-pocket expenses, but may increase commissions, and therefore may decrease overall returns. They may also be used as a means of "recapturing" commissions, that is, the investment company receives as a cash payment a portion of the commission paid to the broker-dealer. Investment advisers may have an incentive to hide some of the expense of a fund in directed brokerage arrangements, to make the fund appear cheaper in terms of fees than it actually

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99 See id.
is. In 1995, the SEC adopted a rule\textsuperscript{100} requiring the expenses paid on behalf of investment companies by broker-dealers under directed brokerage agreements to be reported in investment companies’ shareholder reports and sales literature as indirect expenses.\textsuperscript{101} In the release accompanying the rule change, the SEC indicated that it had considered including the value of research supplied by broker-dealers under soft-dollar arrangements in the indirect expenses to be reported by the investment company. The SEC chose not to do so at that time because of the perceived difficulty in valuing such research and accounting for it among the accounts benefiting from it.\textsuperscript{102}

The SEC has been concerned with the possibility that investment advisers heavily reliant on soft dollars might engage in unnecessary trading to generate the commissions giving rise to soft dollars.\textsuperscript{103} In addition, the SEC has warned that soft-dollar arrangements must benefit the fund investors, rather than the fund management company.\textsuperscript{104} A potential conflict of interest in the soft-dollar arrangements lies in the investment adviser’s incentive to choose brokers on the basis of willingness to provide

\begin{itemize}
  \item \textsuperscript{100} 17 C.F.R. 210.6-07.
  \item \textsuperscript{101} See Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 21221, 60 F.R. 38918 (July 26, 1995).
  \item \textsuperscript{102} See id.
  \item \textsuperscript{103} See generally, U.S. Securities and Exchange Commission, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994).
\end{itemize}
services in return for soft-dollar credits, rather than for trade execution.

2. Evaluation

Because investment companies are not currently required to report the details of soft-dollar arrangements, there is no publicly available evidence by which to evaluate this hypothesis. If and when the SEC requires the value of soft-dollar arrangements to be reported, an examination of the correlation between fees, fund performance and soft-dollar credits should demonstrate either support or refutation of this hypothesis.

F. Lack of price pressure hypotheses

1. The rise in average expenses reflects a lack of investor concern with fees.

If investors do not pay attention to fees specifically, and instead judge funds by only by overall performance, there may be little pressure on investment companies to lower fees if overall fund performance is good. Especially during bull markets, where all funds are performing well, this lack of price pressure may result in a type of market failure, where the market does not punish unjustifiably high fees or reward efficiently low fees.

2. Evaluation

In support of the hypothesis, there is evidence to suggest that investors do not know the expenses of funds they own. A recent survey found that fewer than 20 percent of mutual fund investors could give any estimate of the fees charged by the largest fund they own, and fewer still could give a reasonable
Fewer than one in six understood that higher expenses lead to lower returns, while one in five believed that higher expenses produced higher returns.\textsuperscript{106}

Further support for the hypothesis that investors focus on performance to the exclusion of fees may be understood to come from the fact that some index funds are sold with a load.\textsuperscript{107} An index fund is designed to track a specified stock index, such as the Standard & Poor’s 500, thereby eliminating the cost of investment advice and management, and producing extremely low fees. Financial commentators appear to agree that paying a load for an index fund is irrational because by definition two index funds tracking the same index will produce precisely the same pre-expense returns.\textsuperscript{108} Because many index funds without loads and with very low fees exist, there seems to be no reason to buy an index fund with high expenses in the form of a load. The fact that some investors choose to do so indicates that they may be focusing on the very good performance of index funds in recent years and overlooking the funds’ fees.

On the other hand, evidence does exist that low-fee funds are attractive to investors, suggesting some price pressure and undermining the hypothesis. For example, mutual fund investors


\textsuperscript{106} See id. at 13, 35.


\textsuperscript{108} See id.
have been buying relatively few shares of high-fee funds in recent years, and have been buying relatively more shares of index funds, most of which have very low fees.\textsuperscript{109} Fees in these low-fee index funds have been declining further, rather than rising; according to one measure, fees in index funds dropped from 0.87 percent of assets to 0.80 percent of assets from 1993 to 1997.\textsuperscript{110}

Furthermore, investors as a group invest in funds with lower-than-average expenses. Although the expense ratio of an average growth fund in 1997 was 1.50 percent, the dollar-weighted\textsuperscript{111} average for growth funds was 1.09 percent.\textsuperscript{112}

These conflicting pieces of evidence may indicate the strength of the segmented market hypothesis.\textsuperscript{113} Those investors that are concerned with fees will seek out low fees, and a market of low-fee funds exists for them. Those investors that are less concerned or unconcerned with fees may allow some funds to charge higher fees than a perfectly competitive market would allow. Lack of knowledge or concern with fees may also be relevant to the retirement plan market, which is described in the following paragraphs.

\textsuperscript{110} See id.
\textsuperscript{111} Dollar-weighting includes the relative size of funds in the averaging calculation. For example the fees of a fund with $1 billion assets will be given twice as much weight in the averaging calculation relative to a fund with $500 million in assets.
\textsuperscript{113} See infra, II.G.
3. The rise in average expenses reflects distribution through defined contribution plans.

A hypothesis similar to the proposed lack of investor concern with fees is a lack of investor choice of funds (possibly combined with a lack of investor concern with fees) in the context of defined contribution retirement plans created by employers for the benefit of their employees. The creation of defined contribution plans, such as 401(k) plans, and the choice of mutual funds by the employer as the assets to be held by the plan, relieves the employer of having to play the part of investment adviser, as well as eliminates some record-keeping functions that would otherwise have been performed by the employer. The narrowed range of choices from which employee-investors may choose in the context of a defined contribution plan may reduce competitive price pressure on funds distributed through the plan. Furthermore, potentially compounding the problem, those persons with the responsibility for administering the retirement plan on behalf of the employee-investors may select funds with higher expenses in exchange for administrative and record-keeping services that benefit the employer-administrator rather than the employee-investors.

4. Evaluation

Expenses in defined contribution plans have been rising. The Wall Street Journal has reported a rise in costs from 1995 to 1997.

114 See Brian Reid and Jean Crumrine, Retirement Plan Holdings of Mutual Funds, 1996, at 2 (Investment Company Institute, 1997).
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in 401(k) plans in both large and small companies,\footnote{See Ellen E. Schultz and Vanessa O'Connell, A 401(k) Surprise: Fees Keep Going Up and Up, Wall St. J., Nov. 12, 1997, at Cl.} and attributed this rise to the increasing distribution costs associated with mutual fund ownership.\footnote{See id.} These increases are indirectly attributable to distribution costs. Mutual fund distributors believe it is crucial to get their funds into the 401(k) distribution channel, so they pay retirement plan providers distribution fees, which are passed on to employees in the form of 12b-1 fees.\footnote{See id.} Employers have an incentive to accept these 12b-1 fees, because funds will compensate for those fees with free or reduced cost record-keeping.\footnote{See id.}

There is also evidence to suggest that defined contribution plan participants do not serve as effective watchdogs with regard to the expenses of funds held by their retirement plans. To a degree similar to the group of all mutual fund investors, purchasers of mutual funds through pension plans are ignorant of the fees charged by the funds they own. Less than 20 percent of investors who hold mutual funds through a pension plan think they know the expenses of their largest fund, and only roughly 40 percent report that they knew the expenses charged by the fund at the time they first purchased it.\footnote{See Gordon J. Alexander, Jonathan D. Jones and Peter J. Nigro, Mutual Fund Shareholders: Characteristics, Investor Knowledge and Sources of Information, Office of the Comptroller of the Currency, E&PA Working Paper 97-13, at 12, 35 (December 1997).}
G. Segmented market hypothesis

1. The rise in average expenses reflects segmentation in the market.

Because of the varying levels of sophistication among mutual fund investors, or barriers to choice among mutual funds themselves, investment companies may create low fee funds for smart and flexible investors, and let unsophisticated or inflexible investors choose to buy into or remain in more expensive funds. Segmentation of the market in this fashion is likely to lead to inefficiencies, and quite possibly, to higher overall fees. We have already seen suggestions of evidence supporting this hypothesis in the sections on price pressure. Further evidence bearing on the hypothesis is presented in the following paragraphs.

2. Evaluation

As a counterweight to evidence tending to show higher fees in defined contribution plans, but as support for the idea that the market is segmented, there is evidence that large investors may affect the fee structures of investment companies. For example, employers with large 401(k) plans sometimes persuade fund companies to set up a replica fund holding only 401(k) assets. This fund is allowed to charge lower fees than the original mutual fund.121 To recoup lost this lost revenue, investment companies may raise fees on the shareholders of the non-401(k) fund.122

121 See Anne Willette, Fees: 401(k)s Usually Cheaper, Money, Sept. 11, 1995, at 3B.
122 See id.
As evidence supporting the hypothesis that the market is segmented along lines of sophistication, we can return to the phenomenon of index funds sold with a load. Russell Kinnell, a Morningstar analyst, noted that most index funds sold with a load are distributed by banks. Kinnell suggests that bank customers are less sophisticated, and therefore, good targets for an unnecessary charge. Survey data supports Kinnell’s suggestion: purchasers of mutual funds through banks are less likely than purchasers through any other channel to know the expenses of their largest fund, and are more likely than purchasers through any other channel to believe that a fund with higher than average expenses will have above average performance.

H. Price-gouging hypothesis

1. The rise in average expenses is explained by the refusal of investment companies to pass savings to investors.

Some have charged that high fees are the result of a refusal on the part of fund companies to pass savings resulting from

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124 See id.
125 See Gordon J. Alexander, Jonathan D. Jones and Peter J. Nigro, Mutual Fund Shareholders: Characteristics, Investor Knowledge and Sources of Information, Office of the Comptroller of the Currency, BOPA Working Paper 97-13, at 35 (December 1997). Only 15.3 percent of purchasers of mutual funds through banks could estimate the expenses of their largest fund, compared to 35.0 percent of purchasers directly from the investment company and 23.0 percent of purchasers through a broker. See id.
126 See id. Almost 24 percent of purchasers of mutual funds through the bank channel expected above average performance from funds with above average expenses, compared to 16.6 percent of direct purchasers and 19.3 percent of purchasers through brokers. See id.
economies of scale on to consumers. For example, a senior research analyst at Morningstar stated that, although his view of the growth of the mutual fund industry led him to believe that "there are certain economies of scale occurring," he also believed that it was "obvious the fund companies aren't allowing them to kick in."

This theory of high fees posits that investment companies are keeping for themselves ever-greater profits resulting from improved efficiency in the industry, and rests on the assumption that market mechanisms pushing toward efficient prices (and thereby pushing mutual fund companies to pass savings from economies of scale on to investors) are functioning poorly in the mutual fund industry.

2. Evaluation

An application of economic theory to this hypothesis yields skepticism. The charge that investment companies are simply keeping excess profits for themselves seems inherently implausible in the context of mutual funds because of the large number of market participants and the low barriers to entry in the industry. Such a situation should push investment companies to compete with each other; this competition should include competition to produce low fees. Skepticism born of economic theory is especially acute with respect to a theory positing some sort of collusion among mutual fund companies. There are thousands of funds operated by dozens of fund families. Such a fragmented market should be unable to sustain express or tacit agreements among fund families.

to keep fees high. Competitive forces should overwhelm the necessarily weaker force of group discipline.

Empirical evidence exists that reinforces this skepticism. A study by Lipper Analytical Services suggests that rising fees are not producing super-competitive profits. Despite rising assets and greater flows of investment into mutual funds, seven of the eight publicly-traded mutual fund management companies had after-marketing margins below peak levels in 1996.\textsuperscript{128} Furthermore, the average return on equity of the eight companies was well below peak levels and close to the return on equity enjoyed by comparable industries.\textsuperscript{129}

There is an interesting feature of the current market structure that initially appears to support the hypothesis. The Vanguard Group fund complex has lowered fees while the industry average fees have risen.\textsuperscript{130} The existence and behavior of the Vanguard Group might be understood to support the market failure hypothesis in that the ability of other fund families to continue

\textit{See Are Mutual Fund Fees Reasonable?} at 6. However, the study also shows that three of the eight had peak \textit{premarketing} margins, suggesting that marketing costs are depressing what might otherwise be record high margins. The average premarketing margin remained more than seven percent lower than average peak margins. \textit{See id.}

\textit{See id.} The average 1996 return on equity, at 24.4 percent, was 17.3 percent below the average peak return on equity. \textit{See id.} Lipper compares this return with the software manufacturing industry at 28.6 percent and the pharmaceutical industry at 33.3 percent, because all three industries are “knowledge intensive, have low marginal cost of production, have high distribution costs, and have high continuing service responsibilities.” \textit{See id.} at 7.

Vanguard’s average fund fee dropped from .25 percent of assets to .05 percent of assets over the period 1977 to 1996. \textit{See Ellen E. Schultz, Fund Track: Vanguard Bucks Trend by Cutting Fund Fees, Wall St. J., Jun. 30, 1996, at Cl.}

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charging higher fees despite the existence of a competitor that charges lower fees indicates that high-price competitors are not being forced to react to market pressure.\textsuperscript{131} In combination with evidence that many investors may be largely unaware of fees,\textsuperscript{132} Vanguard may be seen as the exception which proves the rule that mutual fund companies are getting away with charging fees higher than a competitive market could sustain.

However, because of another special characteristic of Vanguard, its low fees probably are not as relevant to an evaluation of industry fee trends as they might at first appear. Vanguard is a mutual corporation. Therefore, the shareholders of Vanguard, to whom Vanguard's profits belong, are the same persons as the investors from whom fees are extracted. It is unsurprising, therefore, that Vanguard does not try to make profits on its mutual funds, choosing instead to provide mutual funds at cost.\textsuperscript{133} Competing fund complexes created to make a profit for their shareholders cannot provide mutual funds to investors at fees similar to Vanguard and hope to achieve their profit-making purpose. Therefore, we would expect that non-mutual fund complexes would charge higher fees, and attempt to attract investors by paying for greater investor services or well-known

\textsuperscript{131} In several categories of funds with the same investment objective (e.g., aggressive growth or income), the difference in fees between the average of the most expensive 20 percent of funds and the least expensive 20 percent of funds is approximately 100 basis points. See Are Mutual Fund Fees Reasonable? at 7.

\textsuperscript{132} See supra, II.G.2.

\textsuperscript{133} See interview with Mike Schwartz, former Registered Representative in the Vanguard Group's Flagship Department, in Doylestown, Pa. (Mar. 21, 1998).
and talented managers out of the greater profits earned through higher fees.

III. Conclusion

The evidence regarding trends in mutual fund fees indicates that the situation is too complex to allow a single industry average fee trend to be of much use. There is evidence of increasing average fees, but also of falling fees among larger and older funds. There is evidence of investor ignorance about fees, but also of increasing popularity of low-fee funds. There is evidence of seemingly unjustified imposition of fees (such as loads on index funds or 12b-1 fees on closed funds), but also of removal of fees in response to market forces. The shift from front-end loads to distribution fees and the shift of assets from less expensive bond funds and domestic funds to more expensive equity funds and international funds further complicates an attempt to assess the reasonableness of mutual fund fees, and makes the industry average misleading when used to compare fees in 1996 with fees in 1996.

Market segmentation of one kind or another may explain many of the apparent contradictions in measures and trends. An explanation of fee trends in terms of market segmentation may seem at first blush to be little more than a pronouncement that "The data conflict." However, as has been seen, mutual fund investors have divergent investing purposes and levels of sophistication, and it is not surprising that, in an industry expanding as
explosively as the mutual fund industry, a large proportion of investors should get a worse deal than more knowledgeable or careful investors. Assuming that market segmentation exists, both in terms of sophistication and investment purpose, then the question "Are mutual fund fees rising or falling?" is mostly pointless; the questions must be much more narrowly drawn: "Are mutual fund fees for equity funds more than 10 years old and sold directly to investors rising or falling?" or "Are mutual fund fees for funds sold through the supermarket channel rising or falling?"

Recognition of market segmentation does not answer the question of how concerned we should be about it. To draw a conclusion from the evidence presented in this paper, there seems to be little cause for very profound reforms to deal with the problem. There seem to be enough investors with enough knowledge to make the market generally competitive in terms of price, with some exceptions, such as the seeming irrationality of paying a load for an index fund. Lipper found that, despite the absence of any industry-wide economies of scale, there are observed economies of scale in older funds. Unlike the average of all funds, the average fund created before 1987 has experienced a significant increase in size, from $0.326 billion in 1986 to $1.188 billion in 1996. Lipper suggests a cycle of growth: New funds begin small with high expenses, but if successful, grow and realize economies of scale that are passed on to investors. Something of the converse may also be true--funds may survive and be successful

135 See id.
because of their success in containing fees, and in passing along savings to investors. Thus, the correlation of fund survival with dropping fees is reassuring. This is especially true when it is recalled that the average investor does not pay the average fee; low-fee funds do attract more assets than high-fee funds. Over time, sophisticated investors reward efficient funds to a great enough degree to preserve price pressure on funds. This seems enough to ask of the mutual fund market, and suggests that mutual fund fees are within a reasonable range.