Fundamentals

INVESTMENT COMPANY INSTITUTE RESEARCH IN BRIEF

Vol. 14 / No. 6

October 2005

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The Investment Company Institute (ICI) is the national association of U.S. investment companies. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

Fees and Expenses of Mutual Funds, 2004

The fees and expenses incurred by investors who purchase mutual funds have been on the decline since 1980 and that trend continued in 2004: Fees and expenses for investing in equity funds dropped 4 basis points in 2004, bond fund fees and expenses dropped 2 basis points, and money fund fees and expenses fell 1 basis point (Figure 1). The decline in fees and expenses in 2004 resulted from a fall in average expense ratios, while average loads remained unchanged.

This issue of *Fundamentals* documents that the decline in average expense ratios in 2004 reflected three main factors:

- The expense ratios of many funds declined, primarily as the result of appreciable asset growth, and to a lesser degree because certain funds cut fees for competitive reasons.
- The proportion of assets in low-cost funds rose, in part because investors increased their purchases of low-cost funds.
- The expense ratios of funds with "performance fee" contracts fell as some of these funds underperformed their benchmarks.

In addition, some funds experienced fee cuts as the result of legal settlements, which contributed very slightly to the 2004 drop in average expense ratios.

Measuring Mutual Fund Fees and Expenses

Investors incur two primary kinds of fees and expenses when purchasing and holding mutual fund shares: sales loads and mutual fund expenses. Sales loads are one-time fees—paid either at the time of share purchase (front-end loads) or, in some cases, when shares held less than a given number of years are redeemed (back-end loads).[1] On the other hand, fund expense ratios—which cover portfolio management, fund administration, shareholder services, distribution charges known as 12b-1 fees, and other miscellaneous costs—are ongoing.

To create a summary measure that captures total fees and expenses incurred, ICI adds a fund's annual expense ratio to an estimate of the annualized cost that investors incur for one-time sales loads.[2] This summary measure is expressed as a percentage of fund assets (measured in basis points) and is reported as an asset-weighted average. Thus, those funds in greatest demand in any given year—by virtue of their holding the largest proportion of industry assets—contribute proportionally more to the summary measure of fees and expenses than do other funds.

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figure 1

Mutual Fund Fees and Expenses Continue to Decline in 2004

Basis points, 1980–2004, selected years

note: Fees and expenses incurred on mutual funds are measured as an asset-weighted average.

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Equity Fund Fees and Expenses

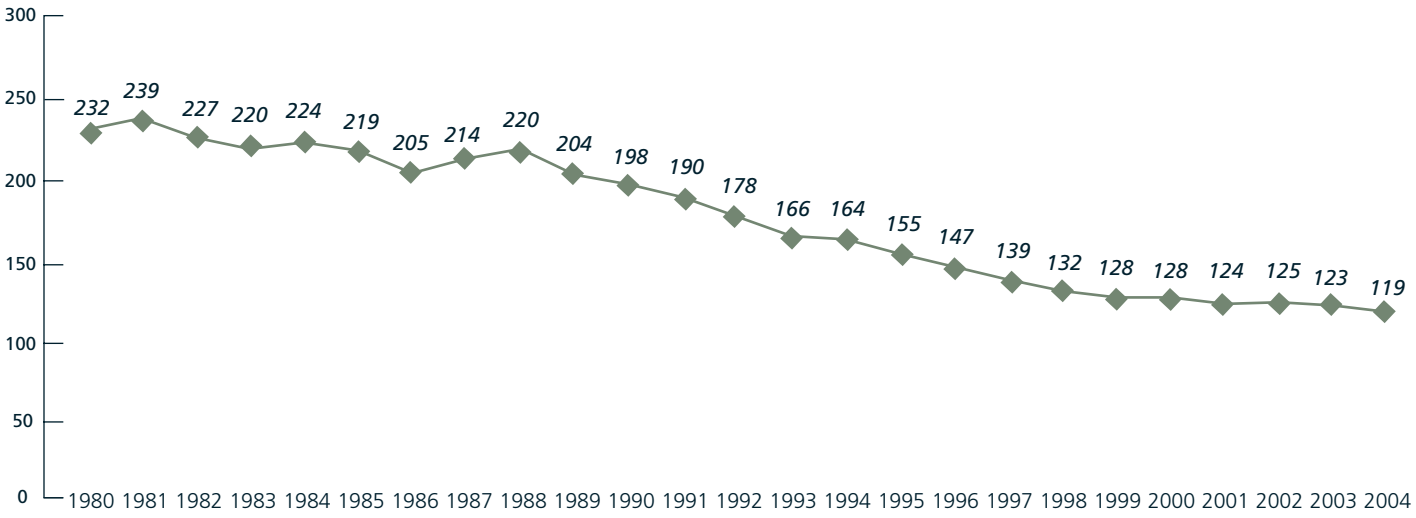
The average fees and expenses that shareholders incurred by investing in equity funds[3] fell by 4 basis points in 2004 to 119 basis points. From 1980 to 2004, these fees and expenses declined 113 basis points, a reduction of 49 percent (Figure 2).

Historically, reductions in equity fund fees and expenses have resulted mainly from lower outlays for one-time sales loads. However, in 2004, one-time sales loads were unchanged. All of the 4 basis point decline in equity fund fees and expenses thus owed to a drop in the average (asset-weighted) expense ratio of equity funds (Figure 3).

figure 2

Fees and Expenses of Equity Funds Have Declined Nearly 50 Percent Since 1980

Basis points, 1980–2004



note: Fees and expenses of equity funds are measured as an asset-weighted average.

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figure 3

Drop in Fund Expense Ratios Drives Down Fees and Expenses in 2004

Basis points, 1980–2004, selected years

	Equity Funds						Bond Funds						Money Market Funds					
	1980	2000	2001	2002	2003	2004	1980	2000	2001	2002	2003	2004	1980	2000	2001	2002	2003	2004
Total Fees and Expenses	232	128	124	125	123	119	205	103	97	93	94	92	55	49	47	45	43	42
One-Time Load Fees (annualized)	164	30	25	25	24	24	132	27	23	20	20	20	-	-	-	-	-	-
Average Expense Ratio	68	98	99	100	99	95	73	76	74	73	74	72	55	49	47	45	43	42

note: Fees and expenses incurred on mutual funds are measured as an asset-weighted average.

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The decline in the average expense ratio of equity funds, in turn, resulted from an increase in the market share of low expense ratio funds, as well as a drop in the expense ratios of many individual funds. The increase in the market share of low expense ratio funds accounted for about 1 basis point of the 4 basis point decline in the (asset-weighted) average expense ratio of equity funds in 2004.[4] Lower expense ratios at individual funds accounted for the remaining 3 basis points (Figure 4).[5]

Popularity of Low-Cost Funds Contributes to Drop in Average Expense Ratio

Equity fund assets typically have been concentrated in funds with below-average expense ratios (Figure 5). This pattern was accentuated in 2004, in part, because investors skewed their purchases of new fund shares toward those funds with the lowest expense ratios. For example, of the $178 billion in net new cash flow to equity funds in 2004, 27 percent ($48 billion) went to those equity funds with expense ratios of less than 50 basis points, up from 22 percent in 2003 (Figure 6).

Lower Expense Ratios at Individual Funds Drive Down Average Expense Ratio

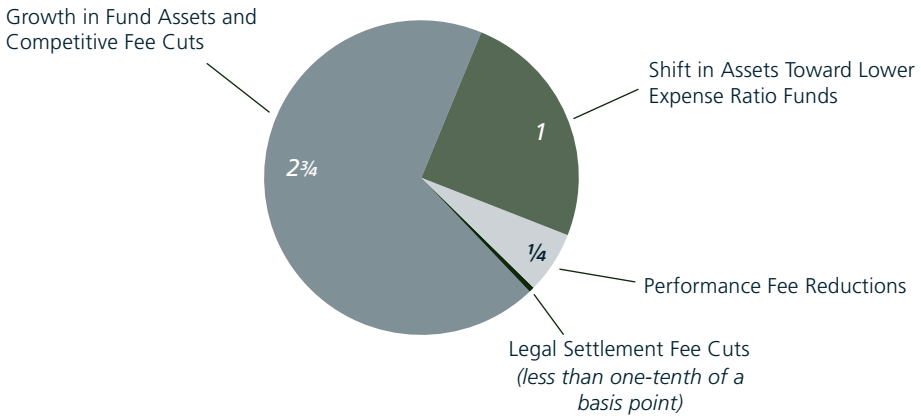
Several factors contributed to the drop in the expense ratios of individual funds. One was that the advisers of some funds introduced fee cuts agreed to in legal settlements stemming from late trading or market timing issues. Fee cuts associated with those settlements are estimated to have contributed very slightly (less than 1/10 of a basis point) to last year's 4 basis point fall in the (asset-weighted) average expense ratio of equity funds (Figure 4).

Performance fees were another factor. A small number of equity funds with considerable assets have performance fee contracts, which in part link their expense ratios to fund performance. For such funds, when fund performance exceeds a given benchmark, the fund's expense ratio increases, rewarding the fund's adviser for good performance.

figure 4

Factors Contributing to the Decline in the (Asset-Weighted) Average Equity Fund Expense Ratio in 2004

Basis point drop due to each factor



Total Decline in 2004: 4 basis points

note: Contributions do not add to 4 basis points points because of rounding.

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figure 5

Equity Funds with Below-Average Expense Ratios Hold Nearly 90 Percent of Assets

Percent of total equity fund assets, 2000–2004

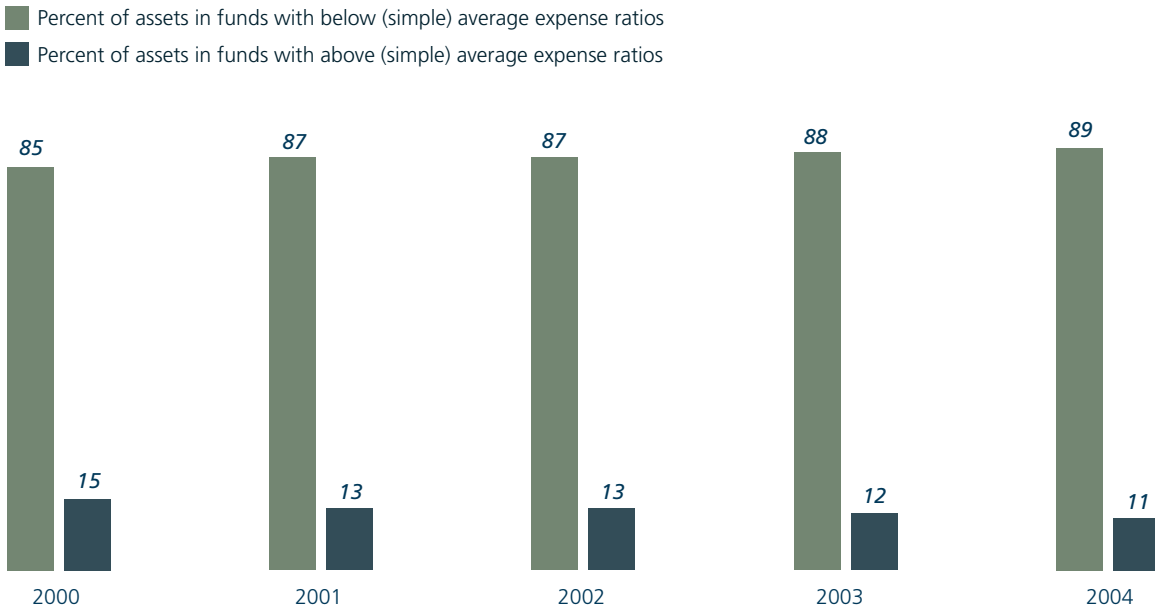

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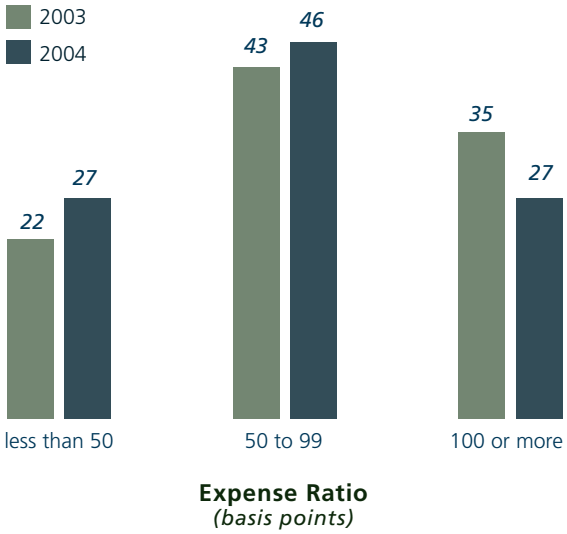
figure 6

New Cash Flow to Low-Cost Equity Funds Increases in 2004

Percent of annual net new cash flow, 2003 and 2004



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Similarly, when fund performance falls short of the given benchmark, the fund's expense ratio falls. In 2004, equity funds with performance fee contracts tended to underperform their benchmarks, leading to reductions in their expense ratios. Performance fees were responsible for an estimated ¼ basis point of the 4 basis point drop in the (asset-weighted) average expense ratio of equity funds (Figure 4).[6]

The most important influences, however, contributing to the declines in the expense ratios of individual funds were other factors, such as growth in fund assets and competitive fee cuts. Equity fund assets rose $700 billion last year, owing to capital gains stemming from good fund performance associated with the advancing stock market,[7] as well as to $178 billion in net new cash flow.[8]

The rise in equity fund assets helped reduce fund expense ratios for a number of reasons. Some mutual funds have "breakpoints" in their management contracts, which means that they incur lower management fees in percentage terms as their assets grow. Also, fund expenses that are relatively fixed in dollar terms (such as audit fees) add proportionally less to a fund's expense ratio as its assets rise. In addition, transfer agent fees—fees that mutual funds pay for shareholder services such as call centers that help investors purchase or redeem shares—tend to add less to a fund's expense ratio when its assets grow as the result of capital appreciation. Indeed, lower transfer agent fees alone accounted for 1½ basis points of the 4 basis point drop in the average expense ratio of equity funds. The expense ratios of some funds also fell in 2004 because their advisers reduced their fees for competitive reasons, either by cutting management fees outright, or by adding new breakpoints, or by offering fee waivers.

Bond Fund Fees and Expenses

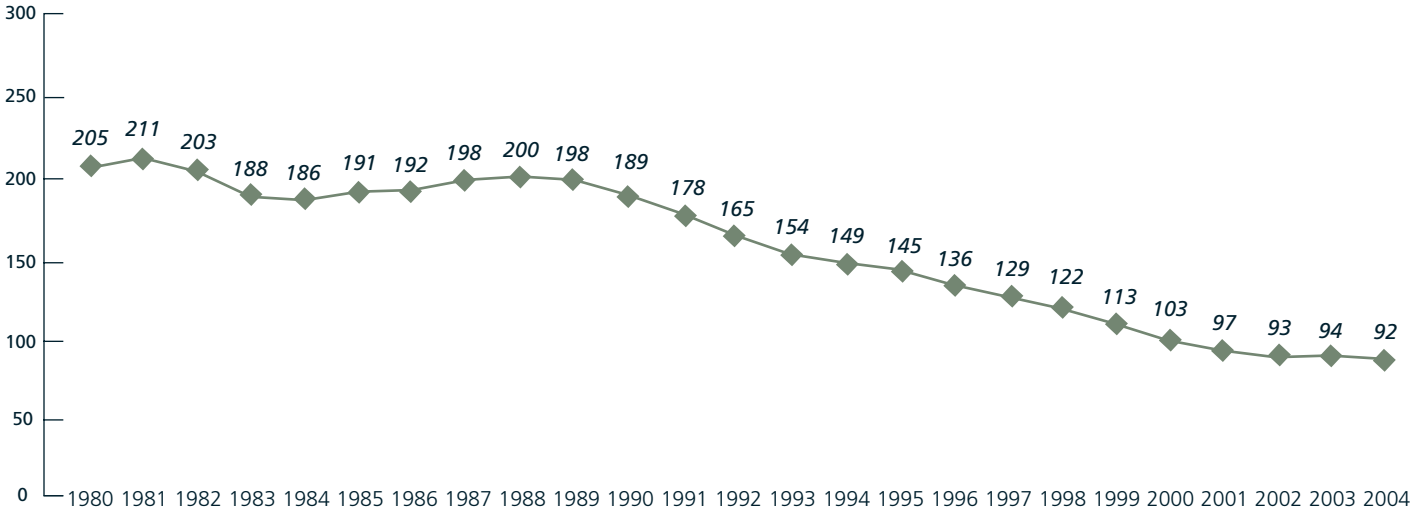
Average fees and expenses that shareholders incurred for investing in bond funds fell 2 basis points in 2004 to 92 basis points. From 1980 to 2004, these fees declined 113 basis points (Figure 7), a reduction of 55 percent.

The decline in fees and expenses incurred on bond funds in 2004 owed, as with equity funds,

figure 7

Fees and Expenses of Bond Funds Decline 55 Percent Since 1980

Basis points, 1980–2004



note: Fees and expenses incurred on bond funds are measured as an asset-weighted average.

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to a fall in the average expense ratio of bond funds (Figure 3). This, in turn, resulted from a range of factors. Bond funds saw an even more dramatic shift in assets toward lower expense ratio funds than did equity funds. In 2004, bond funds experienced a net cash outflow of $11 billion. However, bond funds with very low expense ratios—those whose expense ratios were among the lowest 10 percent of all bond funds—garnered $10 billion in net new cash *inflow*. In addition, the average expense ratio of bond funds fell, in part, because of a modest rise in the proportion of bond fund assets held in no-load funds.[9] Finally, the average expense ratio of bond funds with sales loads declined slightly (1 basis point).

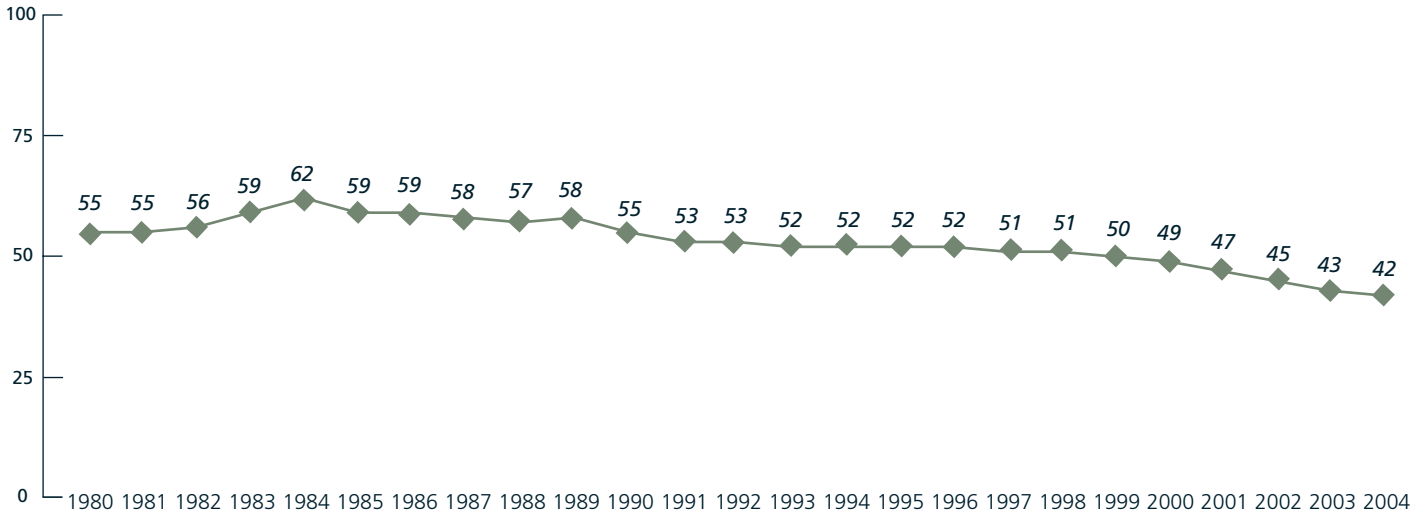
Money Market Fund Fees and Expenses

Average fees and expenses that shareholders incurred for investing in money market funds fell 1 basis point in 2004 to 42 basis points. From 1980 to 2004, fees and expenses incurred for investing in money market funds have declined 13 basis points (Figure 8), a reduction of 24 percent.

figure 8

Money Market Fund Fees and Expenses Fall 24 Percent Since 1980

Basis points, 1980–2004



note: Fees and expenses incurred on money market funds are measured as an asset-weighted average.

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Notes

[1] Back-end loads are also called contingent deferred sales loads (CDSLs).

[2] To put fund expense ratios and one-time sales loads on a comparable basis, one-time sales loads must be converted into the equivalent of an annual payment made over the life of the investment. For details, see John D. Rea and Brian K. Reid, "Trends in the Ownership Cost of Equity Mutual Funds," *Perspective*, Vol. 4, No. 3, November 1998 (www.ici.org/pdf/per04-03.pdf).

[3] Fees and expenses of equity funds are inclusive of those on hybrid funds.

[4] The shift in the proportion of assets toward low expense ratio funds was centered in load funds, rather than no-load funds.

[5] The contribution analysis in Figure 4 is determined by first calculating the amount by which the asset-weighted average expense ratio of equity funds would have declined if the expense ratio of each and every equity fund remained unchanged between 2003 and 2004. This contributed 1 basis point (labeled in Figure 4 as "Shift in Assets Toward Lower Expense Ratio Funds") to the 4 basis points reduction in the asset-weighted average expense ratio of equity funds because equity funds with lower-than-average expense ratios increased their market share in 2004.

By definition, the remaining 3 basis points of the 4 basis point decline in the weighted-average expense ratio between 2003 and 2004 must owe solely to changes in fund expense ratios between the two years. Of these 3 basis points, declines in fund expense ratios owing to performance fees are estimated to have contributed ¼ of a basis point, which is determined by calculating the dollar amount by which management fees fell between 2003 and 2004 at the small number of funds with performance fees, which is then measured as a percent of total equity fund assets.

Declines in fund expense ratios owing to legal settlements are estimated to have amounted to less than 1/10 of a basis point to the 3 basis point decline. This is calculated by taking the total annual dollar reduction in fees agreed to by eight mutual fund advisers in legal settlements ($185 million per year) as a percent of total equity fund assets.

The remaining 2¾ basis points must by definition reflect declines in fund expense ratios because of other factors such as growth in fund assets or competitive fee cuts. The majority of this (1½ basis points) owes to reductions in transfer agent fees.

[6] For more information on performance fees and their effects on fund expense ratios, see Investment Company Institute, "Performance Fees and Expense Ratios," *Fundamentals*, Vol. 12, No. 2, August 2003 (www.ici.org/pdf/fm-v12n2.pdf).

[7] In 2004, the S&P 500 index rose 10.88 percent, while the Wilshire 5000 index advanced 12.63 percent.

[8] Assets of hybrid funds rose by $89 billion because of capital appreciation and net new cash flow of $43 billion. Thus, the assets of equity and hybrid funds rose a combined $789 billion and these funds garnered total net new cash flow of $221 billion.

[9] Load funds tend to have higher expense ratios than no-load funds because of 12b-1 fees. 12b-1 fees, like one-time load fees, are a form of distribution charge. They are used to compensate brokers and other financial intermediaries for their sales efforts and for providing advice and service to fund investors both before and after they purchase fund shares. However, unlike one-time load fees, 12b-1 fees are by law included in a fund's expense ratio. Investors who purchase no-load funds either do not use a financial intermediary or use a financial intermediary but pay directly for the services provided by the intermediary, and may have 12b-1 fees of at most 25 basis points. As a result, expense ratios of load funds tend to be higher than those of no-load funds.