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## WHAT'S INSIDE



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# Trends in the Fees and Expenses of Mutual Funds, 2010

## KEY FINDINGS

» **On average, fees and expenses incurred by investors in long-term mutual funds declined in 2010.** Stock fund investors in 2010 paid an average of 95 basis points (0.95 percent) in fees and expenses, down 3 basis points from 2009. Fees and expenses of bond funds declined 1 basis point, to 72 basis points.

» **Expense ratios of stock funds declined in 2010, while expense ratios of bond funds were unchanged.** The average expense ratio of stock funds fell 2 basis points to 84 basis points, after having risen the previous year. Bond fund expense ratios remained unchanged at 64 basis points.

» **The decline in fees and expenses of long-term funds was aided by a decline in load fee payments by investors.** In 2010, the maximum sales load on stock funds offered to investors averaged 5.3 percent. But the average sales load investors actually paid was only 1.0 percent, owing to load fee discounts on large purchases and fee waivers, such as those on purchases through 401(k) plans.

» **The average fees and expenses of money market funds declined sharply in 2010.** The average expense ratio on money market funds fell 7 basis points, from 33 basis points in 2009 to 26 basis points in 2010. Expense ratios on money market funds fell sharply in 2010 because the great majority of funds waived expenses to ensure that net returns to investors remained positive in the current low interest rate environment.

» **Average expense ratios of funds of funds—mutual funds that invest in other mutual funds—declined for the fifth consecutive year.** In 2010, the total expense ratio of funds of funds, which includes both the expenses that a fund pays directly out of its assets as well as the expense ratios of the underlying funds in which it invests, fell 1 basis point to 90 basis points. Since 2005, the average expense ratio for investing in funds of funds has fallen 11 basis points, in part reflecting a shift by investors toward funds with lower expense ratios.

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## Mutual Fund Fees and Expenses Have Declined by More Than Half Since 1990

Over the past two decades, average fees and expenses paid by mutual fund investors have fallen by more than half (Figure 1). In 1990, investors on average paid 200 basis points, or $2.00 for every $100 in assets, to invest in stock funds.[1] Fees and expenses averaged 95 basis points for stock fund investors in 2010, a decline of 53 percent from 1990. Similarly, the average fees and expenses paid by investors in bond funds declined 61 percent, from 185 basis points in 1990 to 72 basis points in 2010, while fees incurred by investors in money market funds dropped 52 percent, from 54 basis points in 1990 to 26 basis points in 2010.

## How ICI Measures Average Mutual Fund Fees and Expenses

Investors in mutual funds incur two primary kinds of fees and expenses: sales loads and fund expenses. Sales loads are one-time fees that investors pay either at the time of purchase (front-end loads) or when shares are redeemed (back-end loads). Fund expenses are paid from fund assets, and investors thus pay these expenses indirectly. Fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, distribution charges (known as 12b-1 fees), and other operating costs. A fund's expense ratio, which is disclosed in the fund's prospectus and shareholder reports, is the fund's total annual expenses expressed as a percentage of the fund's net assets.

Various factors affect a mutual fund's fees and expenses, including its investment objective, its level of assets, the average account balance of its investors, the range of services it offers, fees that investors may pay directly, and whether the fund is a "load" or "no-load" fund.

Load funds are sold through financial intermediaries such as brokers and registered financial advisers. These professionals help investors define their investment goals, select appropriate funds, and provide ongoing service. Financial professionals are compensated for providing these services through some combination of front- or back-end loads and 12b-1 fees.

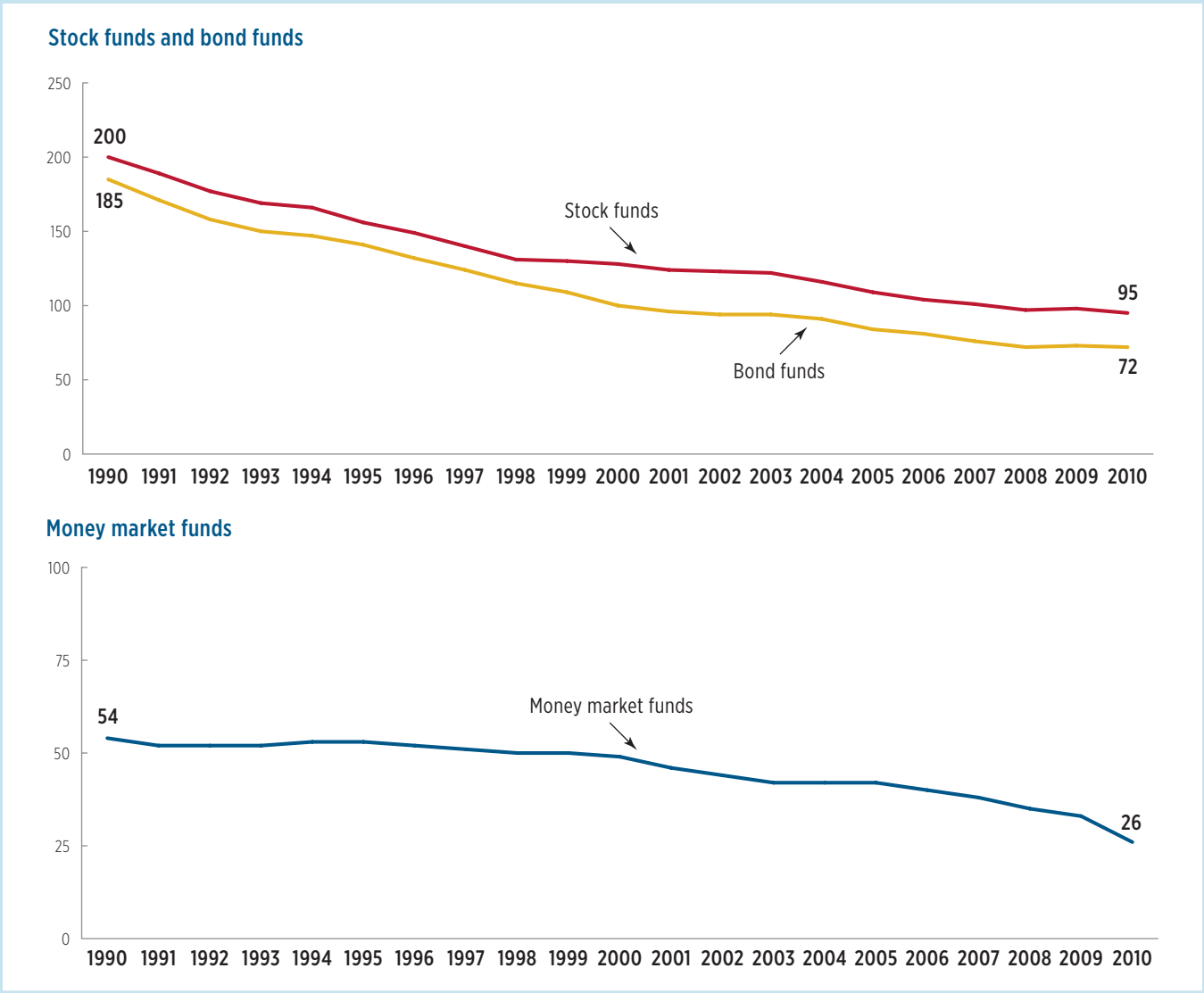
Investors who do not use a financial adviser (or who pay the financial adviser directly for services) purchase no-load funds, which have neither front- nor back-end load fees and have low or no 12b-1 fees. Because load funds include payments to brokers or other financial professionals, they typically have higher fees and expenses than no-load funds.

To understand trends in the cost of owning mutual funds, it is helpful to combine one-time sales loads and fund expenses in a single measure. ICI does this by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads.[2]

FIGURE 1

## Mutual Fund Fees and Expenses Have Fallen by More Than Half Since 1990

*Basis points, 1990–2010*




Note: Fees and expenses are measured as an asset-weighted average; figures exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

ICI uses asset-weighted averages to summarize the fees and expenses that shareholders actually pay through mutual funds. In this context, asset-weighted averages are preferable to simple averages, which would overstate the fees and expenses of funds in which investors hold few dollars. Note that in this study, fees and expenses shown for years prior to 2010 have been revised slightly because of a change in asset-weighting methodology. Previously, ICI created asset-weighted fee and expense ratio measures by averaging a fund's assets over all months in that fund's fiscal year. Beginning with this study, to simplify calculations and exposition, as well as to enhance consistency with other ICI publications, ICI weights each fund's expense ratio by its end-of-year assets.

In addition, to assess the fees and expenses incurred by individual shareholders in long-term funds, the analysis includes both retail and institutional share classes of long-term mutual funds. Including institutional share classes is appropriate because the vast majority of the assets in the institutional share classes of long-term funds represent investments made on behalf of retail investors, such as through defined contribution (DC) plans, individual retirement accounts (IRAs), broker-dealers investing on behalf of retail clients, 529 plans, and other accounts such as "omnibus accounts."[3]

For money market funds, this study provides an overall summary of fees and expenses, as well as a breakdown between retail and institutional share classes of money market funds. In contrast with long-term funds, a large portion of the assets in money market funds is held by corporations, municipalities, endowments, and other institutional investors investing for their own accounts, rather than on behalf of retail investors.

## Stock Funds

The average fees and expenses paid by stock fund investors declined 3 basis points in 2010, to 95 basis points (Figure 2). This decline was the result of a 1 basis-point drop in load fees paid by stock fund investors, combined with a 2 basis-point fall in the average expense ratio of stock funds.

The drop in load fees paid by stock investors reflects an increased volume of sales of load funds that were entitled to a discounted load fee (see "Understanding the Decline in Load Fee Payments" below). For example, in 2010, the maximum sales load charged by stock funds averaged 5.3 percent (Figure 3). However, owing to sales of fund shares with load fee discounts, the average sales load actually paid by fund investors was just 1.0 percent.

FIGURE 2

## Average Load Fees and Expense Ratios for Mutual Funds

*Basis points, 1990–2010*

| | Stock funds | | | Bond funds | | | Money market funds |
|---|---|---|---|---|---|---|---|
| Year | Fees and expenses | Load fees *Annualized* | Total expense ratio | Fees and expenses | Load fees *Annualized* | Total expense ratio | Total expense ratio |
| 1990 | 200 | 100 | 100 | 185 | 97 | 88 | 54 |
| 1991 | 189 | 89 | 100 | 171 | 85 | 86 | 52 |
| 1992 | 177 | 76 | 101 | 158 | 73 | 84 | 52 |
| 1993 | 169 | 64 | 105 | 150 | 66 | 83 | 52 |
| 1994 | 166 | 60 | 106 | 147 | 64 | 83 | 53 |
| 1995 | 156 | 51 | 105 | 141 | 56 | 84 | 53 |
| 1996 | 149 | 46 | 103 | 132 | 49 | 83 | 52 |
| 1997 | 140 | 41 | 98 | 124 | 43 | 81 | 51 |
| 1998 | 131 | 36 | 95 | 115 | 36 | 79 | 50 |
| 1999 | 130 | 33 | 97 | 109 | 31 | 78 | 50 |
| 2000 | 128 | 30 | 98 | 100 | 25 | 76 | 49 |
| 2001 | 124 | 26 | 98 | 96 | 21 | 75 | 46 |
| 2002 | 123 | 24 | 99 | 94 | 21 | 73 | 44 |
| 2003 | 122 | 23 | 99 | 94 | 20 | 75 | 42 |
| 2004 | 116 | 22 | 94 | 91 | 19 | 72 | 42 |
| 2005 | 109 | 19 | 90 | 84 | 16 | 69 | 42 |
| 2006 | 104 | 17 | 87 | 81 | 14 | 67 | 40 |
| 2007 | 101 | 16 | 85 | 76 | 12 | 64 | 38 |
| 2008 | 97 | 15 | 82 | 72 | 11 | 61 | 35 |
| 2009 | 98 | 12 | 86 | 73 | 9 | 64 | 33 |
| 2010 | 95 | 11 | 84 | 72 | 8 | 64 | 26 |

Note: Fees and expenses, one-time load fees, and total expense ratio are measured as asset-weighted averages. Figures exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

The average expense ratio of stock funds fell by 2 basis points in 2010, following a rise of 4 basis points in 2009. This pattern was not unexpected, given recent stock market developments. Expense ratios often vary inversely with fund assets. The reason is that certain fund costs—such as transfer agency fees, accounting and audit fees, and directors' fees—are more or less fixed in dollar terms. Thus, as fund assets rise, these costs become smaller relative to those assets. As fund assets fall, the fixed costs become relatively greater.

FIGURE 3

## Front-End Sales Loads That Investors Paid Were Well Below Maximum Front-End Loads That Funds Charged

*Percentage of purchase amount, selected years*

| | Maximum front-end sales load[1] *Percent* | | Front-end sales load that investors actually incurred[1] *Percent* | |
|---|---|---|---|---|
| | Stock[2] | Bond | Stock[2] | Bond |
| 1990 | 5.0 | 4.6 | 3.9 | 3.5 |
| 1995 | 4.8 | 4.1 | 2.5 | 2.1 |
| 2000 | 5.2 | 4.2 | 1.4 | 1.1 |
| 2001 | 5.2 | 4.2 | 1.2 | 1.0 |
| 2002 | 5.3 | 4.1 | 1.3 | 1.0 |
| 2003 | 5.3 | 4.1 | 1.3 | 1.0 |
| 2004 | 5.3 | 4.1 | 1.4 | 1.1 |
| 2005 | 5.3 | 4.0 | 1.3 | 1.0 |
| 2006 | 5.3 | 4.0 | 1.2 | 0.9 |
| 2007 | 5.3 | 4.0 | 1.2 | 0.9 |
| 2008 | 5.3 | 4.0 | 1.1 | 0.8 |
| 2009 | 5.3 | 3.9 | 1.0 | 0.8 |
| 2010 | 5.3 | 3.9 | 1.0 | 0.8 |

[1] The maximum front-end sales load is a simple average of the highest front-end load that funds may charge as set forth in their prospectuses. The average actually incurred is the maximum sales load multiplied by the ratio of total front-end sales loads collected by stock funds as a percentage of new sales of shares by such funds.

[2] Stock funds include equity and hybrid funds.

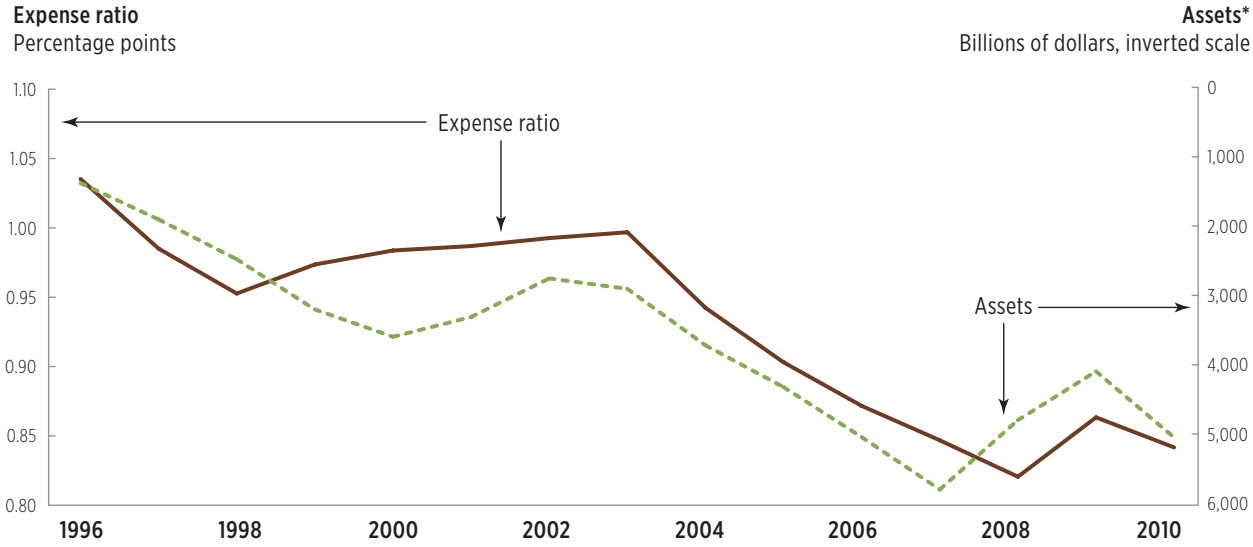
Note: Figures exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Strategic Insight Simfund

During the stock market downturn from October 2007 to March 2009, the assets of stock funds declined markedly (Figure 4, dashed line with an inverted scale), leading expense ratios to rise slightly. As the stock market recovered, stock fund assets rebounded. For example, excluding variable annuities and funds of funds, the net assets of stock funds rose from $4.7 trillion in December 2009 to $5.4 trillion in December 2010, a 15 percent increase. (For exposition, Figure 4 plots fund asset levels as a two-year moving average.) This turnaround in stock fund assets helped to lower stock fund expense ratios in 2010.

FIGURE 4

## Stock Fund Expense Ratios Are Related to Stock Fund Assets




*Assets are the total net assets of equity and hybrid funds. Figure excludes assets of mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds. Assets are plotted as a two-year moving average.

Sources: Investment Company Institute and Lipper

### *Understanding the Decline in Load Fee Payments*

Over time, load fee payments have declined very substantially as a proportion of the total fees investors incur in mutual funds. Load fees now contribute considerably less than fund expense ratios to the total fees investors pay to invest in mutual funds. For example, load fees now contribute just 11 basis points to the annualized cost of investing in stock funds, while fund expense ratios contribute 84 basis points. In 1990, by contrast, load fees and expense ratios contributed equally (100 basis points each) to the costs of investing in stock funds.

This decline in load fees paid reflects several developments. First, the ways in which mutual funds are sold have changed. In the 1980s and early 1990s, mutual funds were sold largely through stock brokers. Load fees were a primary means of compensating brokers for service they provided to investors. Over time, however, brokers and other financial professionals who sell mutual funds have increasingly been compensated through "asset-based" fees (assessed as a percentage of the assets that the financial professional manages for an investor).[4] Investors may pay these fees indirectly through a fund's 12b-1 fee, which is included in the fund's expense ratio. The fund's underwriter collects the 12b-1 fee from the fund but passes the bulk of that fee to the financial professionals serving fund investors. Alternatively, investors may purchase no-load funds with the help of a financial professional, then directly pay the professional a fee (typically an asset-based fee) for his or her services. Either way, the increased use of asset-based fees to compensate financial professionals has resulted in lower front-end load fee payments.

A second factor is the increasingly significant role of mutual funds in helping investors save for retirement. Some portion of share purchases made through 401(k) plans has gone to funds that normally charge front- or back-end load fees. However, load funds often waive sales charges on purchases made through 401(k) plans. As a result, the total dollar amount of load fees paid by investors has declined over time relative to the assets in load funds.

Third, even for purchases made outside of retirement plans, load funds typically offer significant load fee discounts, called "breakpoints," for initial purchases above a given dollar amount or cumulative purchases above pre-specified levels. For example, in 2010, among domestic equity funds (excluding sector funds) that charged a front-end load fee, investors most commonly incurred a front-end load of 5.75 percent of initial share purchases up to $50,000 (Figure 5). For larger initial purchases—or cumulative purchases that over time exceeded $50,000—investors paid a lower front-end load fee, with the front-end load fee declining with total dollars invested. In 2010, for purchases between $50,000 and $100,000, investors most commonly paid a front-end load fee of 4.5 percent of the amount invested. In most cases, front-end load fees are waived altogether for purchases over $1 million. Fee breakpoints thus help reduce investors' load fee payments as a percentage of share purchases, which contributes to a reduction in load fees paid as a percentage of assets.

Fourth, fee breakpoints have interacted with inflation to reduce the real (inflation-adjusted) cost to investors of load fees. As Figure 5 shows, the most common front-end load fees and associated fee breakpoints have remained the same since 2000. However, over the 10-year period 2000 to 2010, the consumer price level rose almost 30 percent. Consequently, by 2010 investors could in real terms achieve a given breakpoint with a considerably smaller investment than they could in 2000. For example, in 2000, shareholders most commonly needed a minimum investment of $50,000 to achieve a breakpoint. By 2010, however, $50,000 was worth only $39,830 in inflation-adjusted terms. Thus, it was easier for investors to achieve a breakpoint in 2010 than in 2000, which likely contributed to a reduction in load fees paid as a percentage of dollars invested.

FIGURE 5

## Front-End Load Fees and Associated Fee Breakpoints

*Most frequently occurring values*[1]

| 2010 | | 2000 | | 2010-adjusted for inflation[2] | |
|---|---|---|---|---|---|
| **Cumulative dollar purchases** *Fee breakpoints* | **Front-end load fee**[3] | **Cumulative dollar purchases** *Fee breakpoints* | **Front-end load fee**[3] | **Cumulative dollar purchases** *Fee breakpoints* | **Front-end load fee**[3] |
| $0 to $49,999 | 5.75 | $0 to $49,999 | 5.75 | $0 to $39,829 | 5.75 |
| $50,000 to $99,999 | 4.5 | $50,000 to $99,999 | 4.5 | $39,830 to $79,660 | 4.5 |
| $100,000 to $249,999 | 3.5 | $100,000 to $249,999 | 3.5 | $79,661 to $199,151 | 3.5 |
| $250,000 to $499,999 | 2.5 | $250,000 to $499,999 | 2.5 | $199,152 to $398,304 | 2.5 |
| $500,000 to $999,999 | 2.0 | $500,000 to $999,999 | 2.0 | $398,305 to $799,608 | 2.0 |
| $1,000,000 or more | 0.0 | $1,000,000 or more | 0.0 | $796,609 or more | 0.0 |

[1] "Most frequently occurring values" are modal values for load fees and breakpoints among all domestic equity (excluding sector funds) that charged a front-end load fee.

[2] Fee breakpoints are adjusted for inflation by taking the fee breakpoints available in 2010 and multiplying by the Consumer Price Index in December 2000 and dividing by the Consumer Price Index in December 2010.

[3] The front-end load fee is a percentage of purchase amount.

Sources: Investment Company Institute, U.S. Bureau of Labor Statistics, and Morningstar

## Bond Funds

The average fees and expenses that shareholders paid for investing in bond funds declined by 1 basis point in 2010, to 72 basis points (Figure 2). This reflects a 1 basis-point drop in the annualized cost of load fee payments and no change in the average expense ratio of bond funds.

Like stock funds, bond funds experienced strong asset growth in 2010. Bond fund assets totaled $2.6 trillion at the end of 2010, up 18 percent from year-end 2009. As noted, growth in fund assets often puts downward pressure on fund expense ratios. In 2010, however, bond fund expense ratios on average remained unchanged. At least two factors played a role.

First, investors, seeking higher yields available in a number of foreign markets, increased their holdings of global/international bond funds. Such funds generally are more costly to manage than bond funds with a domestic orientation and thus have above-average expense ratios.

Second, certain bond funds that saw large increases in assets have "unified fee" structures. With a unified fee structure, investors incur an expense ratio that is fixed as a percentage of a fund's assets for a bundle of services. As a result, the expense ratios of these funds do not automatically decline as fund assets rise. Investors in these funds in 2010 were not disadvantaged because the funds had performance at the upper end—and expense ratios at the lower end—of all bond funds with similar investment objectives.

## Money Market Funds

The average expense ratio of money market funds was 26 basis points in 2010, a drop of 7 basis points from 2009 (Figure 2). Because investors generally do not pay sales loads for investing in money market funds, the fees and expenses of money market funds are simply measured as the expense ratios of these funds.

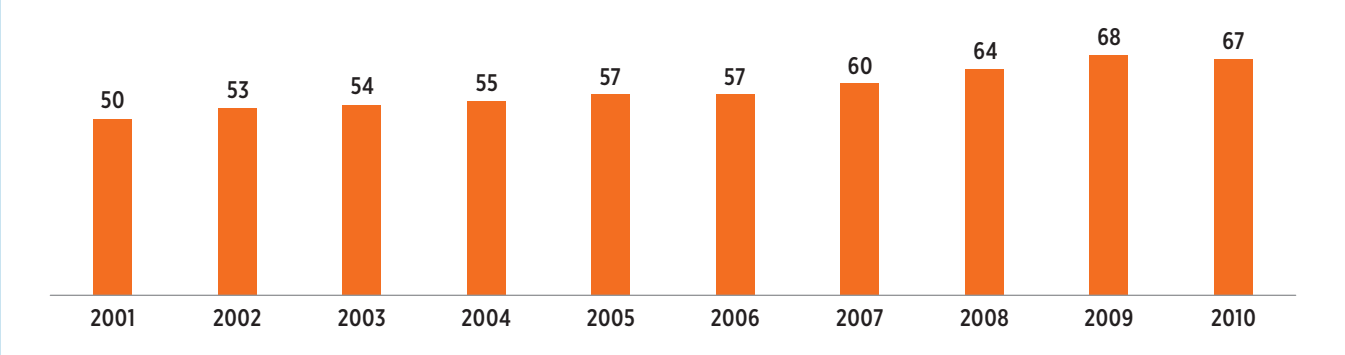
From 2001 to 2009, the declining average expense ratio of money market funds largely reflected an increase in the market share of institutional share classes of money market funds (Figure 6). Because institutional share classes serve fewer investors with larger average account balances, they tend to have lower expense ratios than retail share classes of money market funds (Figure 7). Thus, the increase in the institutional market share helped reduce the industry-wide average expense ratio of all money market funds.

By contrast, the market share of institutional share classes of money market funds dropped slightly in 2010 (to 67 percent from 68 percent in 2009), indicating that other factors pushed expenses down. Primarily, the steep decline in the average expense ratio of money market funds reflects developments stemming from the current low interest rate environment.

FIGURE 6

## Market Share of Institutional Share Classes of Money Market Funds

*Percentage of assets of all money market funds, 2001–2010*

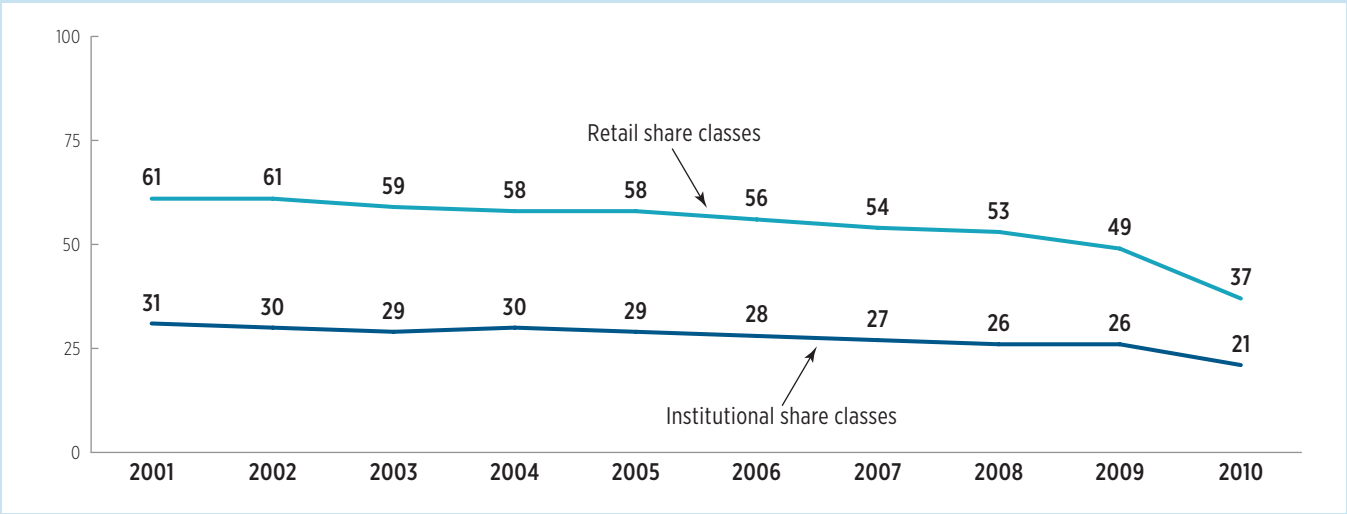



Source: Investment Company Institute

FIGURE 7

## Expense Ratios of Institutional and Retail Money Market Share Classes

*Basis points, 2001–2010*




Note: Expense ratios are measured as an asset-weighted average; figures exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

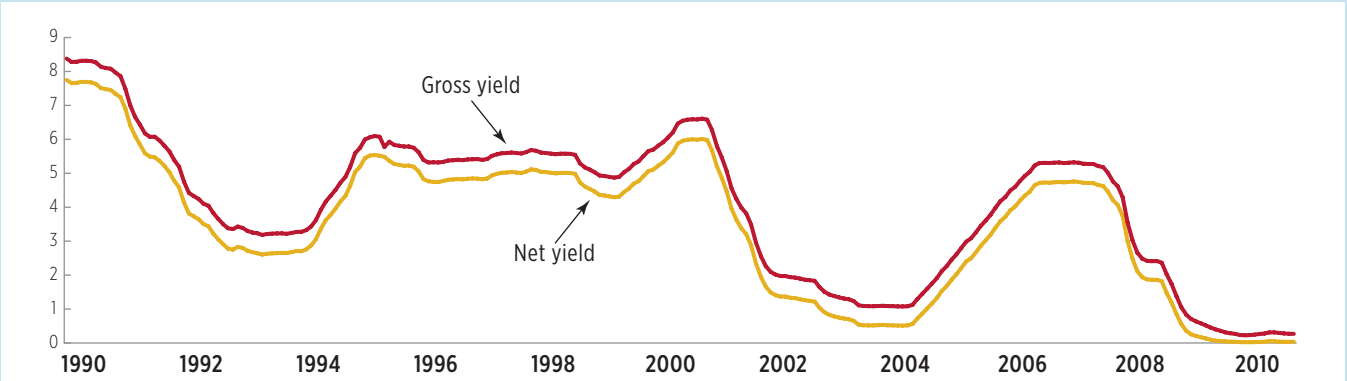
In 2007 and 2008, to stimulate the economy and respond to the financial crisis, the Federal Reserve sharply reduced short-term interest rates. Yields on money market funds, which closely track short-term interest rates, tumbled (Figure 8). In 2010, the average gross yield (the yield before deducting fund expense ratios) on taxable money market funds hit a historic low, hovering just above zero.

In this setting, money market fund advisers increased expense waivers to ensure that fund net yields (the yields after deducting fund expense ratios) did not fall below zero. Waivers raise a fund's net yield by reducing the fund's expense ratio. Historically, money market funds have often waived expenses, usually for competitive reasons. For example, in 2006, before the onset of the financial crisis, 60 percent of money market fund share classes were waiving expenses. By the end of 2010, over 90 percent of money market fund share classes were waiving some or all expenses (Figure 9).

FIGURE 8

**Taxable Money Market Fund Yields**

*Percent, 1990–2010*

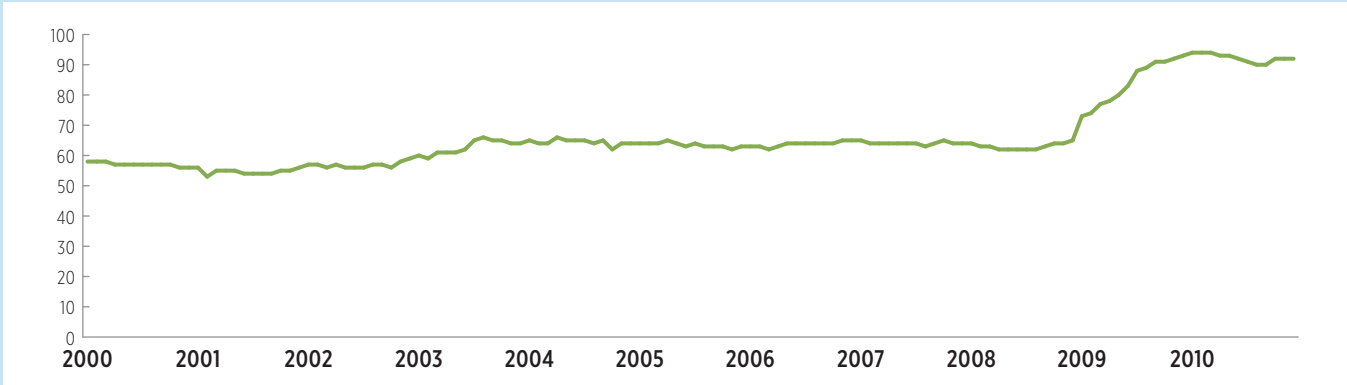



Sources: Investment Company Institute and iMoneyNet

FIGURE 9

**Percentage of Money Market Fund Share Classes That Waive Expenses Has Increased**

*Percent, January 2000–December 2010*




Sources: Investment Company Institute and iMoneyNet

Expense waivers are paid for by money market fund advisers, who thus forego profits and bear more, if not all, of the costs of running their money market funds. Money market fund advisers waived an estimated $4.5 billion in expenses in 2010, over three times the amount waived in 2006 (Figure 10). Thus, these waivers posed a substantial financial cost on fund advisers. In the future, if gross yields on money market funds rise, advisers may reduce or eliminate waivers, which could lead expense ratios on money market funds to rise somewhat.

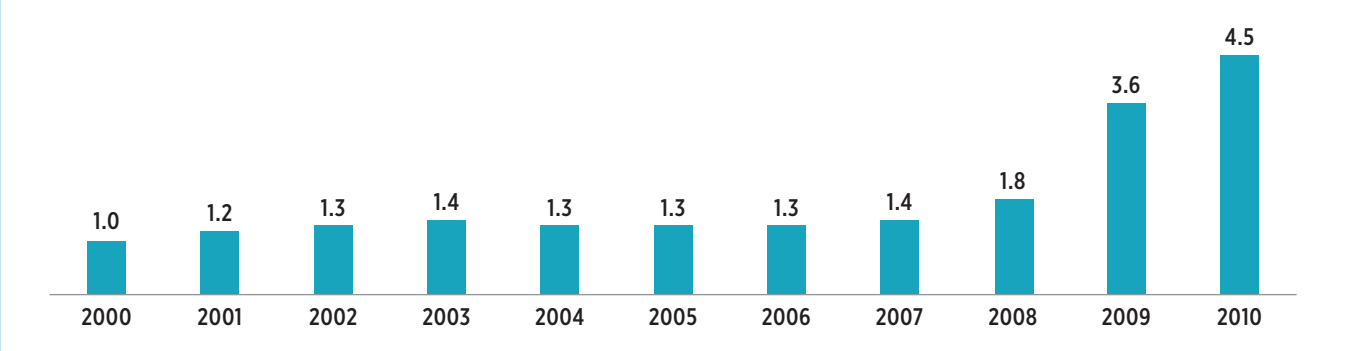
## Funds of Funds

Funds of funds are mutual funds that invest in other mutual funds.[5] The market for funds of funds has expanded considerably in recent years. By the end of 2010, there were 966 funds of funds with $928 billion in assets (Figure 11). Approximately 85 percent of the assets of funds of funds are in hybrid funds of funds, which are funds that invest in a mix of stock, bond, and hybrid mutual funds.

FIGURE 10

**Money Market Funds Waived an Estimated $4.5 Billion in Expenses in 2010**

*Estimated expense waivers, billions of dollars, 2000–2010*




Sources: Investment Company Institute and iMoneyNet

FIGURE 11

## Funds of Funds Have Grown Rapidly in Recent Years

*Number of funds of funds*

| | | | | | Memo | |
|---|---|---|---|---|---|---|
| Year-end | Total | Equity | Hybrid | Bond | Lifestyle[1] | Target date[2] |
| 1996 | 45 | 24 | 19 | 2 | 9 | 0 |
| 1997 | 94 | 41 | 48 | 5 | 30 | 3 |
| 1998 | 175 | 75 | 91 | 9 | 60 | 7 |
| 1999 | 212 | 83 | 115 | 14 | 78 | 8 |
| 2000 | 215 | 86 | 119 | 10 | 88 | 9 |
| 2001 | 213 | 85 | 123 | 5 | 86 | 15 |
| 2002 | 269 | 103 | 160 | 6 | 115 | 15 |
| 2003 | 302 | 111 | 185 | 6 | 115 | 26 |
| 2004 | 380 | 116 | 259 | 5 | 123 | 64 |
| 2005 | 475 | 129 | 334 | 12 | 160 | 91 |
| 2006 | 609 | 162 | 433 | 14 | 201 | 154 |
| 2007 | 721 | 174 | 536 | 11 | 222 | 220 |
| 2008 | 866 | 184 | 667 | 15 | 245 | 286 |
| 2009 | 932 | 172 | 745 | 15 | 233 | 339 |
| 2010 | 966 | 184 | 761 | 21 | 229 | 345 |

*Total net assets of funds of funds, billions of dollars*

| | | | | | Memo | |
|---|---|---|---|---|---|---|
| Year-end | Total | Equity | Hybrid | Bond | Lifestyle[1] | Target date[2] |
| 1996 | $13.4 | $4.6 | $8.7 | $0.1 | $2.4 | $0.0 |
| 1997 | 21.4 | 7.6 | 13.8 | 0.1 | 5.9 | 0.3 |
| 1998 | 35.2 | 12.2 | 22.9 | 0.1 | 11.8 | 2.8 |
| 1999 | 48.1 | 18.6 | 29.4 | 0.2 | 17.0 | 5.4 |
| 2000 | 56.7 | 16.1 | 40.4 | 0.2 | 20.0 | 7.2 |
| 2001 | 63.2 | 15.7 | 47.2 | 0.3 | 21.5 | 10.7 |
| 2002 | 68.7 | 14.3 | 53.7 | 0.6 | 24.4 | 13.5 |
| 2003 | 122.7 | 28.4 | 93.4 | 1.0 | 43.0 | 23.7 |
| 2004 | 199.1 | 41.7 | 156.3 | 1.1 | 71.9 | 40.5 |
| 2005 | 305.4 | 58.4 | 246.3 | 0.7 | 116.1 | 66.0 |
| 2006 | 470.2 | 96.2 | 372.2 | 1.8 | 171.2 | 108.1 |
| 2007 | 637.6 | 116.0 | 519.3 | 2.4 | 220.2 | 174.9 |
| 2008 | 486.5 | 76.0 | 407.7 | 2.8 | 164.3 | 153.4 |
| 2009 | 672.8 | 73.5 | 594.9 | 4.4 | 217.0 | 242.5 |
| 2010 | 927.9 | 125.6 | 787.8 | 14.5 | 249.0 | 320.7 |

[1] A lifestyle mutual fund maintains a predetermined asset allocation and generally contains "conservative," "aggressive," or "moderate" in its name.

[2] A target date mutual fund is a hybrid fund that typically rebalances to an increasingly conservative portfolio as it approaches and passes the fund's target date, which is usually included in the fund's name.

Note: Components may not add to total because of rounding.

Source: Investment Company Institute

Much of the growth in funds of funds stems from investor interest in lifestyle and target date funds. Lifestyle funds, also known as "target risk" funds, maintain pre-determined asset allocations and usually contain "conservative," "moderate," or "aggressive" in the funds' names. Target date funds adjust their asset allocations over time in a pre-specified way. Typically, a target date fund provides investors more exposure to fixed income and cash as it approaches and passes the target date, which is usually mentioned in the fund's name.

These features have made lifestyle and target date funds especially attractive for individuals saving for retirement in 401(k) plans and IRAs.[6] Lifestyle and target date funds of funds account for 59 percent of the total number and 61 percent of the total assets of funds of funds.

From 2005 to 2010, the average expense ratio of funds of funds fell from 101 basis points to 90 basis points (Figure 12). The total expense ratios shown in Figure 12 account for both the expenses that a fund pays directly out of its assets (sometimes called "direct expenses"), as well as the expense ratios of the underlying funds in which it invests (often called "acquired fund fees" or "indirect expenses").[7] Of that 11 basis-point drop from 2005 to 2010, 3 basis points are due to a fall in the expense ratios of individual funds of funds over the period (Figure 13). The remaining 8 basis points reflect a shift by investors toward lower-cost funds of funds, as well as other factors.[8]

FIGURE 12

**Total Expense Ratios of Funds of Funds**

*Basis points*

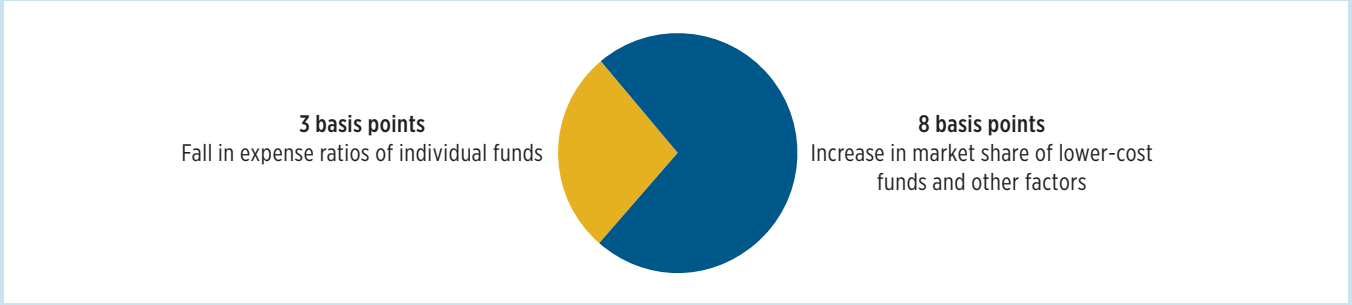
| | Asset-weighted average | Simple average | Median |
|---|---|---|---|
| 2005 | 101 | 156 | 152 |
| 2006 | 96 | 144 | 139 |
| 2007 | 94 | 144 | 135 |
| 2008 | 92 | 138 | 129 |
| 2009 | 91 | 135 | 126 |
| 2010 | 90 | 136 | 128 |

Sources: Investment Company Institute and Morningstar

FIGURE 13

**Factors Contributing to the Drop in the Average Expense Ratio of Funds of Funds from 2005 to 2010**

*Basis point drop due to each factor*




Sources: Investment Company Institute and Morningstar

## Notes

[1] Stock funds includes both equity mutual funds and balanced/hybrid mutual funds. Balanced and hybrid funds that are funds of funds are analyzed separately along with all funds of funds in the discussion at the end of this report.

[2] For more details, see Rea and Reid 1998.

[3] When an investor purchases shares of a mutual fund through a brokerage firm, the broker often registers the purchase with the mutual fund under the broker's name in a pooled ("omnibus") account, which is known as registering in "street name." Brokers do this for operational convenience and to help reduce costs.

[4] See, for example, Damato and Pessin 2010.

[5] Some funds of funds also invest in exchange-traded funds.

[6] As of September 2010, 43 percent of lifestyle mutual fund assets and 87 percent of target date mutual fund assets were held in IRAs and DC retirement plans. See Brady et al. 2011.

[7] An SEC rule addressing funds of funds, adopted in 2006, requires a fund of funds to report a total expense ratio in its prospectus fee table that accounts for both direct and indirect expenses. The expense ratios in Figure 12 include both types of expenses.

[8] The contribution analysis in Figure 13 is determined by first calculating the amount by which the asset-weighted average expense ratio of funds of funds changed from 2005 to 2010 as the result of changes in the expense ratios of individual funds of funds, while holding their assets constant as of 2005. This factor contributed 3 basis points of the 11 basis-point decline in the average expense ratio of funds of funds over the period (labeled in Figure 13 as "Fall in expense ratios of individual funds"). By definition, the remaining 8 basis points must result from an increase in the market share of lower expense ratio funds of funds, or to a net reduction in the average expense ratio of funds of funds because the expense ratios of newly created funds were lower on average than the expense ratios of funds of funds that were merged or liquidated over the period (labeled in Figure 13 as "Increase in market share of lower-cost funds and other factors").

## References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