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Broadridge®

U.S. mutual funds: lower expenses and the changing competitive landscape

Ready for Next

EXPENSE TRENDS

Over the past five years mutual fund expenses in the U.S. have trended downwards. While many factors have caused this trend, it is nearly impossible to identify a “primary” cause. Broadridge believes that it is important to give perspective on the many areas that are driving expenses down, especially for boards and management as part of the 15(c) process. Two of the common themes that are discussed for the impetus for lower expenses are related to downward pricing pressure from ETFs and passive products, and a shift in how investors purchase mutual fund shares, moving from retail load shares to institutional share classes, typically without sales loads, or 12b-1 fees.

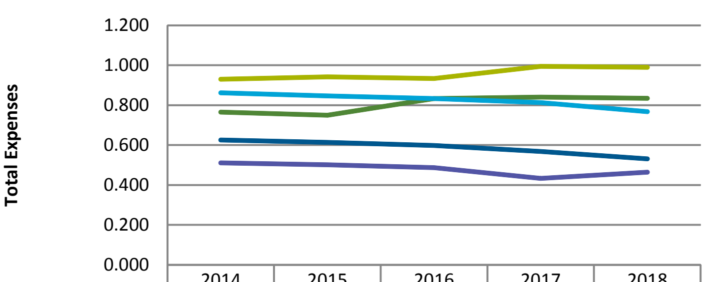
Our research clearly indicates that expenses are decreasing for mutual funds; however, this does not depict the full cost of ownership, where it is difficult to capture the shift in how distribution is paid.

FIVE YEAR EXPENSE TRENDS

The mutual fund industry has seen an overall decrease in total expense ratios over the past five years based on 12 month rolling periods with a fiscal end date of September 30th. On a dollar-weighted average basis, active funds’ total expenses ratios dropped ten percent, from 73.3 basis points in 2014 to 65.8 basis points in 2018. This trend is also true for funds’ management expenses, where fees have decreased by 6%, from 48.7 bps to 45.9 bps. However during this same time period, the percent of management fees that make up a fund’s total expense have actually increased by 5%. This indicates that the fee pressures faced by fund companies are an area where both internal and external service providers are affected.

The amount in which total expense ratios have changed varies based on fund type. However, total expense and management fee ratios for equity, bond, and mixed asset mutual funds have each decreased by at least three percent since 2014. This downward movement in expenses is in part attributed to asset growth. In the past five years, average net assets for equity funds have increased by 45%, bond funds have increased by 17% and

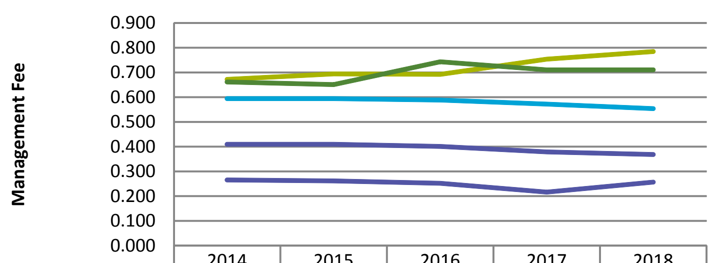
Figure 1
Active funds expense ratios



	2014	2015	2016	2017	2018
Alternatives	0.930	0.941	0.933	0.995	0.990
Bond	0.626	0.614	0.598	0.568	0.531
Commodity	0.765	0.749	0.834	0.840	0.834
Equity	0.861	0.846	0.833	0.813	0.767
Mixed Assets	0.511	0.501	0.488	0.433	0.464

Data source Lipper

Figure 2
Active funds management fees



	2014	2015	2016	2017	2018
Alternatives	0.672	0.694	0.692	0.754	0.784
Bond	0.410	0.409	0.401	0.379	0.368
Commodity	0.661	0.651	0.743	0.711	0.711
Equity	0.594	0.594	0.588	0.572	0.554
Mixed Assets	0.266	0.262	0.252	0.217	0.257

Data source Lipper

mixed asset funds have increased by 57%. This asset growth will create on-going decreases in management fees for funds with breakpoint fee schedules even if there aren't new breakpoints added. Additionally, as some fund costs are relatively fixed, (accounting and audit fees, and director fees), any increase to fund size may have a downward effect on expense ratios.

"In the past five years, average net assets for equity funds have increased by 45%, bond funds have increased by 17%, and mixed asset funds have increased by 57%. This asset growth creates economies of scale, decreasing management fees for funds with breakpoint fee scheduling."

Historically, alternative mutual funds tend to have higher expense ratios, but have still been identified as an anomaly when it comes to current expense trends. Although, alternative funds have seen a 17% increase in assets since 2014, total expenses have actually increased by 6%, from 93 bps to 99 bps. Management fee expenses even more so, by 17%. Fund investors may be drawn to alternative strategy mutual funds because they offer exposure to a wide range of asset classes and work to mitigate volatility in an investor's portfolio. However, these strategies can be costly to manage, driving expenses up. With a more stable market, investors may also be inclined to invest in mixed asset funds, which offer similar benefits through diversification, but at a much lower expense ratio. Since 2014, the total expense ratio for mixed asset funds has decreased by 9% (for direct expenses only), and of all actively managed mutual funds, has maintained the lowest total expense ratio, averaging between 43 and 51 bps.

SHARE CLASS IMPACT ON EXPENSES

One partial explanation for the decrease in overall total expenses is the share class make-up of the market. Prior to 2014, retail share classes made up a majority of the market at 55%. Since 2014, there has been a shift. The number of institutional share classes that have launched since 2014 increased by 82%, from 7,203 to 13,108. Whereas the number of retail share classes has only grown by about 33%, from 8,664 to 11,499 funds. Institutional share classes now make up a greater share of the market at 53%. Institutional share classes, including clean share classes, semi-bundled (no distribution or revenue sharing but with shareholder servicing), and retail-esque institutional for small retirement type plans all tend to have lower costs than retail products. This is driven by lower nonmanagement expenses, in part due to lower transfer agent and shareholder servicing costs. In 2018 the average share class held about $419.6 million in assets, compared to the retail share classes which one average held $399.0 million in assets. These larger account balances create economies of scale, lowering overall expenses. From 2014 to 2018, overall institutional share classes have maintained average total expenses, around 51 to 53 bps, whereas retail share classes have averaged around 77 to 80 bps. As a result of a greater portion of the market now consisting of institutional share classes, the overall total expense average has declined. One thing to note: institutional share classes typically have a higher percentage of their overall expense ratio taken up by management fees, around 82% in 2018, compared to retail share class management fees which take up about 62%.

Figure 3
Share class composition 2018

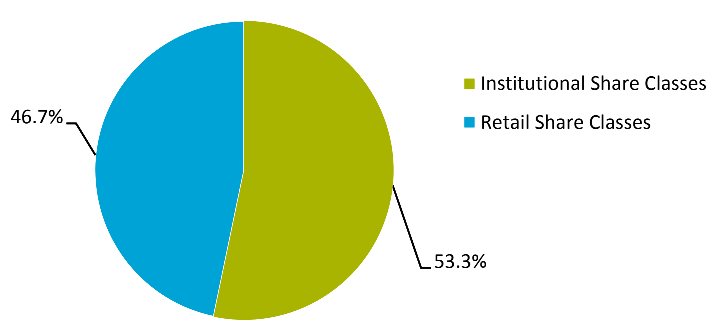
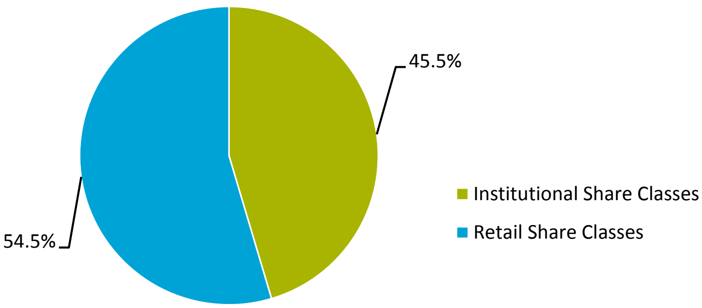


Figure 4
Share class composition 2013



This shift to institutional products devoid of distribution costs and some shareholder servicing costs allowed fund companies to make substantial reductions in costs to investors. However, moving forward there is less room for large expense savings. As fund companies and boards look to reduce costs, a steady eye with a scalpel will be needed to further reduce expenses.

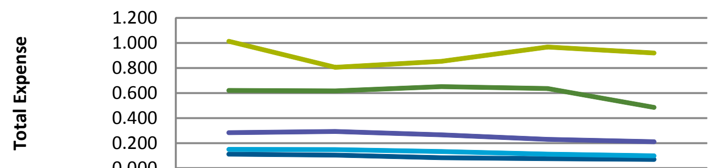
"This shift to institutional products devoid of distribution costs and some shareholder servicing costs allowed fund companies to make substantial reductions in costs to investors."

ETFS AND PASSIVE PRODUCTS

The growing popularity of index investing whether in passive mutual funds or ETFs has also worked to decrease the expenses investors paid both on a whole as well as within the passive space. Since 2014 passive mutual funds have seen a decrease in expenses from 10 basis points to 15 in 2018. On the ETF side expenses have decreased on an asset weighted average, even as new products lean towards the esoteric or the factor-based model.

The direct benefit to shareholders as a result of this downward expense trend for management fees and total expenses appears on the surface to be a positive, though danger may lurk as many managers are utilizing other tools such as securities lending to increase their revenues from these products. While the majority of the income produced in securities lending also benefits the investor, the vast majority of the risk also resides with the investor. The benefit of lower expenses may be outweighed if there are significant defaults on securities on loan.

Figure 5
Passive funds total expenses



	2014	2015	2016	2017	2018
Alternatives	1.012	0.805	0.852	0.967	0.919
Bond	0.113	0.105	0.084	0.076	0.070
Commodity	0.621	0.616	0.651	0.636	0.485
Equity	0.151	0.148	0.133	0.113	0.100
Mixed Assets	0.284	0.293	0.267	0.231	0.212

WHAT FACTORS ARE DRIVING EXPENSES

While we have clearly demonstrated that fund expenses have decreased over the past five years, a trend that is likely to continue for the foreseeable future, what are the factors causing this decrease? Without an understanding of the causes driving expenses down, it becomes difficult for boards and management to discuss options during the 15(c) process and while pricing new products. The primary factors Broadridge sees impacting expenses, beyond benefitting from economies of scale due to organic asset growth are: 1. Regulatory/litigation pressure, 2. Distribution landscape changes, and 3. Product choices. In isolation each of these three areas may have a slight impact on expenses; however, with the convergence of all three occurring simultaneously over the past few years, the impact to funds has been noticeable.

“The low costs of ETFs and passive products has forced active mutual funds to consider those products when pricing new funds or during the 15(c) process for existing funds.”

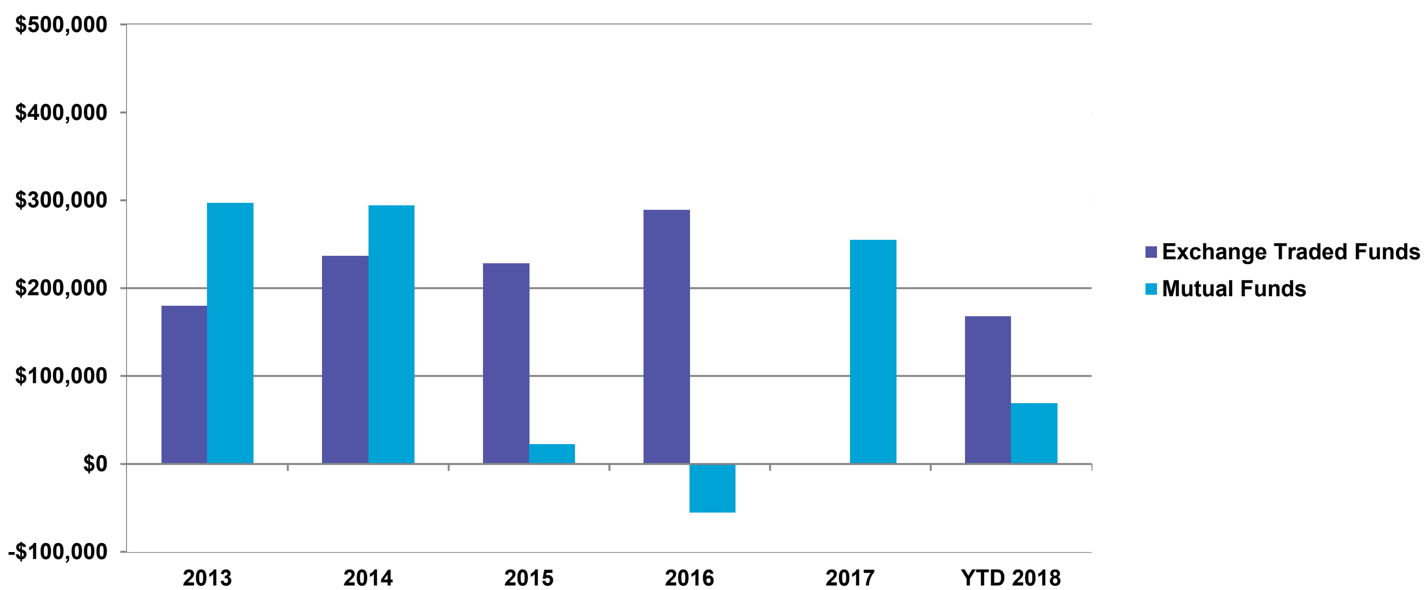
REGULATORY

The first impact to expenses is the ongoing focus on expenses by regulatory agencies as well as concern over pricing that weighs on directors’ minds due to excessive fee litigation. During the 15(c) process, boards and management alike must keep a vigilant eye on expenses and need to be able to fully detail why a particular fund is relatively more expensive without charging an excessive fee. Due to this, boards now spend more time discussing and understanding potential economies of scale that can be passed on to investors. Additionally, boards focus more time on nonmanagement expenses during the process, even though 15(c) is directly about the approval of the management fee contract. While the now-failed DOL Fiduciary Rule has not directly resulted in shareholders moving to a clean share class like RDR did in the UK, it has prompted fund companies to launch many clean share classes, reducing fund expenses.

DISTRIBUTION LANDSCAPE

With the failure to implement the DOL Fiduciary Rule we have not seen the significant shift in the share class investors put their money. In the UK with RDR there was a regulatory cause that essentially forced fund companies, distributors, and shareholders to move to a clean share class; had the Fiduciary Rule gone into effect in the U.S. a similar shift in share classes would have occurred. The DOL has helped expedite this reallocation of investing where we now see the bulk of industry flow coming into institutional share classes, though it has not regulated it so the transition will be slower than that in the UK. At a minimum this transfer from retail to institutional is 25 basis points of 12b-1 expenses; however, for level load funds (C share classes) this savings in expenses, on the fund level, for investors could be 1.00%. This savings does not take into account any other expenses that may be lower in an institutional share class such as transfer agent costs. This shift in where investors put their money has a significant impact on the decrease in expenses paid. With that being said, our data does support lower expenses across the board over the past five years when slicing costs by share class/load type.

Figure 6
Mutual Fund versus ETF net flow 2013-2018



PRODUCT OPTIONS

With the proliferation of ETFs and the money being invested in that product type, active mutual funds face their third challenge with pricing. Investors can now easily access indexed products for nearly any type of investment with very low, and in some cases, no fund level expenses. The low costs of ETFs and passive products has forced active mutual funds to consider those products when pricing new funds or during the 15(c) process for existing funds. Investors are not willing to pay as high a premium on active funds that are providing beta performance. The wide product offerings available to investors does show the one anomaly with data however, that being alternative products where we have seen an increase in expenses. These unique strategies are difficult, if not impossible, to replicate in a passive strategy and investors appear to be willing to pay a premium to de-risk their overall portfolio. With an ever expanding range of investment options divergent expense trends likely will continue with diversified long-only products facing continued downward fee pressure whereas alternative strategy products and niche long-only equity products will likely face far less fee pressure.

EXPENSE TRENDS IMPACT ON BOARDS

What do these expense trends mean to a mutual fund board when they are sitting down to approve a new fund or renew a contract during the 15(c) process? Generally speaking we feel understanding a fund's pricing history in isolation as well as compared to other funds with a similar investment strategy is a logical starting point for any discussion with management. If there is a decision that a fund needs to have expenses adjusted to stay competitive, then there are multiple tools available. The two primary tools are a change in contractual management fees and expense waivers through a voluntary cap. Contractual management fee changes have a guaranteed long-term benefit to shareholders as any attempt to increase fees would require shareholder approval. In some cases this may seem to be the preferred model for boards to request when working with management to reduce fees. There are, however, limitations with the contractual change model that limit management's ability to best serve shareholders in an agile manner. We are seeing more fund companies work with voluntary waivers to reduce expenses as this model allows the fund company to address the immediate concern of pricing with flexibility to address costs in the long term. For example, a fund company may agree to voluntarily waive expenses in the near term from their management fee and concurrently work to renegotiate agreements with other service providers. If the renegotiation of fees is successful then fund management can charge their full fee and reinvest those proceeds in the business to strengthen returns and services for investors. In our analysis we have seen the percentage of funds utilizing a fee waiver increase from just under 50% of all share classes for the 2013 fiscal period to over 57% for the 2017 fiscal period. We have also reviewed contractual management fees during the same five year period and have found that 22.5% of all funds have made a change to their contractual management fee schedule that reduces the cost. These contractual fee reductions include lowering a flat-rate fee, lowering all portions of a breakpoint fee schedule, as well as adding additional, lower breakpoints. During the 15(c) process the board has the ability to have a dialog with management about the overall pricing philosophy of the complex as well as the specific pricing of individual funds. While macro level trends show expenses moving downwards not every fund or every fund company is going to have expenses move in line with the industry. Trying to keep up with the annual year over year decrease in expenses may not work, as it may limit management's ability to oversee a fund, retain talent, and provide reasonable performance to investors. Expenses are one piece of a large puzzle that likely includes performance, risk, and other factors that can't be measured by cost alone. Broadridge feels that boards and management alike should be aware of expense trends and have a conversation about the general industry trends and where each particular fund company fits within those trends based on its business model. A holistic approach to understanding the dynamics impacting expenses should be used before demanding expense concessions.

Figure 7
Percentage of funds with waivers

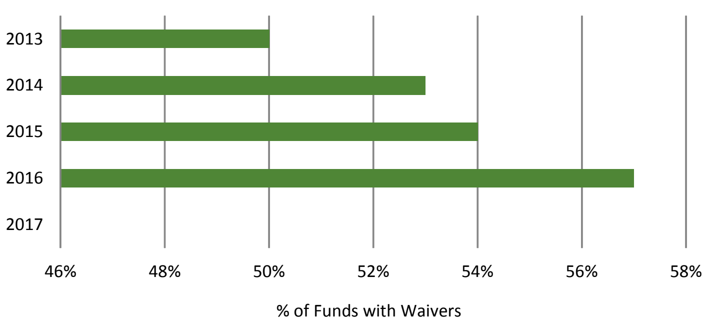


Figure 8
Funds with contractural management fee changes - past five years

TAKEAWAY

Board members and management should be aware of general expense trends and the multiple factors that have caused expenses to decrease: asset growth, shift in distribution costs away from funds, regulatory/litigation pressures, and fee pressure from passive products.

An on-going dialog between the board and management about pricing philosophy should occur, making the options and decisions when and if to request an expense reduction a more informed process.

Consider all options for fee reductions, voluntary waivers, fee caps, and contractual fee changes.

Boards and management may also want to consider where fee reductions come from, management fees versus nonmanagement expenses.

Comments and questions from readers of this white paper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study. Please direct any feedback to:

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