

## WHAT'S INSIDE

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For a complete set of data files for each figure in this report, see [www.ici.org/info/per23-03\\_data.xls](http://www.ici.org/info/per23-03_data.xls).

## Trends in the Expenses and Fees of Funds, 2016

### KEY FINDINGS

- » **On average, expense ratios for long-term mutual funds have declined substantially over the past 20 years.** In 1996, equity mutual fund expense ratios averaged 1.04 percent, falling to 0.63 percent in 2016. Bond mutual fund expense ratios averaged 0.84 percent in 1996 compared with 0.51 percent in 2016. Hybrid mutual fund expense ratios averaged 0.95 percent in 1996, falling to 0.74 percent in 2016.
- » **The average expense ratios for money market funds rose 5 basis points in 2016 to 0.18 percent.** This was indirectly related to the Federal Reserve raising short-term interest rates in December 2015, which prompted fund advisers to begin paring expense waivers that most money market funds offered during the period of near-zero short-term interest rates that had prevailed in the post-financial crisis era.
- » **Expense ratios of target date mutual funds averaged 0.51 percent in 2016.** Since 2008, the expense ratios of target date mutual funds have fallen 24 percent. Attractive to individuals saving for retirement, investor demand for these funds has flourished in recent years. Ninety-seven percent of target date mutual funds are funds of funds—mutual funds that invest in other funds—the expense ratios of which fell from 0.70 percent in 2015 to 0.66 percent in 2016.
- » **No-load mutual fund share classes continue to experience positive net new cash flow.** In 2016, no-load mutual fund share classes received net inflows of \$113 billion, while load mutual fund share classes experienced net outflows of \$232 billion. This disparity, in large part, reflects a growing trend—investors paying intermediaries for advice and assistance directly out of their pockets rather than indirectly through funds.
- » **Average expense ratios for both actively managed and index equity mutual funds have fallen since 1996.** In 2016, the average expense ratio of actively managed equity mutual funds fell to 0.82 percent, down from 1.08 percent in 1996. Index equity mutual fund expense ratios fell from 0.27 percent in 1996 to 0.09 percent in 2016. Investor interest in lower-cost equity mutual funds, both actively managed and indexed, has fueled this trend, as has asset growth and resulting economies of scale.
- » **Economies of scale and intense competition are putting downward pressure on expense ratios of exchange-traded funds (ETFs).** In 2016, the expense ratios of index equity ETFs fell to 0.23 percent (down from 0.34 percent in 2009). Expense ratios of index bond ETFs, although down from a recent peak of 0.26 percent in 2013, were unchanged in 2016 at 0.20 percent.

## Mutual Fund Expense Ratios Have Declined Substantially over the Past Two Decades

Fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, certain kinds of distribution charges (known as 12b-1 fees), and other operating costs. A fund's expense ratio, which is shown in the fund's prospectus and shareholder reports, is the fund's total annual expenses expressed as a percentage of its net assets. Unlike sales loads, fund expenses are paid from fund assets.

Many factors affect a mutual fund's expense ratio, including its investment objective, its 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.

On an asset-weighted basis, average expense ratios\* incurred by mutual fund investors have fallen substantially over the past two decades (Figure 1).<sup>1</sup> In 1996, equity mutual fund investors incurred expense ratios of

FIGURE 1

### Average Expense Ratios for Long-Term Mutual Funds Have Fallen

Percent, 1996–2016

	Equity	Hybrid	Bond	Money market
1996	1.04%	0.95%	0.84%	0.52%
1997	0.99	0.92	0.82	0.51
1998	0.95	0.89	0.80	0.50
1999	0.98	0.90	0.78	0.50
2000	0.99	0.89	0.76	0.49
2001	0.99	0.89	0.75	0.46
2002	1.00	0.89	0.74	0.44
2003	1.00	0.90	0.75	0.42
2004	0.95	0.85	0.72	0.42
2005	0.91	0.81	0.69	0.42
2006	0.88	0.78	0.67	0.40
2007	0.86	0.77	0.64	0.38
2008	0.83	0.77	0.61	0.35
2009	0.87	0.84	0.64	0.33
2010	0.83	0.82	0.63	0.24
2011	0.79	0.80	0.62	0.21
2012	0.77	0.79	0.61	0.18
2013	0.74	0.80	0.61	0.17
2014	0.70	0.78	0.57	0.13
2015	0.67	0.77	0.54	0.13
2016	0.63	0.74	0.51	0.18

Note: Expense ratios are measured as asset-weighted averages. Data 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 Morningstar

\* Unless otherwise noted, this report calculates average expense ratios on an asset-weighted basis. See note 1 on page 29.

1.04 percent, on average, or \$1.04 for every \$100 in assets. By 2016, that average had fallen to 0.63 percent. Bond and hybrid mutual fund expense ratios also have declined since 1996. The average bond mutual fund expense ratio fell from 0.84 percent in 1996 to 0.51 percent in 2016, and the average hybrid mutual fund expense ratio fell from 0.95 percent to 0.74 percent.<sup>2, 3</sup> The average expense ratio for money market funds dropped from 0.52 percent to 0.18 percent over this period.

The declines in 2016 in the expense ratios of equity, bond, and hybrid mutual funds reflect a shift by investors toward lower-cost funds or fund share classes. This shift appears to have been a continuation of a long-running trend, in which investors have been moving toward no-load share classes—those that had neither a front-end load fee, nor a back-end load fee, nor a 12b-1 fee of more than 0.25 percent.

## Equity Mutual Funds

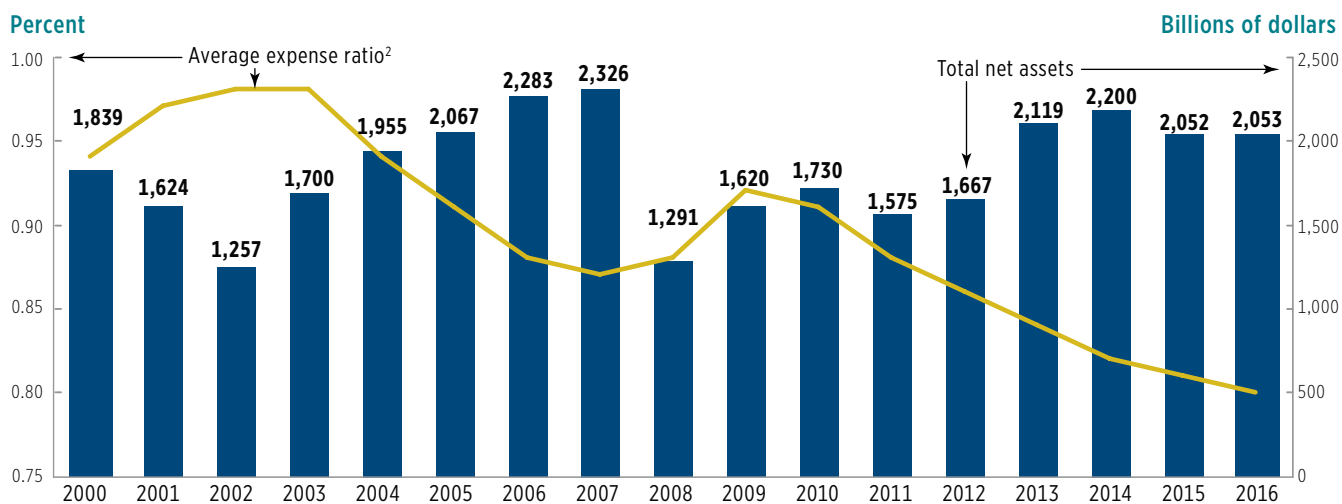
Equity mutual fund expense ratios declined for the seventh straight year in 2016, falling 4 basis points in 2016.\* Some fund costs—such as transfer agency fees, accounting and audit fees, and director fees—are relatively fixed in dollar terms, regardless of fund size. When fund assets rise, these relatively fixed costs make up a smaller proportion of a fund’s expense ratio.

Consequently, asset growth tends to contribute to declines in fund expense ratios. During the stock market downturn from October 2007 to March 2009, actively managed domestic equity mutual fund assets decreased markedly (Figure 2), leading their expense ratios to rise in 2009. As the stock market recovered, however, actively managed domestic equity mutual fund assets rebounded and their expense ratios fell. Since 2008, equity mutual funds’ assets have grown substantially and their expense ratios have fallen significantly.

FIGURE 2

### Mutual Fund Expense Ratios Tend to Fall as Fund Assets Rise

Share classes of actively managed domestic equity mutual funds continuously in existence since 2000<sup>1</sup>



<sup>1</sup> Calculations are based on a fixed sample of share classes. Data exclude mutual funds available as investment choices in variable annuities, index mutual funds, and mutual funds that invest primarily in other mutual funds.

<sup>2</sup> Expense ratios are measured as asset-weighted averages.

Sources: Investment Company Institute, Lipper, and Morningstar

\* Occasionally, this report will refer to increases or decreases of expense ratios in basis points. Basis points simplify percentages written in decimal form. A basis point equals one-hundredth of 1 percent (0.01 percent), so 100 basis points equals 1 percentage point. When applied to \$1.00, 1 basis point equals \$0.0001; 100 basis points equals one cent (\$0.01).

Additional factors have contributed to lower average expenses of equity and other long-term mutual funds. First, the average expense ratio of equity mutual funds has declined as a result of growth in index fund investing (see Index Funds on page 13).

Second, since 2000, a secular trend has developed toward fund investors compensating financial professionals for assistance through payments outside of funds (see Mutual Fund Load Fees on page 21). An important aspect of this development has been that an increasing share of fund assets are held in no-load share classes, which tend to have below-average expense ratios. The decline in the asset-weighted average expense ratios of equity mutual funds in 2016 reflected a continuation of this long-running trend.

Given the recent regulatory developments surrounding the fiduciary rule, one might ask if this is connected; any correlation, however, appears to be entirely coincidental (see Did the DOL's Fiduciary Rule Affect Fund Expense Ratios in 2016? on page 26).

In addition to varying from year to year, fund expenses can also vary by fund type (Figure 3).<sup>4</sup> For example, bond and money market mutual funds tend to have lower expense ratios than equity and hybrid mutual funds. Among equity mutual funds, expense ratios tend to be higher for funds that specialize in a given sector—such as healthcare or real estate—or those that invest in equities around the world, because the assets such funds hold tend to be more costly to manage. Even within a particular investment objective,

FIGURE 3

### Expense Ratios for Selected Mutual Fund Investment Objectives

Percent, 2016

Investment objective	10th percentile	Median	90th percentile	Asset-weighted average	Simple average
<b>Equity mutual funds<sup>1</sup></b>	<b>0.68%</b>	<b>1.21%</b>	<b>2.04%</b>	<b>0.63%</b>	<b>1.28%</b>
Growth	0.71	1.15	1.97	0.77	1.23
Sector	0.77	1.33	2.15	0.78	1.38
Value	0.70	1.13	1.92	0.74	1.20
Blend	0.41	1.01	1.83	0.39	1.06
World	0.83	1.33	2.15	0.78	1.41
<b>Hybrid mutual funds<sup>1</sup></b>	<b>0.65</b>	<b>1.19</b>	<b>2.01</b>	<b>0.74</b>	<b>1.29</b>
<b>Bond mutual funds<sup>1</sup></b>	<b>0.45</b>	<b>0.83</b>	<b>1.63</b>	<b>0.51</b>	<b>0.94</b>
Investment grade	0.35	0.70	1.51	0.37	0.79
World	0.62	1.01	1.84	0.65	1.11
Other taxable	0.49	0.90	1.75	0.65	1.01
Municipal	0.48	0.78	1.58	0.54	0.91
<b>Money market funds<sup>1</sup></b>	<b>0.09</b>	<b>0.22</b>	<b>0.39</b>	<b>0.18</b>	<b>0.23</b>
<b>Memo:</b>					
<b>Target date mutual funds<sup>2</sup></b>	<b>0.37</b>	<b>0.84</b>	<b>1.52</b>	<b>0.51</b>	<b>0.89</b>
<b>Index equity mutual funds<sup>1</sup></b>	<b>0.06</b>	<b>0.35</b>	<b>1.51</b>	<b>0.09</b>	<b>0.63</b>

<sup>1</sup> Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

<sup>2</sup> Data include mutual funds that invest primarily in other mutual funds, but exclude mutual funds available as investment choices in variable annuities. Ninety-seven percent of these mutual funds invest primarily in other mutual funds.

Note: Each fund's share class is weighted equally for the median, 10th, and 90th percentiles. Data include index mutual funds but exclude exchange-traded funds.

Sources: Investment Company Institute and Morningstar

mutual fund expense ratios can vary considerably. For example, 10 percent of equity mutual funds that focus on growth stocks have expense ratios of 0.71 percent or less, while the top 10 percent have expense ratios of 1.97 percent or more. This variation reflects, among other things, the fact that some growth funds focus more on small- or mid-cap stocks and others focus more on large-cap stocks. This is important because portfolios of small- and mid-cap stocks tend to cost more to manage.

### Hybrid Mutual Funds

Assets in hybrid mutual funds (which invest in a mix of equities and bonds) have nearly quadrupled since 2000, to nearly \$1.4 trillion in 2016, and now account for 10 percent of long-term mutual fund assets. Their expense ratios have fallen from 0.95 percent in 1996 to 0.74 percent in 2016 (Figure 1).

The average expense ratio of hybrid mutual funds over the past few years has been influenced by developments in “alternative strategy” mutual funds.\* Hybrid alternative strategy mutual funds may offer fund investors exposure to a wide range of asset classes, protection against market downturns or volatility, or a lower correlation with the equity market, but such strategies can be costly to manage. From 2009 to 2013, these funds attracted \$68 billion in net inflows, helping to boost their assets from \$29 billion to \$110 billion. This, combined with the fact that alternative strategy mutual funds tend to have higher-than-average expense ratios, boosted the asset-weighted expense ratio of hybrid mutual funds. After 2013, inflows to hybrid alternative strategy mutual funds tapered off and their assets expanded at a much more moderate pace. Since 2013, assets of other hybrid mutual funds with lower expense ratios have experienced proportionally larger growth, contributing to the 3 basis point decline in the expense ratios of hybrid mutual funds in 2016 (Figure 1).

### Bond Mutual Funds

In 2016, the asset-weighted average expense ratio for bond mutual funds fell 3 basis points to 0.51 percent (Figure 1), marking the seventh straight year that the expense ratios of bond mutual funds have either remained unchanged or have fallen. In total, from 2009 to 2016, the average expense ratio of bond mutual funds fell 20 percent (13 basis points).

The 2016 decline in part reflected a shift in demand away from world bond markets toward the US bond market. In 2016, world bond mutual funds saw net outflows of \$40 billion. In contrast, investment grade bond mutual funds, which invest primarily in high-quality corporate bonds issued by US firms, experienced \$84 billion in net inflows.

This helped reduce the asset-weighted average expense ratio of bond mutual funds because investment grade bond mutual funds tend to have lower expense ratios than world bond mutual funds. In 2016, the asset-weighted average expense ratio of investment grade bond mutual funds was 0.37 percent, compared to 0.65 percent for world bond mutual funds (Figure 3).

An increase in assets held in index bond mutual funds also contributed to the lower asset-weighted expense ratio for bond mutual funds. In 2016, actively managed bond and hybrid mutual funds had net outflows of \$6 billion.<sup>5</sup> In sharp contrast, index bond and hybrid mutual funds saw net inflows of \$67 billion. This, combined with the fact that the expense ratios of index funds tend to be lower than those of actively managed funds with the same investment objectives, helped lower the average expense ratio of bond mutual funds (see Index Funds on page 13).

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\* Alternative strategy mutual funds are included primarily in ICI's hybrid mutual fund category, which is discussed in this section.

### *Analyzing the Asset-Weighted Average Expense Ratio*

Why did the expense ratios of equity, bond, and hybrid mutual funds fall in 2016? Was it because the expense ratios of individual funds declined, or because assets shifted toward lower-cost funds, or both? Was it because new, lower-cost funds entered the market or that higher-cost funds left? Or was it some combination of these factors?

To answer these questions, it is helpful to break down the asset-weighted average expense ratio into two components. The first component measures how much the asset-weighted average expense ratio declined because the expense ratios of individual funds fell. This can be determined by calculating what the asset-weighted expense ratio would hypothetically be for a group of funds if the expense ratios of the individual funds in the group changed as they actually did between 2015 and 2016, but the assets in those funds remained unchanged.

For instance, if the asset-weighted average expense ratio in reality declined by 4 basis points, while the hypothetical average that holds assets constant fell by 1 basis point, it would indicate that, of the 4 basis point decline, 1 basis point of the decline arose because the expense ratios of individual funds fell.

The second component is just the difference between the fund's expense ratio and the first component. It accounts for all other factors that could have affected the asset-weighted average, including assets shifting toward lower-cost funds, higher-cost funds closing up, or lower-cost funds entering the business.

Continuing with this hypothetical example, if the asset-weighted average fell 4 basis points and 1 basis point of that reflected reductions in the expense ratios of individual funds, the second component—reflecting factors such as assets shifting toward lower-cost funds—accounted for the remaining 3 of the 4 basis points in the decline.

This kind of analysis provides a clear picture for 2016. The asset-weighted average expense ratios for equity, hybrid, and bond mutual funds each fell by 3 basis points or more in 2016. Breaking down expense ratios in the manner described above shows that for each of these three types of funds, the decline in their asset-weighted average expense ratios was due entirely to assets moving toward lower-cost funds (and other factors including the opening of new lower-cost funds and the closing of older higher-cost funds), rather than the decline of individual mutual fund expense ratios.

This does not mean, however, that the expense ratios of all funds were unchanged. In 2016, 40 to 50 percent of the share classes of equity, bond, and hybrid mutual funds had expense ratios that were unchanged (Figure 4). Among the remaining share classes, though, the percentage of share classes whose expense ratios fell was about equal to the percentage whose expense ratios rose.

FIGURE 4

### More Than Half of Mutual Fund Share Classes Saw Their Expense Ratios Change

2016

Category	Percentage of total share classes for which expense ratios in 2016:		
	Fell	Were unchanged	Rose
Equity	29%	40%	31%
Hybrid	32	41	27
Bond	30	47	23

Note: Tabulations are based on a consistent sample; that is, a share class must have existed in both 2015 and 2016.

Sources: Investment Company Institute, Lipper, and Morningstar

## Money Market Funds

The average expense ratio of money market funds rose to 0.18 percent in 2016, an increase of 5 basis points from the level in 2015 (Figure 1). This marks a reversal from the historical trend in which money market fund expense ratios had remained steady or fallen each year since 1996.

From 2000 to 2009, a combination of two factors played a significant role in reducing the average expense ratios of money market funds. First, expense ratios of retail money market fund share classes declined 21 percent over this period. Second, the market share of institutional share classes (which tend to have larger average account balances and therefore tend to have lower expense ratios) rose to two-thirds of total money market fund assets.<sup>6</sup> After 2009, however, other factors had been pushing down the average expense ratios of these funds—primarily developments that stemmed from the low interest rate environment. Over 2008–2009, the Federal Reserve sharply reduced short-term interest rates. By 2009, the federal funds rate was hovering only a little above zero. Gross yields on taxable

money market funds (the yield before deducting the fund’s expense ratio), which closely track short-term interest rates, fell to all-time lows. This situation remained in stasis from 2010 to late 2015 (Figure 5).

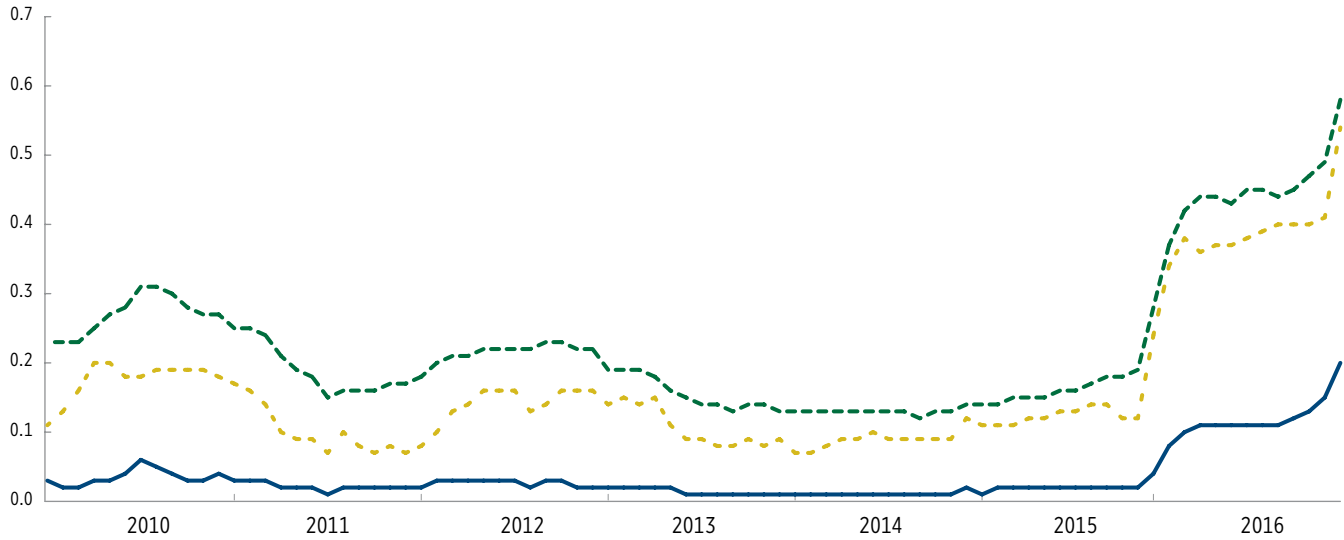
In this environment, most money market funds adopted expense waivers<sup>7</sup> to ensure that net yields (the yield on a fund after deducting fund expenses) did not fall below zero.<sup>8</sup> With an expense waiver, a fund’s adviser agrees to absorb the cost of all or a portion of a fund’s fees and expenses for a period of time. The expense waiver, by reducing the fund’s expense ratio, boosts the fund’s net yield. These expense waivers are costly for fund advisers, reducing their revenues and profits. From 2009 to 2015, advisers waived an estimated \$36 billion in money market fund expenses (Figure 6). It was expected that if short-term interest rates were to rise, pushing up gross yields on money market funds, advisers might reduce or eliminate expense waivers, which would cause the expense ratios of money market funds to rise somewhat.<sup>9</sup>

FIGURE 5

### Taxable Money Market Fund Yields

Percent; monthly, January 2010–December 2016

- Gross yield on taxable money market funds
- Federal funds rate
- Net yield on taxable money market funds

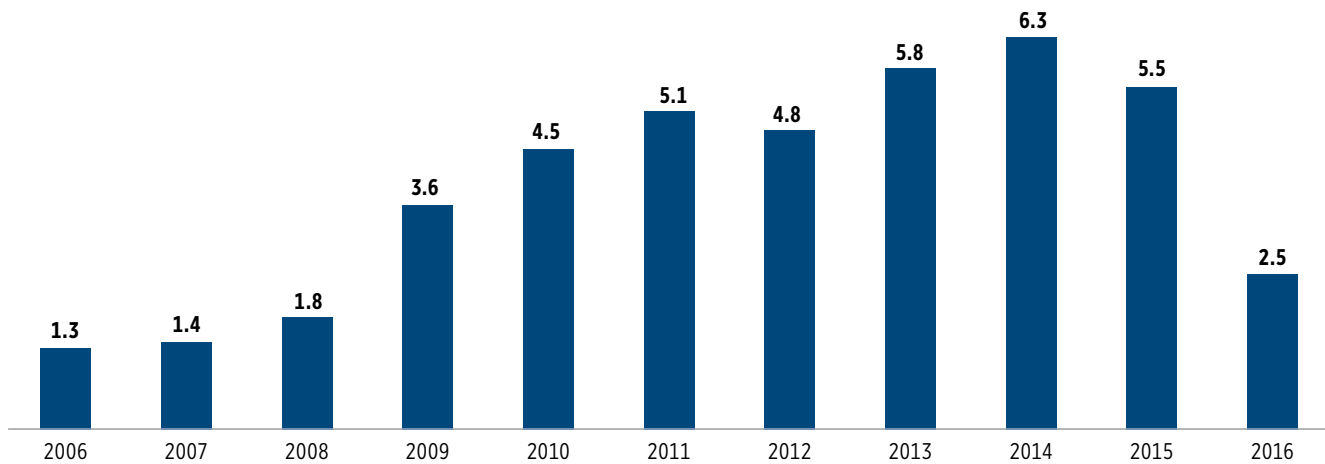


Sources: iMoneyNet and Federal Reserve Board

FIGURE 6

### Money Market Funds Reduced Expense Waivers in 2016

Money market fund expenses waived, billions of dollars, 2006–2016



Sources: Investment Company Institute and iMoneyNet



That, ultimately, is what happened. In December 2015, the Federal Reserve raised the federal funds rate by 0.25 percent, signifying a strengthening economy. In December 2016, the Federal Reserve hiked the federal funds rate another 0.25 percent. Both Federal Reserve actions were reflected in short-term interest rates and hence the gross yields on money market funds. With gross yields rising, there was less chance that the net yields of money market funds might fall below zero. Consequently, in 2016, advisers pared somewhat the expense waivers they had provided to their money market funds. For example,

at the end of 2014, 99 percent of the share classes of money market funds had expense waivers. That dropped to 88 percent by the end of 2016 and expenses waived dropped sharply from an estimated \$5.5 billion in 2015 to an estimated \$2.5 billion in 2016.

### Funds of Funds

Funds of funds are mutual funds that invest in other funds.<sup>10</sup> The market for funds of funds has expanded considerably in recent years. By year-end 2016, there

FIGURE 7

## Funds of Funds Have Grown Rapidly in Recent Years

### Number of funds of funds, 2008–2016

Year	Total	Equity	Hybrid	Bond
2008	839	123	706	10
2009	945	131	804	10
2010	979	147	819	13
2011	1,083	157	905	21
2012	1,154	163	961	30
2013	1,257	173	1,050	34
2014	1,331	174	1,116	41
2015	1,402	178	1,185	39
2016	1,445	173	1,231	41

### Total net assets of funds of funds, billions of dollars, 2008–2016

Year	Total	Equity	Hybrid	Bond
2008	\$469.4	\$42.9	\$425.2	\$1.3
2009	680.1	55.3	622.8	2.0
2010	914.6	80.6	824.6	9.4
2011	1,035.6	80.7	939.2	15.7
2012	1,271.6	93.1	1,150.4	28.1
2013	1,560.4	128.8	1,393.5	38.1
2014	1,694.9	127.9	1,519.7	47.3
2015	1,722.3	136.7	1,531.6	54.0
2016	1,870.4	149.9	1,663.6	56.9

Source: Investment Company Institute

were 1,445 funds of funds with \$1,870 billion in assets (Figure 7).

The great majority (85 percent) of funds of funds are hybrid mutual funds. Hybrid funds of funds invest in a mix of equity, bond, and even other hybrid funds. Hybrid funds of funds are often target date mutual funds (see Target Date Mutual Funds on the following page). They also may be asset allocation funds, which have exposure to

equities, bonds, or other securities, often in a mix that may change in response to market conditions to achieve a given investment objective.

In 2016, the asset-weighted average expense ratio of funds of funds was 0.66 percent, down from 0.70 percent in 2015 (Figure 8).<sup>11, 12</sup> From 2005 to 2016, the average expense ratio of funds of funds fell nearly 35 percent, from 1.01 percent to 0.66 percent.

FIGURE 8

### Expense Ratios of Funds of Funds

Percent, 2005-2016

Year	Asset-weighted average	Simple average	Median
2005	1.01%	1.56%	1.52%
2006	0.96	1.44	1.39
2007	0.94	1.44	1.35
2008	0.92	1.40	1.34
2009	0.91	1.38	1.31
2010	0.87	1.33	1.28
2011	0.83	1.30	1.23
2012	0.82	1.26	1.19
2013	0.80	1.21	1.14
2014	0.76	1.19	1.10
2015	0.70	1.12	1.04
2016	0.66	1.09	1.02

Note: Data exclude mutual funds available as investment choices in variable annuities.

Sources: Investment Company Institute, Lipper, and Morningstar

## Target Date Mutual Funds

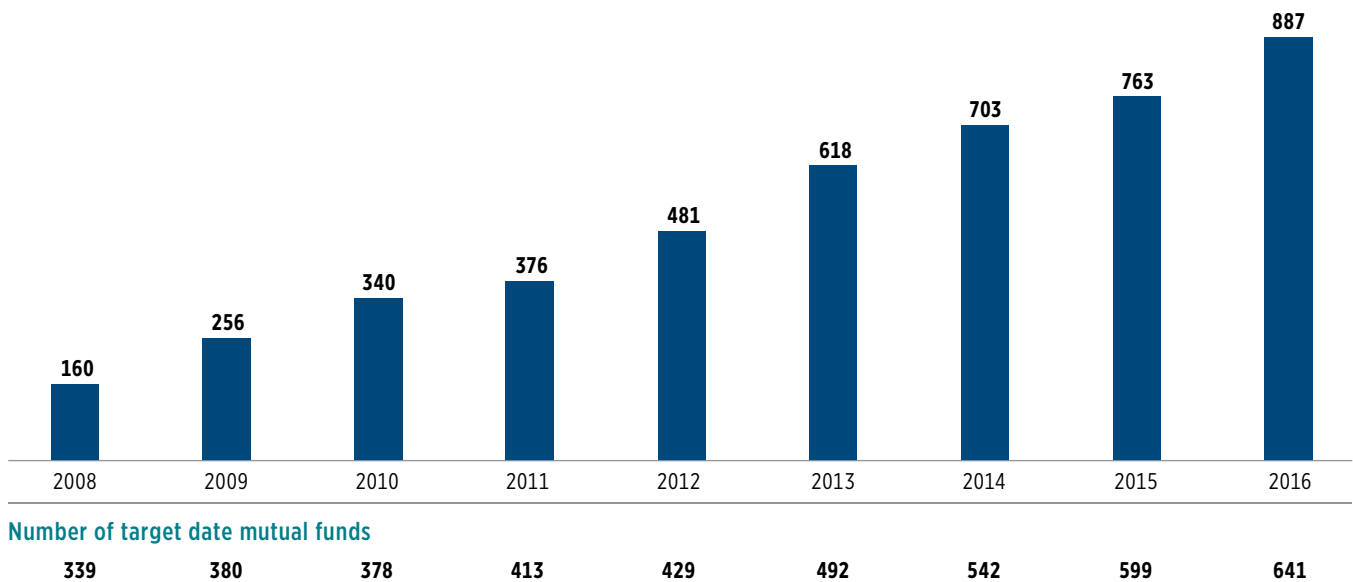
Much of the growth in funds of funds stems from investor interest in target date mutual funds, which invest in a mix of stocks, bonds, and other securities. Target date mutual funds usually invest through a fund-of-funds structure, meaning they primarily hold and invest in shares of other mutual funds and exchange-traded funds (ETFs)—97 percent of target date mutual funds are funds of funds, and 43 percent of funds of funds are target date mutual

funds. A target date (also known as lifecycle) mutual fund typically rebalances its portfolio to become less focused on growth and more focused on income as it approaches and passes the target date of the fund, which is usually included in the fund's name. This change in investment mix over time is typically referred to as the *glide path* for the fund. At year-end 2016, target date mutual funds had \$887 billion in assets (Figure 9).

FIGURE 9

### Target Date Mutual Fund Assets Have More Than Quadrupled Since 2008

Billions of dollars, total net assets; year-end, 2008–2016



Note: Data include mutual funds that invest primarily in other mutual funds.

Source: Investment Company Institute

The strong investor demand for target date mutual funds likely reflects a number of factors. Investors value the features of target date mutual funds, including diversification and the glide path; these are especially attractive for individuals saving for retirement in 401(k) plans and individual retirement accounts (IRAs).<sup>13</sup> Additionally, target date funds often are used as a qualified default option<sup>14</sup> for 401(k) plans.<sup>15</sup> As a result, newly hired employees often invest their 401(k) contributions in target date funds. At year-end 2014, for example,

47 percent of the account balances of recently hired 401(k) plan participants in their twenties were invested in target date funds.<sup>16</sup>

The average expense ratio of target date mutual funds has declined sharply in recent years. In 2008, investors on average paid 0.67 percent to invest in target date mutual funds (Figure 10).<sup>17</sup> By 2016, the average expense ratio had fallen by 16 basis points to 0.51 percent.

FIGURE 10  
**Expense Ratios of Target Date Mutual Funds**  
*Percent, 2008–2016*

Year	Asset-weighted average	Simple average	Median
2008	0.67%	1.23%	1.18%
2009	0.67	1.20	1.14
2010	0.65	1.14	1.11
2011	0.61	1.11	1.09
2012	0.59	1.07	1.04
2013	0.58	1.04	1.01
2014	0.57	1.03	0.96
2015	0.54	0.91	0.87
2016	0.51	0.89	0.84

Note: Data include mutual funds that invest primarily in other mutual funds but exclude mutual funds available as investment choices in variable annuities.

Sources: Investment Company Institute, Lipper, and Morningstar

## Index Funds

An index fund generally seeks to replicate the return on a specified financial market index. Under this approach, often referred to as *passive management*, portfolio managers buy and hold all, or a representative sample of, the securities in their target indexes. This approach to portfolio management is a primary reason that index funds—whether mutual funds or ETFs—tend to have below-average expense ratios. By contrast, under an active management approach, managers have more discretion to increase or reduce exposure to sectors or securities within their funds’ investment mandates. Active managers may also undertake significant research about individual stocks or bonds, about market sectors, or geographic regions. This approach offers

investors the chance to earn superior returns, or meet other investment objectives such as limiting downside risk, managing volatility, under- or overweighting various sectors, and altering asset allocations in response to market conditions. However, active management also tends to be more costly than management of an index fund.

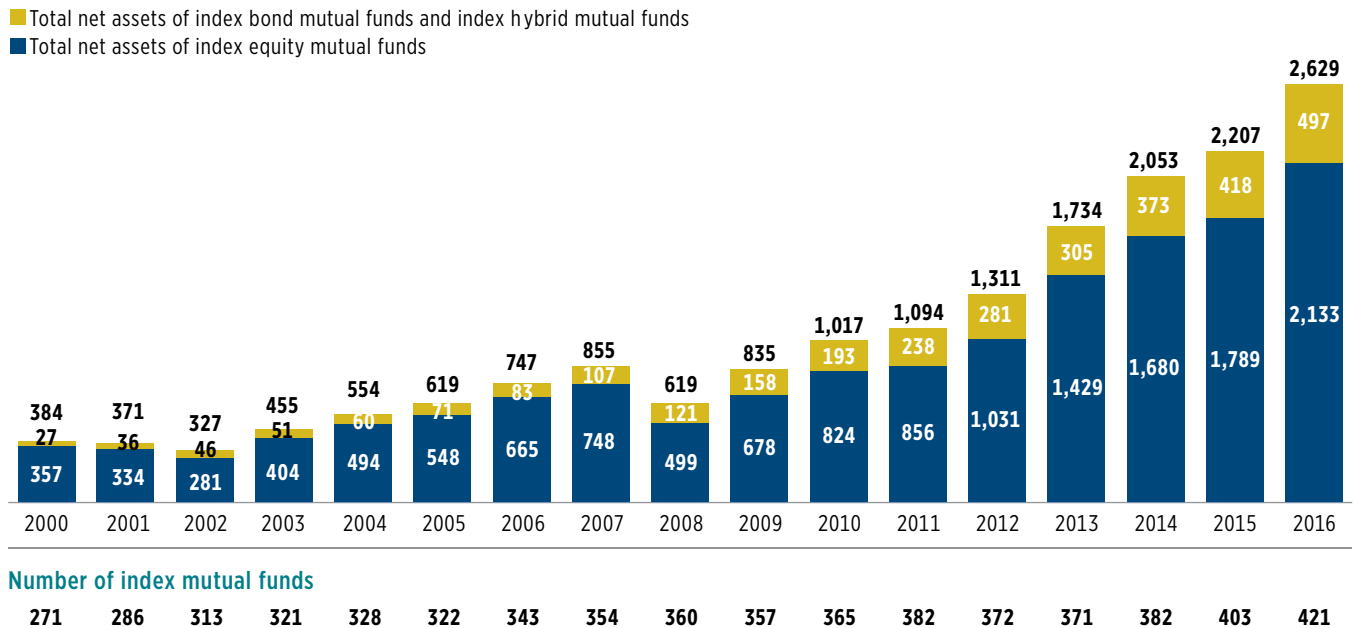
## Index Mutual Funds

Growth in index mutual funds has contributed to the decline in asset-weighted average expense ratios of equity and bond mutual funds. From 2000 to 2016, index mutual fund assets increased nearly sevenfold, from \$384 billion to \$2.6 trillion (Figure 11). This rapid growth contributed to a rise in index mutual funds’ share of long-term mutual

FIGURE 11

### Total Net Assets and Number of Index Mutual Funds Have Increased in Recent Years

Billions of dollars; year-end, 2000–2016



Note: Data exclude mutual funds that invest primarily in other mutual funds. Components may not add to the total because of rounding.

Source: Investment Company Institute

fund assets, which more than doubled from 7.5 percent in 2000 to 19.3 percent in 2016 (Figure 12). Nevertheless, in 2016 index equity mutual funds still accounted for the lion's share (81 percent) of index mutual fund assets.

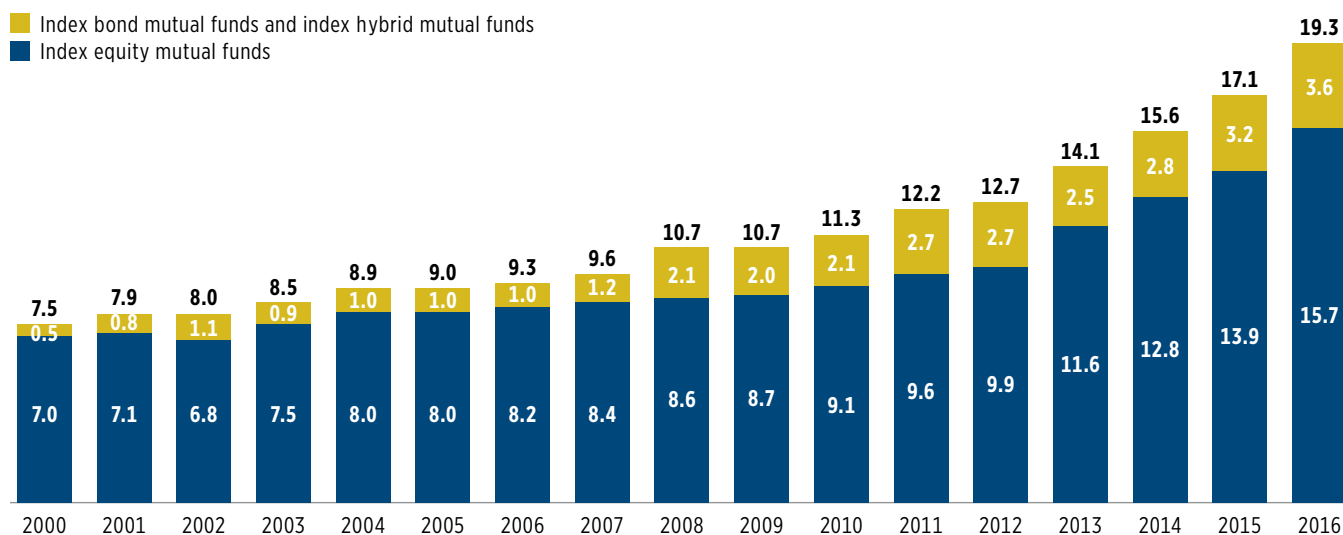
Index mutual funds tend to have below-average expense ratios for several reasons. First, the passive approach to portfolio management generally seeks to replicate the return on a specified index. In doing so, portfolio managers buy and hold all, or a representative sample of, the securities in their target indexes. This naturally lends itself to being less costly.

Second, the investment focus of index mutual funds helps keep their expense ratios low. Assets of index equity mutual funds are concentrated more heavily in large-cap blend funds that target US large-cap indexes, such as the S&P 500. Assets of actively managed equity mutual funds, on the other hand, are more widely distributed across stocks of varying market capitalization, international regions, or specialized business sectors. Managing portfolios of mid- or small-cap, international, or sector stocks is generally acknowledged to be more expensive than managing portfolios of US large-cap stocks.

FIGURE 12

### Index Mutual Funds' Share Continued to Rise

Percentage of long-term mutual funds' total net assets, 2000–2016



Note: Data exclude mutual funds that invest primarily in other mutual funds. Components may not add to the total because of rounding.

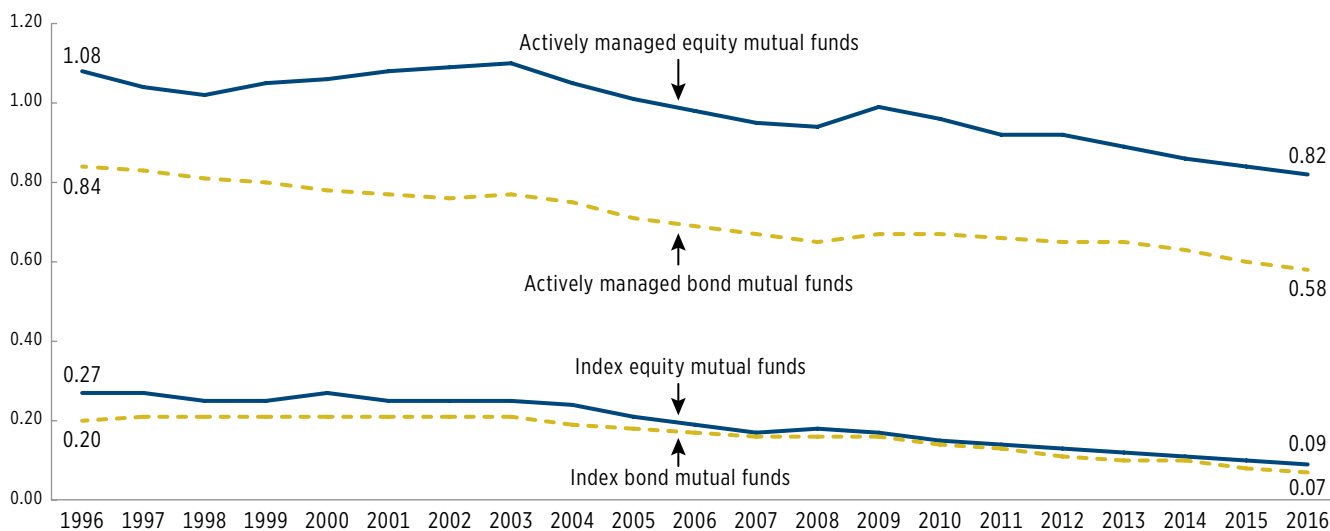
Source: Investment Company Institute

Third, index mutual funds are larger on average than actively managed funds, which, through economies of scale, helps reduce fund expense ratios. In 2016, the average index equity mutual fund was nearly four times larger than the average actively managed equity mutual fund (with \$5.9 billion for index equity mutual funds and \$1.5 billion for actively managed equity mutual funds).

Finally, index mutual fund investors who hire financial professionals might pay for that service out of pocket, rather than through the fund's expense ratio (see Mutual Fund Load Fees on page 21). In contrast, actively managed mutual funds more commonly have share classes that bundle those costs into the expense ratio.

These reasons, among others, help explain why index mutual funds generally have lower expense ratios than actively managed mutual funds. Note, however, that both index and actively managed mutual funds have contributed to the decline in the average expense ratios of mutual funds (Figure 13). From 1996 to 2016, the average expense ratio of index equity mutual funds fell from 0.27 percent to 0.09 percent, while the average expense ratio for actively managed equity mutual funds fell from 1.08 percent to 0.82 percent. Over the same period, the average expense ratios of index bond mutual funds fell from 0.20 percent to 0.07 percent and those of actively managed bond mutual funds fell from 0.84 percent to 0.58 percent.

FIGURE 13  
**Expense Ratios of Actively Managed and Index Mutual Funds**  
*Percent, 1996–2016*



Note: Expense ratios are measured as asset-weighted averages. Data 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 Morningstar

The downward trend in the average expense ratios of both index and actively managed mutual funds reflects, in part, investors' increasing tendency to buy lower-cost funds. Investor demand for index mutual funds is disproportionately concentrated in funds with the lowest costs. In 2016, for example, 78 percent of index equity mutual fund assets were in funds with expense ratios that were among the lowest 25 percent of all index equity mutual funds.<sup>18</sup>

### Index Exchange-Traded Funds

ETFs have grown in popularity over the past decade as investors increasingly are attracted to the specific features of these funds. General trends in investing and money

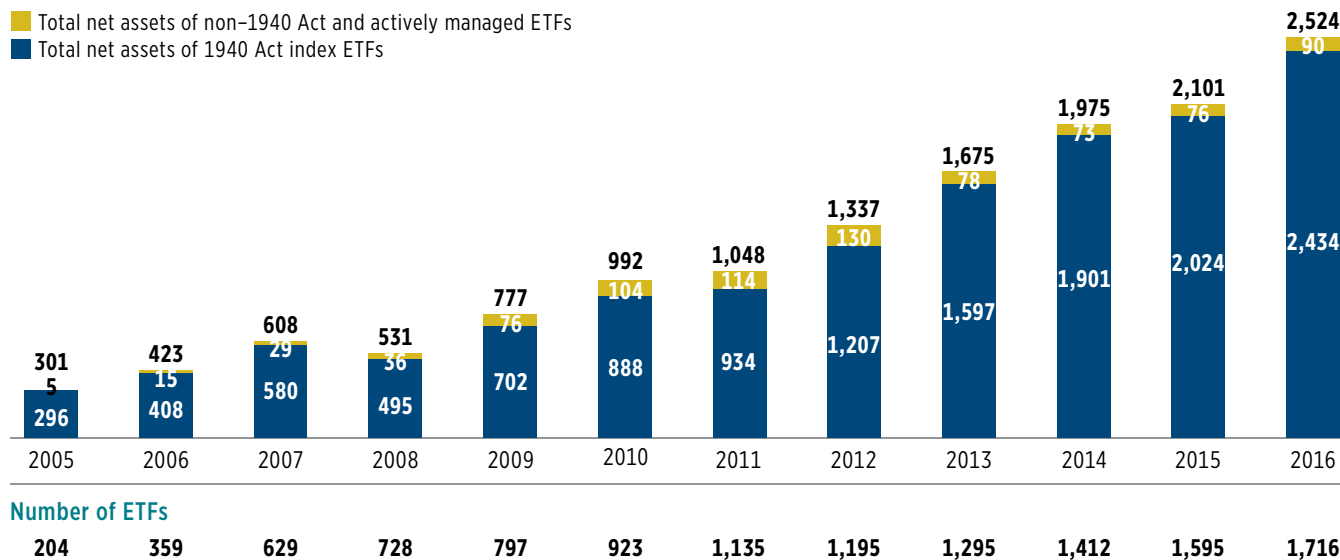
management also have bolstered the demand for ETFs.<sup>19</sup> ETF total net assets have grown rapidly in recent years, from \$301 billion at year-end 2005 to \$2.5 trillion at year-end 2016 (Figure 14).

ETFs are largely index-based and registered with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. Actively managed ETFs and ETFs not registered under the 1940 Act represented only 3.6 percent of ETF total net assets at year-end 2016.<sup>20</sup> As is true of index mutual funds, most of the assets in ETFs are in funds that focus on equities. Equity ETFs account for 83 percent of the total net assets of ETFs.

FIGURE 14

### Total Net Assets and Number of ETFs Have Increased in Recent Years

Billions of dollars; year-end, 2005–2016



Note: Data exclude ETFs that invest primarily in other ETFs. Components may not add to the total because of rounding.

Source: Investment Company Institute



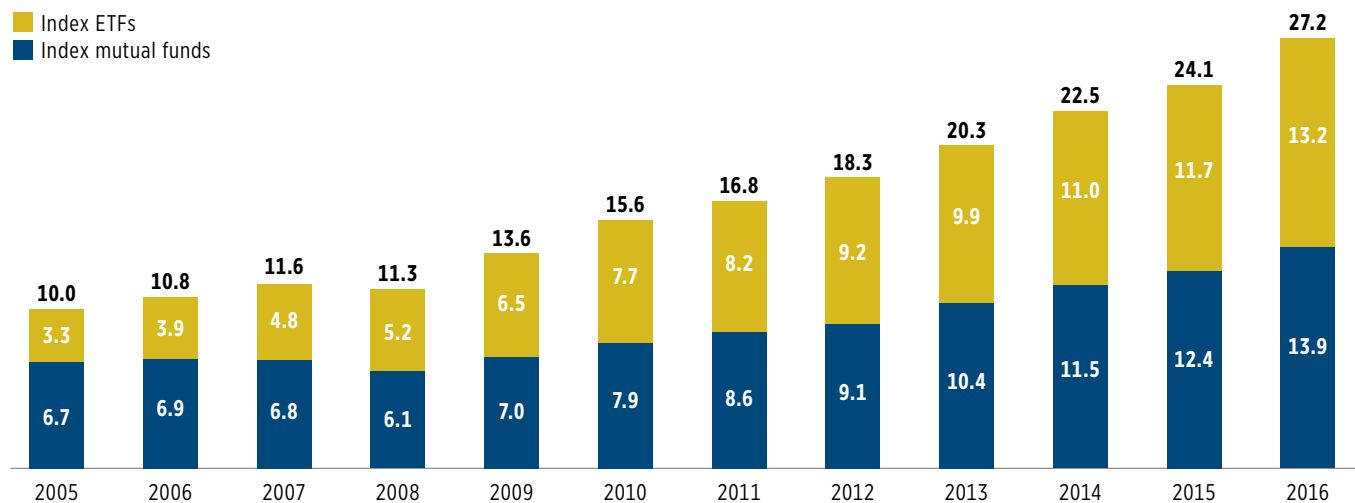
As index funds have grown in popularity, their share of the assets in long-term funds has also grown. In 2005, index ETFs and index mutual funds accounted for 10.0 percent of the assets in long-term funds (Figure 15). That share rose to 27.2 percent by 2016. Over the same time, the market penetration of index ETFs has increased significantly. In 2005, just 3.3 percent of the assets of long-term funds were in index ETFs. That rose to 13.2 percent by 2016. Consequently, by 2016, index ETFs accounted for about half of the 27.2 percent of the market share of index mutual funds and index ETFs.

ETFs fit well within the business model of compensating financial professionals through an asset-based fee. Compensation to financial professionals for distribution or account servicing and maintenance will typically be paid by the investor directly (rather than indirectly through a 12b-1 fee charged by the fund). Although some ETFs do bundle distribution fees in their expense ratios to cover marketing and distribution expenses, these fees are usually very small, ranging between 0.01 and 0.05 percent. Also, financial professionals often provide programs that offer investors a suite of ETFs suited to their investment goals. In such cases, investors would typically pay financial professionals an asset-based fee over and above the expense ratios of the ETFs in the suite of ETFs selected.

FIGURE 15

### Market Shares of Index Mutual Funds and Index ETFs Have Grown

Percentage of total long-term mutual fund and ETF assets; year-end, 2005–2016



Note: Data exclude funds that invest primarily in other funds. Components may not add to the total because of rounding.

Source: Investment Company Institute

Because ETFs are generally index funds and typically do not bundle distribution and account servicing or maintenance fees in their expense ratios, their expense ratios are typically low.

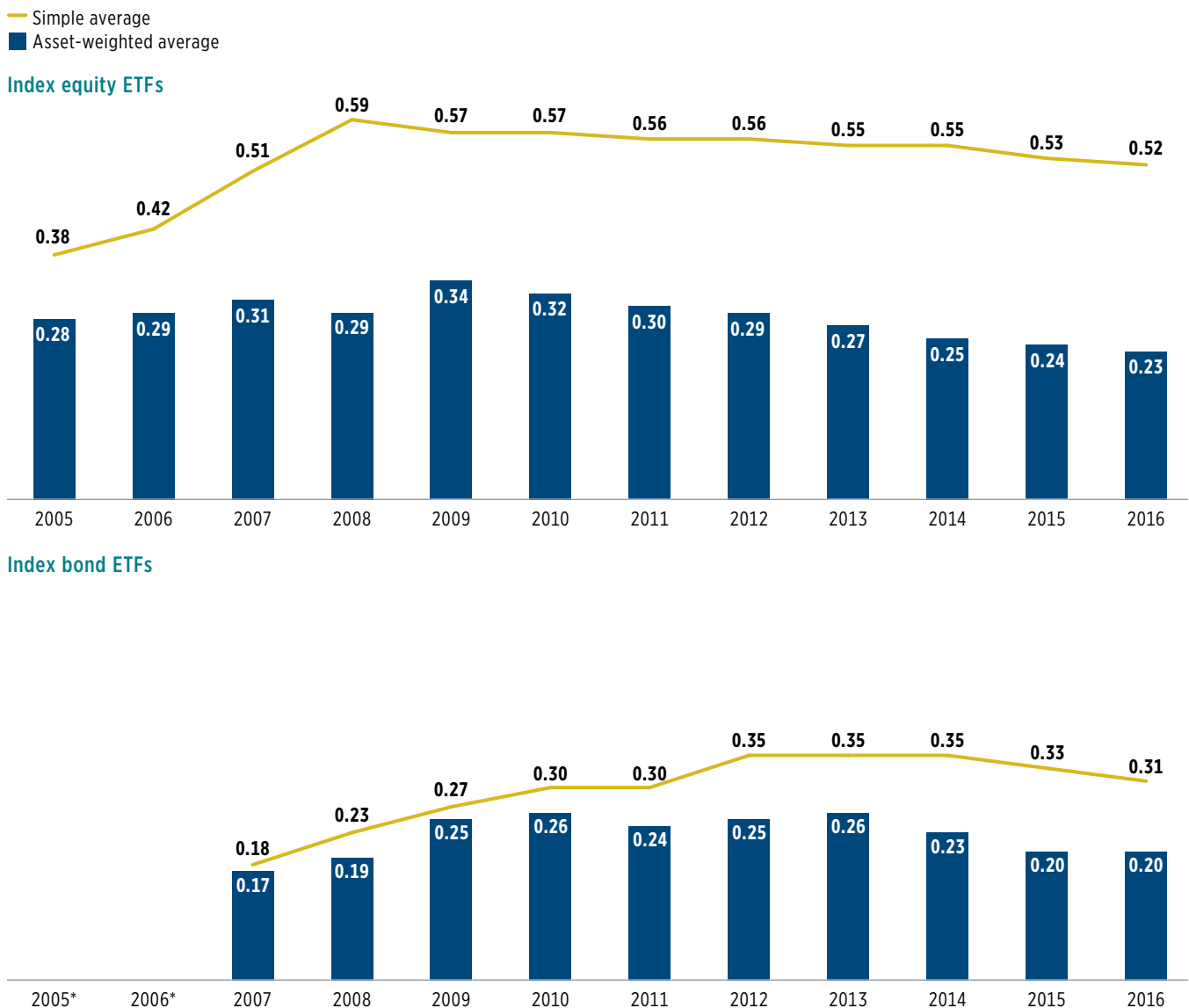
### Index Equity ETFs

In 2016, the asset-weighted average equity ETF expense ratio was 0.23 percent, down 1 basis point from 2015, and down from a peak of 0.34 percent in 2009 (Figure 16). Several factors have influenced the pattern in equity ETF expense ratios since 2005.

FIGURE 16

### Expense Ratios Incurred by Index ETF Investors Have Declined in Recent Years

Percent, 2005–2016



\* Data for index bond ETFs are excluded prior to 2007 because of a limited number of funds.

Note: Data exclude ETFs not registered under the Investment Company Act of 1940 and ETFs that invest primarily in other ETFs.

Sources: Investment Company Institute and Morningstar

Expansion into a variety of equity asset classes contributed to the rise in ETF expense ratios from 2005 to 2009. Until the mid-2000s, assets in ETFs were predominantly in funds that tracked broad-based, large-cap, domestic equity indexes, such as the S&P 500. As the demand for ETFs grew, fund sponsors began offering a much wider variety of equity ETFs, such as those tracking indexes of international stocks or indexes of narrower segments of the domestic stock market or even of particular industries. From 2005 to 2009, net share issuance to sector and world equity ETFs amounted to \$245 billion, outpacing net share issuance of broad-based domestic equity ETFs by about 39 percent. World and sector equity ETFs tend to have higher expense ratios than ETFs focusing on broad-based domestic equity indexes (Figure 17).<sup>21</sup>

Beginning in 2009, competition and economies of scale within the ETF industry appear to have put downward pressure on equity ETF expense ratios. The number of equity ETFs more than quadrupled from 2004 to 2009 and then doubled again over the next seven years. By the end of 2016, 1,409 equity ETFs competed for investors' business. In addition, new ETF sponsors have entered the marketplace to compete for market share. Even with a steady stream of new types of equity ETF offerings, the rapid growth in equity ETF assets has allowed many equity ETFs to increase in size and reduce their expense ratios because of economies of scale.

FIGURE 17

### Index ETF Expense Ratios for Selected Investment Objectives

Percent, 2016

Investment objective	10th percentile	Median	90th percentile	Asset-weighted average	Simple average
<b>Index equity ETFs</b>	<b>0.14%</b>	<b>0.48%</b>	<b>0.95%</b>	<b>0.23%</b>	<b>0.52%</b>
Blend	0.10	0.39	0.95	0.14	0.49
Growth	0.08	0.25	0.65	0.20	0.34
Value	0.09	0.35	0.65	0.22	0.34
Sector	0.14	0.50	0.95	0.27	0.56
World	0.25	0.55	0.85	0.35	0.55
<b>Index hybrid ETFs</b>	<b>0.48</b>	<b>0.60</b>	<b>0.75</b>	<b>0.54</b>	<b>0.64</b>
<b>Index bond ETFs</b>	<b>0.09</b>	<b>0.24</b>	<b>0.63</b>	<b>0.20</b>	<b>0.31</b>
Corporate	0.07	0.13	0.25	0.11	0.17
World	0.32	0.49	0.50	0.37	0.47
Government	0.07	0.16	0.95	0.19	0.36
High-yield	0.40	0.43	0.64	0.48	0.49
Municipal	0.18	0.25	0.35	0.25	0.25
<b>Memo:</b>					
<b>Active equity ETFs</b>	<b>0.60</b>	<b>0.89</b>	<b>0.99</b>	<b>0.88</b>	<b>0.87</b>

Note: Each fund's share class is weighted equally for the median, 10th, and 90th percentiles. Data exclude ETFs not registered under the Investment Company Act of 1940 and ETFs that invest primarily in other ETFs.

Sources: Investment Company Institute and Morningstar

## Index Bond ETFs

The asset-weighted average bond ETF expense ratio was 0.20 percent in 2016, unchanged from the previous year, but down 6 basis points from a recent peak of 0.26 percent in 2013 (Figure 16).

Like the pattern of expense ratios in equity ETFs, the expense ratios of bond ETFs rose earlier on, but then began to fall in more recent years. The reasons are much the same. Bond ETFs are a relatively new product. The first equity ETF registered with the SEC under the 1940 Act opened in 1993, whereas the first bond ETFs did not open until 2002. Three of the first four bond ETFs targeted indexes of US government bond returns (the fourth targeted an index of US investment grade corporate bonds). From 2002 to 2006, relatively few additional bond ETFs were brought to market. By the end of 2006, two-thirds of the assets of bond ETFs were in funds tied to US government bond indexes. Such ETFs tend to have low expense ratios (Figure 17), in large part reflecting that the markets for US Treasury and agency securities are deep and liquid, making it relatively inexpensive to manage portfolios of those securities.

Bond ETFs began to grow and diversify in 2007. The number of bond ETFs jumped from 6 to 49, in part because sponsors opened the first high-yield and world bond ETFs. Following the financial crisis, the share of ETF assets in US government bond ETFs declined. Low yields on US government bonds may have prompted increased demand by investors for the higher yields typically offered by corporate, high-yield, and world bonds, leading to growth in bond ETFs holding these types of securities. Portfolios of high-yield bonds and world bonds, though, are typically more costly to manage. Thus, as diversity increased in the bond ETF market, the asset-weighted average expense ratio of bond ETFs also rose.

In recent years, however, the market for bond ETFs has been maturing. As assets have increased significantly, economies of scale have helped reduce fund expense ratios. In addition, competition has intensified in the bond ETF space, with more funds and sponsors contending for

investor dollars. In part reflecting these developments, the expense ratios of bond ETFs have been falling since 2013.

## Understanding the Differences in Index Mutual Fund and Index ETF Expense Ratios

When compared to index mutual funds, index ETF expense ratios are somewhat higher. In 2016, index equity mutual funds had an asset-weighted average expense ratio of 0.09 percent (Figure 13) compared with 0.23 percent for index equity ETFs (Figure 16). Similarly, index bond mutual funds had an asset-weighted average expense ratio of 0.07 percent in 2016 compared with 0.20 percent for index bond ETFs. This is not surprising; two factors largely explain these differences.

First, assets in index mutual funds are more highly concentrated in categories that, by their nature, tend to have lower-than-average expense ratios. As discussed earlier, expense ratios of domestic equity funds (for both mutual funds and ETFs) tend to be lower than those of funds that target specific markets, regions, or sectors. This is important because 81 percent of the assets of index equity mutual funds as of 2016 were in index domestic equity mutual funds (excluding sector equity). In contrast, domestic equity ETFs (excluding sector equity ETFs) represented a smaller share (59 percent) of index equity ETF total net assets in 2016.

Another primary reason for the difference between index mutual funds' and index ETFs' expense ratios is average fund size. As discussed in this report, average fund size plays a role in reducing fund expense ratios through economies of scale. In 2016, the average fund size for (long-term) index mutual funds was \$6.2 billion, nearly four times the average fund size of index ETFs (\$1.6 billion). Even for domestic equity funds (excluding sector funds), there is a significant difference in average fund size (\$6.7 billion for index mutual funds compared with \$3.3 billion for index ETFs). Compared to the market for index mutual funds, the index ETF market is still relatively young. As the ETF market continues to mature and existing ETFs become larger, the gap between the asset-weighted average expense ratio for index ETFs and index mutual funds seems likely to close.

## Mutual Fund Load Fees

Many mutual fund investors pay for the services of a financial professional.<sup>22</sup> These professionals typically devote time and attention to prospective investors before investors make an initial purchase of funds and other securities. Usually, the professional meets with the investor, identifies goals, analyzes the investor’s existing portfolio, determines an appropriate asset allocation, and recommends funds to help achieve the investor’s goals. Financial professionals also may provide ongoing services, such as periodically reviewing investors’ portfolios, adjusting asset allocations, and responding to customer inquiries.

Traditionally, fund shareholders usually compensated financial professionals through a front-end load fee—a onetime, up-front payment for current and future services. Those compensation arrangements, also described as the

“distribution structure,” have changed significantly in the last 30 to 40 years.

One important element in the changing distribution structure has been a marked reduction in load fees paid by mutual fund investors. The maximum front-end load fee that shareholders might pay for investing in mutual funds has changed little since 1990 (Figure 18). However, the front-end load fees that investors actually paid declined from nearly 4 percent in 1990 to roughly 1 percent in 2016. This in part reflects the increasing role of mutual funds in helping investors save for retirement. For instance, funds that normally charge load fees often waive them on purchases made through retirement plans such as 401(k) plans. Moreover, front-end load funds offer volume discounts, waiving or reducing load fees for large initial or cumulative purchases.

FIGURE 18

### Front-End Sales Loads That Investors Pay Are Well Below the Maximum Front-End Sales Loads That Mutual Funds Charge

Percentage of purchase amount, selected years

	Maximum front-end sales load <sup>1</sup>			Average front-end sales load that investors actually paid <sup>2</sup>		
	Equity	Hybrid	Bond	Equity	Hybrid	Bond
1990	5.0%	5.0%	4.6%	3.9%	3.8%	3.5%
1995	4.8	4.7	4.1	2.5	2.4	2.1
2000	5.2	5.1	4.2	1.4	1.4	1.1
2005	5.3	5.3	4.0	1.3	1.3	1.0
2010	5.4	5.2	3.9	1.0	1.0	0.8
2015	5.4	5.2	3.8	1.1	1.0	0.7
2016	5.4	5.2	3.7	1.1	1.0	0.7

<sup>1</sup> 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.

<sup>2</sup> The simple average front-end sales load that investors actually paid is the total front-end sales loads that funds collected divided by the total maximum loads that the funds could have collected based on their new sales that year. This ratio is then multiplied by each fund’s maximum sales load. The resulting value is then averaged across all funds.

Note: Data 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, Morningstar, and Strategic Insight Simfund

Another important element has been a shift toward compensating brokers and other financial professionals who sell mutual funds through asset-based fees.<sup>23</sup> Asset-based fees are assessed as a percentage of the assets that a financial professional manages for an investor, rather than as a percentage of the dollars initially invested. 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, passing the bulk of it to financial professionals. Alternatively, investors may pay the professional an asset-based fee directly. In such cases, the financial professional typically would recommend the

purchase of some mix of ETFs and no-load mutual funds (no-load mutual funds have neither a front-end load fee, nor a back-end load fee, nor a 12b-1 fee of more than 0.25 percent).

In part because of the recent trend toward asset-based fees, the market shares of front-end and back-end load share classes have fallen, while the market share of no-load share classes has increased substantially. For example, in the past 10 years, front-end and back-end load share classes have seen net outflows of about \$1 trillion (Figure 19), and gross sales of back-end load share classes

FIGURE 19

### No-Load Institutional Mutual Fund Share Classes Garnered Positive Net New Cash Flow in 2016

Billions of dollars, 2007–2016

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>All long-term mutual funds</b>	<b>\$224</b>	<b>-\$211</b>	<b>\$393</b>	<b>\$244</b>	<b>\$28</b>	<b>\$200</b>	<b>\$162</b>	<b>\$98</b>	<b>-\$123</b>	<b>-\$199</b>
<b>Load</b>	<b>-2</b>	<b>-156</b>	<b>9</b>	<b>-62</b>	<b>-129</b>	<b>-77</b>	<b>-70</b>	<b>-173</b>	<b>-130</b>	<b>-232</b>
Front-end <sup>1</sup>	18	-105	2	-56	-100	-67	-56	-160	-101	-181
Back-end <sup>2</sup>	-42	-39	-24	-27	-23	-16	-11	-9	-7	-5
Level <sup>3</sup>	25	-13	31	21	-6	6	-2	-4	-22	-46
Other <sup>4</sup>	(*)	(*)	(*)	(*)	(*)	-1	(*)	(*)	(*)	(*)
Unclassified <sup>5</sup>	-2	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)	(*)
<b>No-load<sup>6</sup></b>	<b>165</b>	<b>-66</b>	<b>322</b>	<b>265</b>	<b>168</b>	<b>299</b>	<b>270</b>	<b>338</b>	<b>76</b>	<b>113</b>
Retail	59	-96	137	55	-46	16	38	111	7	-39
Institutional	106	30	185	210	214	283	232	226	69	152
<b>Variable annuities</b>	<b>25</b>	<b>-26</b>	<b>29</b>	<b>8</b>	<b>-21</b>	<b>-26</b>	<b>-51</b>	<b>-65</b>	<b>-67</b>	<b>-79</b>
<b>"R" share classes<sup>7</sup></b>	<b>37</b>	<b>37</b>	<b>33</b>	<b>33</b>	<b>10</b>	<b>4</b>	<b>13</b>	<b>-2</b>	<b>-2</b>	<b>-2</b>

<sup>1</sup> Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

<sup>2</sup> Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

<sup>3</sup> Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

<sup>4</sup> This category contains all other load share classes not classified as front-end load, back-end load, or level load.

<sup>5</sup> This category contains load share classes with missing load fee data.

<sup>6</sup> Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

<sup>7</sup> "R" shares include assets in any share class that ICI designates as a "retirement share class." These share classes are sold predominantly to employer-sponsored retirement plans. However, other share classes—including retail and institutional share classes—also contain investments made through 401(k) plans or IRAs.

(\*) = inflow or outflow of less than \$500 million

Note: Components may not add to the totals because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Morningstar

have dwindled almost to zero (Figure 20). As a result, the market share of load share classes fell from 31 percent of long-term mutual fund assets at year-end 2007 to 17 percent at year-end 2016 (Figure 21).

By contrast, no-load share classes have seen net inflows and rising assets over the past 10 years. No-load share classes have accumulated the bulk of the net inflows to long-term mutual funds over the past 10 years. At year-end 2007, no-load share classes accounted for 51 percent of long-term mutual fund assets, rising to 67 percent by year-end 2016.

Within no-load funds, the assets of both retail and institutional share classes have grown considerably in the past decade. Assets in no-load institutional share classes, however, have grown faster, rising from 33 percent of the assets in no-load share classes at year-end 2007 to 46 percent at year-end 2016.

Some movement toward no-load funds can be attributed to “do-it-yourself” investors. But two other factors likely explain most of the shift. First, sales of no-load share classes through sales channels that compensate financial professionals with asset-based fees outside mutual funds

FIGURE 20

### Gross Sales of Long-Term Mutual Funds Are Concentrated in No-Load Share Classes

Billions of dollars, 2007–2016

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>All long-term mutual funds</b>	<b>\$2,529</b>	<b>\$2,418</b>	<b>\$2,375</b>	<b>\$2,702</b>	<b>\$2,861</b>	<b>\$2,963</b>	<b>\$3,510</b>	<b>\$3,609</b>	<b>\$3,503</b>	<b>\$3,550</b>
<b>Load</b>	<b>650</b>	<b>604</b>	<b>559</b>	<b>566</b>	<b>543</b>	<b>510</b>	<b>599</b>	<b>545</b>	<b>490</b>	<b>430</b>
Front-end <sup>1</sup>	514	482	435	445	439	403	474	432	387	355
Back-end <sup>2</sup>	23	20	10	7	4	3	3	2	2	1
Level <sup>3</sup>	107	97	112	111	98	99	119	109	99	73
Other <sup>4</sup>	3	4	2	2	2	4	3	1	2	1
Unclassified <sup>5</sup>	2	1	(*)	1	(*)	(*)	(*)	(*)	(*)	1
<b>No-load<sup>6</sup></b>	<b>1,471</b>	<b>1,414</b>	<b>1,446</b>	<b>1,706</b>	<b>1,897</b>	<b>2,049</b>	<b>2,498</b>	<b>2,689</b>	<b>2,614</b>	<b>2,727</b>
Retail	907	807	825	935	948	973	1,153	1,226	1,229	1,223
Institutional	564	607	621	771	949	1,076	1,345	1,463	1,384	1,504
<b>Variable annuities</b>	<b>320</b>	<b>308</b>	<b>270</b>	<b>318</b>	<b>309</b>	<b>295</b>	<b>287</b>	<b>236</b>	<b>248</b>	<b>245</b>
<b>“R” share classes<sup>7</sup></b>	<b>87</b>	<b>91</b>	<b>100</b>	<b>112</b>	<b>111</b>	<b>109</b>	<b>126</b>	<b>139</b>	<b>152</b>	<b>148</b>

<sup>1</sup> Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

<sup>2</sup> Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

<sup>3</sup> Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

<sup>4</sup> This category contains all other load share classes not classified as front-end load, back-end load, or level load.

<sup>5</sup> This category contains load share classes with missing load fee data.

<sup>6</sup> Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

<sup>7</sup> “R” shares include assets in any share class that ICI designates as a “retirement share class.” These share classes are sold predominantly to employer-sponsored retirement plans. However, other share classes—including retail and institutional share classes—also contain investments made through 401(k) plans or IRAs.

(\*) = gross sales of less than \$500 million

Note: Components may not add to the totals because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Morningstar

FIGURE 21

**Total Net Assets of Long-Term Mutual Funds Are Concentrated in No-Load Share Classes***Billions of dollars, 2007–2016*

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
<b>All long-term mutual funds</b>	<b>\$8,914</b>	<b>\$5,788</b>	<b>\$7,797</b>	<b>\$9,030</b>	<b>\$8,942</b>	<b>\$10,361</b>	<b>\$12,331</b>	<b>\$13,149</b>	<b>\$12,896</b>	<b>\$13,616</b>
<b>Load</b>	<b>2,795</b>	<b>1,722</b>	<b>2,185</b>	<b>2,352</b>	<b>2,176</b>	<b>2,362</b>	<b>2,652</b>	<b>2,615</b>	<b>2,440</b>	<b>2,371</b>
Front-end <sup>1</sup>	2,190	1,374	1,750	1,882	1,751	1,893	2,148	2,116	1,989	1,948
Back-end <sup>2</sup>	204	102	98	78	50	39	32	24	15	9
Level <sup>3</sup>	379	237	328	381	367	417	459	468	429	408
Other <sup>4</sup>	10	7	8	8	7	11	10	7	6	6
Unclassified <sup>5</sup>	12	2	2	3	1	2	2	1	(*)	1
<b>No-load<sup>6</sup></b>	<b>4,587</b>	<b>3,067</b>	<b>4,249</b>	<b>5,090</b>	<b>5,224</b>	<b>6,261</b>	<b>7,598</b>	<b>8,382</b>	<b>8,373</b>	<b>9,093</b>
Retail	3,091	1,951	2,659	3,068	2,991	3,464	4,142	4,639	4,598	4,886
Institutional	1,497	1,116	1,589	2,022	2,233	2,798	3,456	3,743	3,775	4,207
<b>Variable annuities</b>	<b>1,346</b>	<b>854</b>	<b>1,130</b>	<b>1,291</b>	<b>1,251</b>	<b>1,398</b>	<b>1,629</b>	<b>1,671</b>	<b>1,596</b>	<b>1,637</b>
<b>“R” share classes<sup>7</sup></b>	<b>187</b>	<b>146</b>	<b>233</b>	<b>297</b>	<b>290</b>	<b>340</b>	<b>452</b>	<b>480</b>	<b>487</b>	<b>514</b>

<sup>1</sup> Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

<sup>2</sup> Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

<sup>3</sup> Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

<sup>4</sup> This category contains all other load share classes not classified as front-end load, back-end load, or level load.

<sup>5</sup> This category contains load share classes with missing load fee data.

<sup>6</sup> Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

<sup>7</sup> “R” shares include assets in any share class that ICI designates as a “retirement share class.” These share classes are sold predominantly to employer-sponsored retirement plans. However, other share classes—including retail and institutional share classes—also contain investments made through 401(k) plans or IRAs.

(\*) = total net assets of less than \$500 million

Note: Components may not add to the totals because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Morningstar



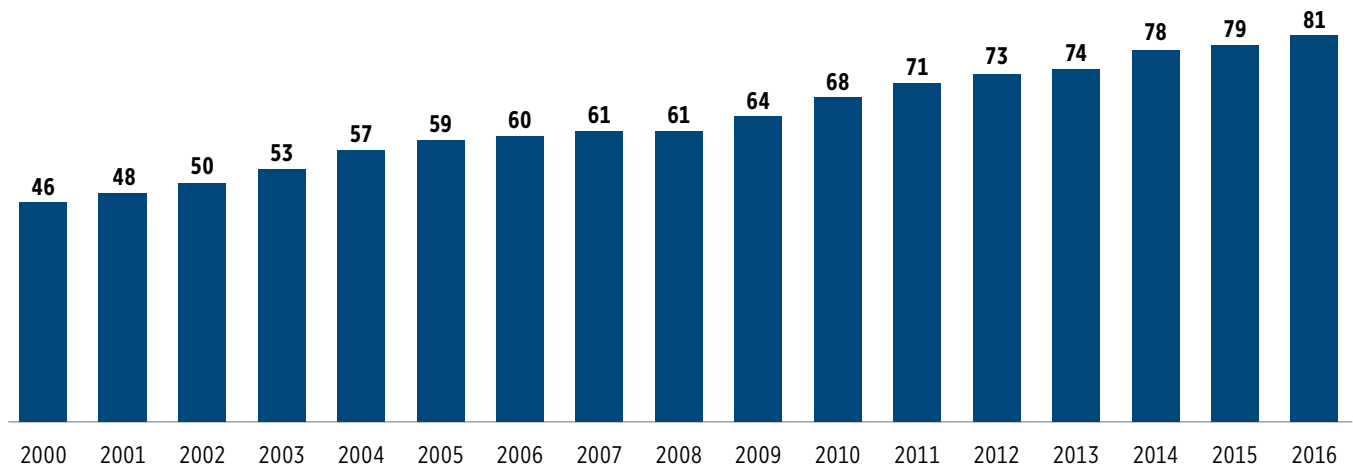
(for example, through mutual fund supermarkets, discount brokers, fee-based professionals, and full-service brokerage platforms) have increased. Second, assets and flows to institutional no-load share classes have been bolstered by 401(k) plans and other retirement accounts, which often invest in institutional no-load share classes. Evidently,

gross sales to no-load mutual funds without 12b-1 fees have grown to 81 percent of total gross sales to long-term mutual funds (Figure 22). The shift toward no-load share classes has been important in driving down the average expense ratio of mutual funds.

FIGURE 22

### The Majority of Long-Term Mutual Fund Gross Sales Went to No-Load Mutual Funds Without 12b-1 Fees

Percentage of long-term mutual fund gross sales, \* 2000-2016



\* Long-term mutual fund data exclude mutual funds available as investment choices in variable annuities, mutual funds that ICI designates as “retirement share classes,” and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Morningstar

### *Did the DOL's Fiduciary Rule Affect Mutual Fund Expense Ratios in 2016?*

On April 6, 2016, the Department of Labor (DOL) issued a final regulation (final rule) defining who—as a result of giving investment advice to an employee benefit plan, plan fiduciary, plan participant or beneficiary, individual retirement account (IRA), or IRA owner—is a “fiduciary” under Section 3(21) of the Employee Retirement Income Security Act of 1974 (ERISA) and Section 4975(e)(3) of the Internal Revenue Code. The applicability date of the final rule was April 10, 2017, although the DOL proposed and adopted a 60-day extension<sup>24</sup> pursuant to a directive from President Trump to reexamine the rulemaking to determine whether the rule may adversely affect the ability of Americans to gain access to retirement information and financial advice.<sup>25</sup>

The DOL's stated intent was to strengthen the standards under which financial professionals provide advice to those saving for retirement in 401(k) plans and IRAs. Intent aside, the likely benefits and costs of the rule to retirement savers have been, and continue to be, hotly debated.<sup>26</sup>

One effect not much in debate is that the rule (if not significantly modified) would accelerate a trend that was in place many years before the DOL began contemplating the rule: investors who want financial advice have been moving toward no-load funds and paying asset-based fees directly to the financial professionals providing advice and assistance (see Mutual Fund Load Fees on page 21). From the investor's point of view, it is far from clear that this rule will lower the total cost of purchasing and holding mutual funds (all-in, including the asset-based fees paid to financial professionals).

Nevertheless, fund expense ratios, on average, will fall. This is because no-load funds have low or no 12b-1 fees (12b-1 fees are included in a fund's expense ratio). Consequently, as the proportion of fund assets in no-load shares rises, as has been the case over the past several years, the average expense ratio of funds, measured on an asset-weighted basis, will decline.

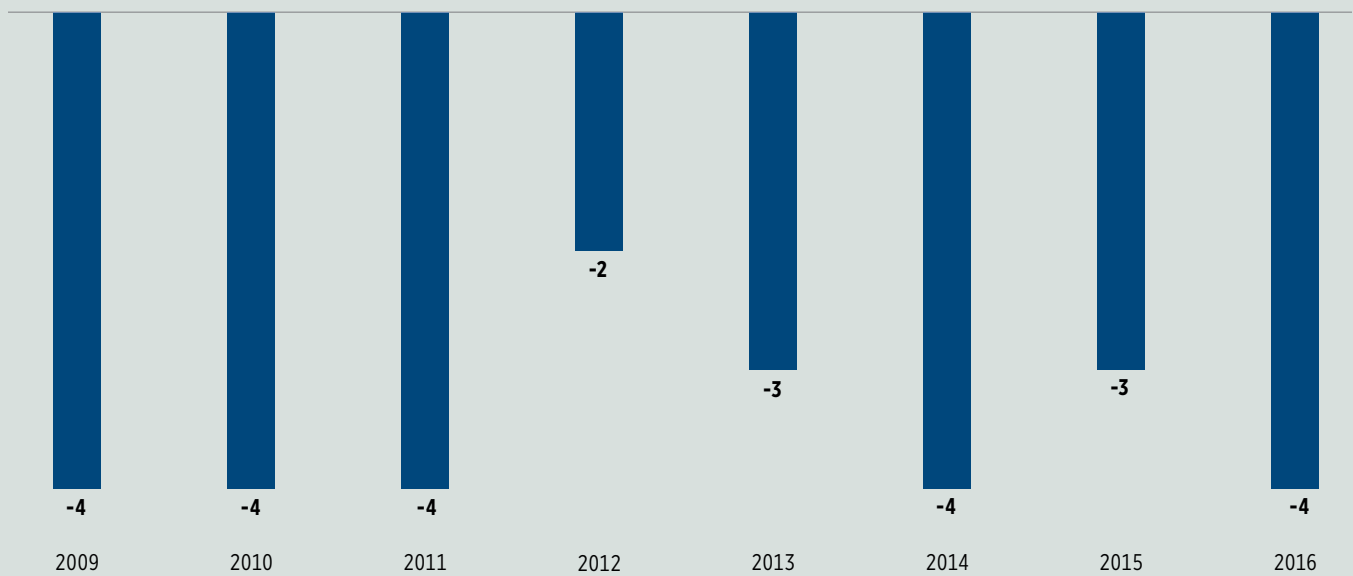
It may be natural to ask whether the decline in the expense ratios of mutual funds in 2016 reflected the DOL's adoption of its fiduciary rule. The evidence of that, however, is limited and even then appears only to be coincidental. As noted, average expense ratios have been trending down for many years. The decline in the asset-weighted average expense ratio in 2016 is consistent with that trend. For instance, as Figure 23 shows, during the years 2009 to 2016, the average expense ratio of equity mutual funds declined by 4 basis points in five separate years (2009, 2010, 2011, 2014, and 2016). This indicates that 2016 is by no means an outlier.

Also, fund providers, broker-dealers, and other third-parties who provide back-office services to funds have been working on operational changes necessary to accommodate the applicability date required by the DOL's April 2016 fiduciary rule. Among other things, these changes include creating new fund share classes within a given fund complex that support compliance with the rule's provisions. Industry participants have indicated, though, that most of these new share classes were not effective for mutual funds and their investors until after December 31, 2016, too late to have had an influence on average fund expense ratios for 2016.

FIGURE 23

### Equity Mutual Funds Have Experienced Similar Levels of Decreasing Expenses Each Year Since 2009

Change in the average expense ratio for equity mutual funds in basis points, 2009–2016



Note: Expense ratios are measured as asset-weighted averages. Data 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 Morningstar

Finally, net cash flows to mutual funds present mixed evidence, at best, that the fiduciary rule may have had an effect on average fund expense ratios. In 2016, net outflows from front-end load mutual funds totaled \$181 billion while no-load share classes experienced net inflows of \$113 billion (see Figure 19). Though this pattern is consistent with what would be expected under the fiduciary rule, because certain large broker-dealers announced they would no longer support commission-based retirement accounts, the pattern of flows was rather similar in 2014, well before the DOL adopted its fiduciary rule. In 2014, front-end load share classes saw net outflows of \$160 billion, only a little bit smaller than the \$181 billion net outflow in 2016. As in 2016, no-load share classes saw net inflows in 2014, but they amounted to \$338 billion, well above the mark set in 2016.

In short, the decline in average expense ratios in 2016 is coincidental with the timing of the DOL's April 2016 adoption of its fiduciary rule with an April 2017 implementation date. The cause of the decline appears simply to be the continuation of a long-term downward trend in mutual fund expense ratios, a market-driven trend that was in place well before the DOL adopted its fiduciary rule.

## Conclusion

Expense ratios of long-term mutual funds declined in 2016 as a result of increased demand for index funds, and a continuing shift by investors in both actively managed and index funds toward lower-cost funds. Expense ratios of money market funds rose as an indirect response to the rise in short-term interest rates associated with a firming

of monetary policy. Strong asset growth and competitive pressures, fueled by individuals saving for retirement and new target date mutual fund entrants, continue to put downward pressure on target date mutual fund expense ratios. Expense ratios of ETFs were little changed in 2016, but reflect a maturing market that is characterized by economies of scale and intense competition.

### *Additional Reading*

- » **The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2015**  
[www.ici.org/pdf/per22-04.pdf](http://www.ici.org/pdf/per22-04.pdf)
- » ***The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2014***  
[www.ici.org/pdf/ppr\\_16\\_dcplan\\_profile\\_401k.pdf](http://www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf)
- » **The US Retirement Market, Fourth Quarter 2016**  
[www.ici.org/research/stats/retirement/ret\\_16\\_q4](http://www.ici.org/research/stats/retirement/ret_16_q4)
- » **Understanding Exchange-Traded Funds: How ETFs Work**  
[www.ici.org/pdf/per20-05.pdf](http://www.ici.org/pdf/per20-05.pdf)
- » ***2017 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry***  
[www.ici.org/pdf/2017\\_factbook.pdf](http://www.ici.org/pdf/2017_factbook.pdf)
- » **For Money Market Funds, Massive Preparation Has Paid Off in Smooth Transition**  
[www.ici.org/viewpoints/view\\_16\\_mmf\\_transition\\_1](http://www.ici.org/viewpoints/view_16_mmf_transition_1)
- » **ICI Resources on 401(k) Plans**  
[www.ici.org/401k](http://www.ici.org/401k)
- » **ICI Resources on 12b-1 Fees**  
[www.ici.org/rule12b1fees](http://www.ici.org/rule12b1fees)

## Notes

- <sup>1</sup> ICI uses asset-weighted averages to summarize the expenses and fees that shareholders pay through funds. In this context, asset-weighted averages are preferable to simple averages, which would overstate the expenses and fees of funds in which investors hold few dollars. ICI weights the expense ratio of each fund share class by its year-end assets.
- <sup>2</sup> Mutual funds that invest primarily in other mutual funds are not included in this section but are analyzed separately in a later section (see page 9).
- <sup>3</sup> To assess the expenses and fees incurred by individual shareholders in long-term mutual funds, this report 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 mutual funds represent investments made on behalf of retail investors, such as through defined contribution plans, IRAs, broker-dealers investing on behalf of retail clients, 529 plans, and other accounts (such as omnibus accounts).
- <sup>4</sup> Use of Morningstar data requires the following disclaimer: © 2016 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.
- <sup>5</sup> ICI reports assets and flows of hybrid and bond mutual funds separately. In contrast, when reporting the assets and flows of actively managed mutual funds and index mutual funds, ICI combines hybrid and bond mutual funds.
- <sup>6</sup> For further discussion, see Gallagher 2014.
- <sup>7</sup> ICI uses the term *expense waivers* to refer to fee waivers and/or expense reimbursements.
- <sup>8</sup> See Gallagher 2014.
- <sup>9</sup> See Gallagher 2014.
- <sup>10</sup> Some funds of funds also invest in ETFs.
- <sup>11</sup> See note 4.
- <sup>12</sup> A 2006 SEC rule requires a fund of funds to include both direct and indirect expenses in the expense ratio reported in its prospectus fee table. The expense ratios shown in Figure 8 account for both the expenses that a fund pays directly out of its assets (direct expenses) and the expenses of the underlying funds in which it invests (acquired fund fees or indirect expenses).
- <sup>13</sup> As of year-end 2016, 88 percent of target date mutual fund assets were held in IRAs and defined contribution retirement plans. See Investment Company Institute 2017a.
- <sup>14</sup> When 401(k) plan participants are enrolled automatically or otherwise do not specify how their contributions should be allocated among plan investment choices, the plan sponsor may invest the contributions in a qualified default investment alternative (QDIA). The Pension Protection Act of 2006 required that QDIAs include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or both. The Department of Labor QDIA regulation (29 CFR 2550.404c-5) allows three types of investments to be used as long-term QDIAs: target date funds (also called lifecycle funds), balanced funds, and managed accounts. These may be mutual funds, collective investment trusts, or separately managed accounts. This section focuses only on target date mutual funds.
- <sup>15</sup> See Exhibit 2.10 in BrightScope and Investment Company Institute 2016, which shows the increased use of target date funds in 401(k) plans.
- <sup>16</sup> In the EBRI/ICI 401(k) database, from which this statistic was generated, *funds* includes mutual funds, bank collective trusts, life insurance separate accounts, and any pooled investment product primarily invested in the security indicated. See Holden et al. 2016.
- <sup>17</sup> See note 4.
- <sup>18</sup> See Investment Company Institute 2017b.
- <sup>19</sup> For a discussion on understanding ETFs and the features that make them attractive to investors, see Antoniewicz and Heinrichs 2014.
- <sup>20</sup> Actively managed ETFs are excluded from the analysis in this report except when indicated. The analysis also excludes ETFs not registered under the Investment Company Act of 1940 (which are ETFs that invest primarily in commodities, currencies, and futures).
- <sup>21</sup> See note 4.
- <sup>22</sup> Among households owning mutual fund shares outside employer-sponsored retirement plans, 80 percent own fund shares through investment professionals.
- <sup>23</sup> See, for example, Damato and Pessin 2010.
- <sup>24</sup> See 82 Fed. Reg. 12319 (March 2, 2017).
- <sup>25</sup> See White House memorandum to the Secretary of Labor, dated February 3, 2017, and published at 82 Fed. Reg. 9675 (February 7, 2017), available at [www.gpo.gov/fdsys/pkg/FR-2017-02-07/pdf/2017-02656.pdf](http://www.gpo.gov/fdsys/pkg/FR-2017-02-07/pdf/2017-02656.pdf).
- <sup>26</sup> See ICI comment letter on reexamination of fiduciary rule at [www.ici.org/pdf/17\\_ici\\_dol\\_fiduciary\\_reexamination\\_ltr.pdf](http://www.ici.org/pdf/17_ici_dol_fiduciary_reexamination_ltr.pdf).

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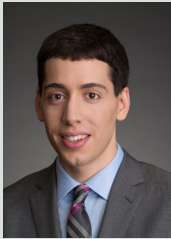
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