Goin' Up?

Have mutual fund costs gone up or down? Are they fair or unfair? It depends on whom you ask.

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By Susan B. Weiner

For most advisors, it's a no-brainer to pick the fund with lower expenses, assuming the fund's style, market capitalization and other major factors are equal. After all, expenses subtract directly from returns. And now that mutual funds seem to have settled into an era of single-digit returns, the impact of fees is more visible to investors than it was in the high-return 1990s. But controversies swirl around several topics related to fees, including their fairness, their correlation with higher fund returns, whether they're rising or falling, and whether fund firms are responding adequately to advisor demands.

First of all, what exactly are we talking about? What constitutes a fee? For the purpose of this discussion, we'll take the broad view: Fees reflect a fund's overall expense ratio—or operating expenses—which includes management fees paid to the investment advisor, distribution and servicing fees (including 12b-1 fees) and other administrative expenses, such as fees to the fund's transfer agent for shareholder services. Fees do not include sales loads—which, in any case don't affect fee-only advisors—redemption fees or expenses that are not explicitly reported as part of the fund's expense ratio.

Investors may not know just what they comprise, but clearly they do care about fees: More assets are flowing into fund complexes identified with low-cost funds, including Vanguard, American Funds, Barclays and Fidelity, says Fran Kinniry of Vanguard's Investment Counseling and Research Department. Russ Kinnel, Morningstar director of fund research, adds that smaller firms, such as Dodge & Cox, are also benefiting from this trend.

Fund costs are a major criterion in fund selection for J. Patrick Collins, principal at Greenspring Wealth Management in Towson, Md. "Since we can't control the market, interest rates or events that affect the market, we focus on areas we can control—like costs," he says. At Benningfield Financial Advisors in San Francisco, principal Milo Benningfield agrees. "There have been many studies showing that among the many variables applicable to mutual funds, expense ratios are one of the best—if not the best—predictors of future fund performance," Benningfield says.

Correlation is Key

Indeed, it's clear that fees can overwhelm slight outperformance, says Robert Johnson, managing director of the CFA Institute. But is there a strong correlation between low fees and good performance? Morningstar's Kinnel says, "All evidence suggests expense ratios are very good predictors of performance. It makes sense to beat the bushes for the best low-cost provider you can find."

There is always a negative relationship between fees and fund performance, according to Gregory Kadlec, co-author of "Transaction-cost Expenditures and the Relative Performance of Mutual Funds," a working paper from the Wharton School Center for Financial Institutions at the University of Pennsylvania. A finance professor at Pamplin College of Business, Virginia Tech, Kadlec says the negative correlation has been proven by a series of academic studies dating back to work by Michael Jensen in the late 1960s.

But fees and performance don't move in a lockstep relationship—at least not according to "How Well Do Expenses and Net Returns Predict Future Performance," a 2004 report from mutual funds consultants Lipper: "…For both open-end equity funds and taxable bond funds, there is often no difference between using low expenses versus good three-year returns for picking index-beating funds," the report asserts, continuing, "…sometimes choosing the most expensive funds will net you the most index-beating funds."

This is why advisors are sometimes willing to consider a well managed, high-performing fund with expenses above the average for its category. But in general, financial advisors are hungry for well managed funds with low expenses.

Some clients have been following their advisors' lead in taking expenses more seriously. "Due to the media… clients are obsessed over expenses and fees that are paid," says Pat Hinds, branch manager of Granite Financial in St. Cloud, Minn. Steven Rogé of. R.W. Rogé & Company in Bohemia, N.Y, sees clients who are more aware of 12b-1 fees because of media coverage.

Mixed Response

Has the mutual fund industry responded to this demand for lower fees? Most financial advisors are not impressed.

Says Alexander Feick, managing director, Paragon Capital Management in Denver, "Fund boards have been too slow to respond to consumers' demands in this area."

In fact, Rick Brooks, a portfolio manager with Blankinship & Foster in Solana Beach, Calif., says he's seen an uptick in expense hikes recently. Moreover, Brooks adds, "I have noticed a trend towards 'advisor' shares, which seem to have slightly higher fees than institutional shares, but lower fees than retail or loaded share classes. There also seems to be an explosion in retirement plan share classes which allow for additional distribution and servicing payments to plan administrators that can be bundled into overall expenses."

But some advisors, like Jamie Milne of Milne Financial Planning in Barre, Vt., say fund firms "that target the fee-only advisor understand the importance of having a low expense ratio." Benningfield notes, "You can stick with companies like DFA, Vanguard and Barclays to get low- cost investments." Others, like Jim Sonneborn at RegentAtlantic Capital in Chatham, N.J., point to isolated, settlement-induced fee reductions at fund families involved in the mutual fund trading scandal.

However, some fund families actually are cutting fees. For example, in 2005 Vanguard broadened and simplified the qualification requirements for investors in Admiral shares, which enjoy lower expense ratios. "You can't charge too much in this return environment and still be competitive with indexing," says Vanguard's Kinniry.

At Fidelity Brokerage Co., "We look at our pricing regularly to make sure we're competitive in the marketplace," says John Sweeney, senior vice president, mutual fund product management. In 2005, Fidelity cut fees by 30 percent on its Spartan equity index funds and cut its investment-grade bond fund fees to 45 basis points (0.45 percent). As for the bond fund cuts, "It made sense from a clarity standpoint to offer one price point for investors, so they can understand the value we offer in fixed income," Sweeney explains.

It's not unusual for investment management advisory fees to decline on a percentage-of-assets basis as assets under management rise. Transfer agency fees don't rise as quickly as assets, especially if asset growth lies mainly in existing investors' accounts. Morningstar's Kinnel has seen funds make these cuts because fund mergers within their complex have pushed the assets above fee breakpoints. "A merger will kill small, high-cost funds," he says.

But not every fund reduces its fees as its asset base increases. It's partly an issue of supply versus demand. For example, a small-cap fund nearing its capacity limit, with people clamoring to get in, has no incentive to reduce its fees. "Far too often, fund companies price on what they can get away with," says Kinnel. In fact, Morningstar has criticized fund companies that charge more for sector, growth and international funds, saying that it is not justified.

Fidelity's Sweeney argues that at least sector and international funds involve more work. For sector funds, "We're digging deeper. The companies are smaller market cap, so the information is harder to get," he says.

Ups or Downs?

Despite many financial advisors' perception that mutual funds are not delivering lower fees, the Investment Company Institute (ICI)—the mutual funds trade association—trumpets research showing that "Mutual fund fees and expenses fell to their lowest levels in more than a century during 2005…The fees and expenses paid by bond and stock investors fell more than 50 percent since 1980." The average for bond funds dropped from 2.05 percent (205 bp) to 0.90 percent (90 bp). For stock funds, the drop was from 2.32 percent (232 bp) to 1.13 percent.

Looks like mutual funds have been cutting their fees, doesn't it? (See charts at left.) But ICI research combines sales loads and ongoing expenses into a single measure, and its calculations are asset-weighted. As a result, as the ICI states, "Increased investor demand for low-cost funds accounted for more than half of the decline in the asset-weighted average expense ratio." In other words, more investors are choosing low-expense funds—both loaded and no-load.

The second major influence according to ICI was "investors incurring lower expense ratios in the funds that they already owned," largely because advisory fees were cut— and other fees became less significant—as the assets of individual funds rose.

The ICI says that industry-wide average expenses are understated due to factors such as launches of new funds, which typically must spread their expenses over a small asset base. Another influence was the introduction of funds in new, more expensive asset classes—such as international and emerging markets—which didn't exist 25 years ago.

Some critics argue that mutual funds are charging too much in investment advisory fees. For example, in "Are Active Management Fees Too High?", an article in the CFA Institute's 2005 *Financial Analysts Journal*, Richard Ennis of Ennis, Knupp & Associates, the Chicago-based investment consulting firm, states that from 1980 to 2004 "the average equity mutual fund expense ratio has risen from 0.96 percent to 1.56 percent." Ennis used equal-weighted expense numbers and did not include sales loads, which may account for the inconsistency between his findings and the ICI's. Ennis argues that these high rates are the legacy of the extraordinary influx of assets during the 1980s and 1990s. But they create a formidable challenge, as the table on the next page shows. "For an investor to enjoy an even chance of realizing a positive alpha when paying 0.5 percent, the manager's required skill level is 0.62. At 3.0 percent per year, the manager's required skill level rises to an inconceivable 0.97."

Ennis reckons that this will hasten investors' move into index and lower-cost actively managed funds. "Impetus for this move will be the growing realization that high fees sap the performance potential of even skillful managers." In an interview, he notes that fund companies may already be cutting fees because they see the handwriting on the wall.

Playing Fair

Ennis is hardly the only industry figure calling for lower investment advisory fees. A lawsuit filed against American Century charged that by collecting advisory fees higher than what it charges institutional investors, it was collecting excessive advisory fees. Although the case was dismissed this past summer, the plaintiffs made a good point, says Roy Weitz, publisher of FundAlarm.com. Pension funds pay much lower investment advisory fees than mutual funds. "There's no more work to picking stocks for a pension fund versus for a mutual fund," says Weitz. Certainly the cost of servicing mutual fund shareholders is much higher, but that comes out of transfer agency fees rather than advisory fees.

Morningstar's Kinnel mentions Davis Selected Advisors to illustrate the viability of this approach. Davis charges the same advisory fees to mutual funds as to institutional investors, although the funds may be sold through distribution

channels that charge additional fees.
Kip Price, who heads Lipper's Global Fiduciary Review, counters that it's more work for investment managers to manage the daily asset flows in and out of mutual funds that characterize retail investors' accounts. Pension fund flows, he points out, are more orderly. "They may even say, 'we're moving money in six months,' so the investment manager can do a managed transition," he says.
Zach Ivey of Alabama-based First Financial Group of the South, says, "The due diligence process for institutions and the competition for large amounts of assets with one client give institutions bargaining power." Moreover, "[Institutions'] stickiness of assets, coupled with bargaining power, will keep pensions getting a better deal. It is probably reasonable," he adds.
Lipper's Price notes that mutual fund fees in Europe are two- to three-times as expensive as in the U.S. Lower fees are a benefit of the more mature U.S. market, he adds. For Granite Financial's Hinds, "It's like ordering a pizza. Do you call and order, or do you go to the store and buy the ingredients to make it yourself?"

Secret Costs

Some financial advisors say both critics and boosters of mutual funds may be missing the point by focusing on disclosed expense ratios.
"It is extremely important to discern, or at least estimate, the other 'hidden costs' of mutual fund investing," says Ron Rhoades, director of research for Joseph Capital Management in Hernando, Fla. Among those costs, he lists:

• Brokerage commissions relating to securities trades within the fund (disclosed in the fund's Statement of Additional Information)
• Other transaction costs due to portfolio turnover (bid-ask spreads, market impact costs, opportunity costs due to delayed or canceled trades)
• Opportunity costs due to cash holdings within the fund

Rhoades pegs the average total cost of U.S. stock mutual funds at 2.5 percent to 3 percent annually—roughly twice the ICI's estimate. He explains his methodology for adding funds' hidden costs to their disclosed costs in his March 2006 paper titled "Estimating the Total Costs of Stock Mutual Funds" (available on the JosephCapital.com Web site).
In fact, Rhoades criticizes some funds that are more accustomed to praise on the expense front, pointing out that, "While commercial index funds and certain exchange-traded funds usually possess relatively low turnover and low disclosed expenses, their market impact costs are often quite high." He praises efforts by commercial indices—such as Frank Russell Co. and Standard & Poor's—to lessen the index turnover that causes market impact. For similar reasons, he also likes DFA's approach to passive investing and Vanguard's shift to the MSCI indices to lower transaction costs.
Rhoades has plenty of company among financial advisors in his criticism of hidden expenses. Benningfield says, "I've seen cases where the trading costs were…two to three times the expense ratios…To me, the failure to be more explicit about these added costs is one of the main reasons that individual investors fare so poorly in the market."
What worries Don Martin, president of Los Altos, Calif.-based Mayflower Capital, "is that a fund could charge shareholders low fees and then use a brokerage that charges high fees." Adds Collins of Greenspring Wealth Management, "When we review prospective clients' portfolios, we have found that [actively managed] funds can add up to over 2 percent more a year in trading costs."
Many financial advisors would like fund companies to improve their disclosure of hidden costs. Presently, commissions are disclosed in the Statement of Additional Information, but they aren't incorporated into the fund's expense ratio.
Commission costs aren't the most relevant indicator of trading costs, according to Lipper's Price. "It's not what you pay per share. It's do they get a good bid/ask spread? Do they spread their trades among 40 brokers so it's not known that you're buying and selling?" There's no requirement for disclosure of other costs not incorporated into the fund's expense ratio.
Vanguard's Fran Kinniry says, "All expenses are disclosed in the [fund's] total return. You can compare that against the fund's peer group and index." And Rogé agrees that the hidden fund expenses aren't important because "fund performance is reported net of all fees."
The debate goes on and on, providing plenty of fodder for controversy about mutual fund expenses. One thing seems clear: Advisors will continue to gravitate toward low-cost funds that also meet their other investment criteria.

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