

FEE FI FO FUM

CAN INVESTORS SMELL FUND MANAGERS' BLOOD — OR VICE-VERSA?

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INTRODUCTION

It is the pantomime season and Jack the investor is trying to climb the beanstalk of investment returns. However the terrifying cry of 'fee, fi, fo, fum, I smell the blood of an Englishman' echoes in his ears.¹ Unsure about fi, fo, or fum, this report will concentrate on issues relating to fees for mutual funds.

CONTENTS SUMMARY

- **Paying more to get more?** New research examines whether companies with similar types of fund vary their fees across a fund range. On the basis that not all funds in a company's range perform as well as each other, the expectation would be that there is some variation in the fee levels charged.
- **Will fund fees fall?** With Ucits IV on the horizon and a greater discussion of the role of passive funds, the evidence is assessed to see whether fund fees will soon fall in Europe — or whether a 'price war' in some sectors may already have begun.
- **Heads I win, tails you lose?** Performance fees have moved back into the spotlight, largely through discussion of hedge funds entering the Ucits arena. However, the appropriateness of some fee structures is open to question. Also, latest data compares the management fees of funds with and without performance fees.
- **Investors' perception of fund costs.** There is not a single figure price tag for each mutual fund — there cannot be. Lipper continues to stress the importance of the 'drag effect' of annual operating costs for long-term investors. The role of fund directors in helping investors is highlighted.

¹) See: <http://en.wikipedia.org/wiki/Fee-fi-fo-fum>

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PAYING MORE TO GET MORE?

It is not uncommon to hear the mantra that investors often have to pay more in order to get better returns from their fund investments. In light of this, it might be expected that fund companies set their management fees specifically for individual funds, rather than using a uniform fee level across their range. In this way, fund companies would recognise that fees should be appropriate for each fund and, in turn, in the interests of that fund's shareholders.

In order to test this, 33 umbrella fund ranges with assets totalling €280bn and over 1,200 individual funds² were examined to see how management fees varied between funds in companies' ranges. Across the cross-border funds universe, the variation (standard deviation) of management fees was 19 basis points, yet 86% of individual groups had a variation in fee levels under 15 basis points and the group-by-group average variation was 9 basis points. Across the UK funds universe, the standard deviation of management fees was 11.5 basis points, yet 76% of individual groups had a variation in fees of 10 basis points or less and the group-by-group average variation was 6 basis points. In addition, more than half the groups in the UK had identical management fees across their range, while this was the case for around a quarter of the cross-border groups.

In other words, this analysis shows that there is very little variation between fees for actively managed equity funds within the vast majority of these companies' ranges.

Of course, fund providers may well say that all funds in their ranges are equally good. However, in an environment where more funds are being closed than launched, this argument seems unlikely to hold water for very many companies.

For cost-conscious investors, one positive angle is the growing number of providers that can offer lower cost ETFs or index trackers alongside their actively managed funds. For example, BlackRock/iShares, DWS/db x-trackers, HSBC, Société Générale/Lyxor, UBS. However, such commission-free products have had inevitable distribution issues when trying to reach European retail investors³. Partly as a result, ETFs in Europe have achieved the vast majority of their recent sales from institutional investors.

Following on from this, there looks to be the start of a trend of ETFs being wrapped into other products that may be presented as a 'solution' with different asset allocation profiles to meet different investors' risk tolerance levels — together with an accompanying fee for the asset allocation. This has been done both by financial advisers/wealth managers, as well as fund providers (eg 7IM Asset Allocated Passives; Credit Suisse Index Selection).

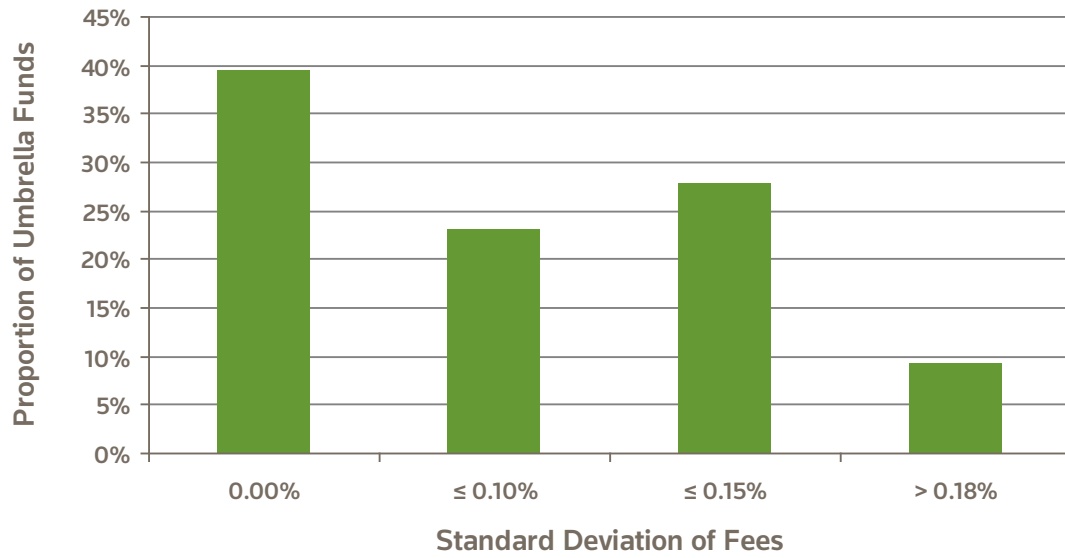
“There is very little variation between fees for actively managed equity funds within the vast majority of these companies' ranges.”

2) Luxembourg or Dublin umbrella funds with the largest equity assets from UK or US promoters, as well as the largest OEIC umbrellas in the UK.

3) Fee-based advisers have been much more likely to use such passive products and, to this end, these and other commission-free funds are predicted to see increasing interest in the wake of the FSA's Retail Distribution Review in the UK.

FIGURE 1 MANAGEMENT FEE VARIATIONS

Figure 1 illustrates the variation of fees within Cross-border and UK fund ranges



WILL FUND FEES FALL?

Some of the original thinking driving the inclusion of fund merger provisions within Ucits IV was that Europe-wide fund rationalisation would increase average fund sizes, thus increasing economies of scale, which could be passed on to investors in the form of lower Total Expense Ratios (TERs).

Gazing into a crystal ball, our analysis shows that if all cross-border groups merged their domestic European funds⁴ into their cross-border ranges, numbers could reduce by 6,500 funds, ie 25% of the European funds universe. To put this into context, the current rate of fund closures and mergers this year will result in a net reduction of less than 1,500 funds in Europe by the year-end (once fund launches have also been taken into account).

The question remains whether a smaller industry with a larger average fund size really will result in lower average annual costs for investors.

Previous analysis⁵ shows that larger funds do tend to have lower average TERs than the smallest funds, but this is partly explained by the disproportionately high expenses borne by the latter. As fund assets continue to rise among funds above €50m, fund expenses borne by investors do not continue to fall and, more importantly, management fees remain largely the same regardless of fund assets⁶. This suggests that the industry is unable (or unwilling) to reduce management fees even for the largest funds. For the industry as a whole to apply downward pressure on annual charges borne by investors, management or distribution fees would need to be reduced.

Part of the difficulty in assessing the shape and dynamics of the European funds industry lie in the distorted view observers gain if they look solely at its size in terms of the number of funds. Around 65% of funds are under €50m in size (and 45% below €20m), but this neglects the fact that the largest companies – and their larger funds – dominate. Re-working the same data to better reflects the larger companies' perspective reveals that 60% of industry assets are in funds over €500m and a further 20% of assets come from funds over €200m. In this way one can see that around 80% of industry assets are held in less than 15% of the industry's funds.

This highlights that the industry, with low barriers to entry, has a long 'tail' of participants. In other words, the number of fund companies with just a handful of funds is large. At the other end of the scale, just 4% of fund groups manage around 80% of European mutual fund assets. If the bulk of investors are to benefit from lower fund costs, then this will have to be driven by these larger companies – or by investors voting with their feet. Certainly no company has yet been able to win market share – and thus enter the larger echelons of the industry – by charging below-average fees (relative to their peers).

4) This excludes guaranteed funds with a fixed maturity and so are opened and closed on a regular basis.

5) See Lipper, Profiting from Proliferation? (June 2009)

6) Unlike in the US, see Lipper, *ibid*.

"A European price war won't be happening any time soon."

... or are fees falling already?

Perhaps the trend to lower fees has already begun. Perhaps the debate over economies of scale is already redundant. Some funds — notably cross-border players — have recently lowered their management fees, while in the UK competition seems to have heated up in relation to passively managed funds and the words ‘price war’ have passed the lips of a fair few onlookers.

Looking a little closer, the picture is not as rosy as it might first seem. Lowering of management fees is significantly weighted to bond and money market products. Particularly for the latter, and particularly for institutional investors (the core money market investors in Europe), this is not really new. As for bond funds, much of the attention has been focussed on those targeting the German market. But this looks to bear out a trend already underway: while bond fund fees and expenses did indeed rise during the late 1990s and into the new century⁷, over the past few years the trend has been relatively flat.

In contrast, the trend for German equity funds has continued upwards (albeit more slowly) through recent years too. Competition from foreign funds being sold into Germany has been much fiercer over the years on the equity side, with annual fees rising in order to maximise the chance of distributors considering a company’s funds. But for products with lower expected returns – bond and money markets – the argument that ‘every basis point counts’ has been more persuasive, particularly at a time when competition in the fixed income arena has got hotter and ongoing positive returns remain difficult to come by.

Where a fund lowers its management fees, it is worth keeping an eye out for whether this moves a high charging fund closer to its sector average or whether the fund is undercutting its competitors.

The second possible arena where there may be evidence of a ‘price war’ is in the UK. Here investors now have a range of different passively-managed fund products with low annual charges, both ETFs

and index tracking funds. But do the range of circumstances that brought this about, including the FSA’s Retail Distribution Review (RDR), really mean that fund companies are now slugging it out to lower their charges?

Looking at some of the evidence, one sees that Vanguard entered the European funds industry nearly ten years ago, at around the same time that ETFs first listed in Europe. Then five years ago Fidelity slashed the annual charges on its UK tracker fund. Most recently, in 2009, Vanguard established some UK-domiciled funds and HSBC took the hammer to the charges on its index tracking funds (originally launched 10 and 20 years ago). One would be hard pushed to say that such changes were at anything more than a pedestrian pace. This was the pace despite the fact that Fidelity’s action in 2004 clearly led to a significant increase in sales for its fund⁸.

Following on from this, it is worth reflecting that Vanguard, having established its position in the US funds industry as the premier low-cost fund provider, has not taken the same approach to creating a business Europe. A high profile advertising campaign targeting retail investors in the US has been replaced by a more ‘niche’ approach in Europe, targeting institutional investors and HNWIs and, in the UK, aiming to capitalise on the shift to a fee-based advisory model in light of the RDR⁹. The lack of an equivalent to the US 401(k) retirement plan must be playing its part here: it does not appear to be possible to deliver successfully a low cost product range across Europe to a retail audience.

The balance of European equity funds remain weighted to actively managed products, certainly on the retail side of the business. And even when ETFs gathered inflows in 2008, while actively managed funds suffered, these remain a strongly institutional product and one that, while growing, is currently a drop in the mutual funds ocean. For retail investors, one has to conclude that a European price war won’t be happening any time soon.

7) See Lipper, Fee Trends in European Funds (December 2008)

8) See Lipper, Review of UK Fund Fees (April 2009)

9) One stated aim of the RDR is to ‘reduce the conflicts of interest inherent in remuneration practices and improve transparency of the cost of all advisory services’.

FIGURE 2 NET SALES OF EUROPEAN EQUITY FUNDS



HEADS I WIN, TAILS YOU LOSE?

The rise of funds seeking 'absolute' returns, as well as the rising number of hedge fund managers looking to enter the Ucits arena, has moved the issue of performance fees into the spotlight. The decline in revenues resulting from the decline in fund assets over the past two years will also have focused the minds of many asset managers who are now trying to increase revenues. Our data shows that among 130/30 funds and absolute return funds in Europe, around 40% of both universes have performance fee structures in place.

On the basis that virtually all performance fees in Europe only have an upside (ie there is not an equivalent fee deduction when a fund underperforms¹⁰, concerns remain that there is a lack of investor understanding surrounding performance fees. The ultimate litmus test is whether the performance fee structure really aligns the interests of investors with those of the manager.

Starting with the basics, the most commonly quoted fee structure for a hedge fund is '2 and 20'. This is the shorthand for a 2% annual management fee and an additional 20% fee charged on gains that the fund achieves. For example, if a manager generates performance of 15% over one year, then the fund will garner an additional 2.6% in performance-related fees, bringing total management and performance fees to 4.6% for the year. In this way the fund investor will receive a one year return of 10.4%.

While a potential investor should check both of these headline rates, the underlying structure of the performance fee can make a huge difference to the fees generated. The structure will address both how much will be accrued (for example, will the performance fee rate be applied to all returns, or only those above a benchmark?), as well as when it will be accrued (for example, does the fund have to exceed its previous High Water Mark?).¹¹

The appropriateness of benchmarks used by some funds is one aspect where questions should be raised. Under the stated aim of seeking absolute returns, some funds have benchmarked their performance fee to an interest rate measure, collected performance fees for doing so, and then lost money for investors (notably over the second half of 2008), but still ended up with inflated fee revenues. The prospect of performance fees being charged on portfolios of passively managed funds is another area that should generate concern.

Looking at the associated fixed management fees, there is no clear evidence that funds with performance fees charge lower annual management fees than those funds without performance fees. Latest analysis of cross-border funds suggests that management fees for equity funds with or without performance fees both average a few basis points within 1.60%. Furthermore, additional operating costs tend to be higher for funds with performance fees. Of course there are funds that keep their management fees below the sector average, which emphasizes that a rigorous examination of funds' fee structures is worth its weight in gold.

"The ultimate litmus test is whether the performance fee structure really aligns the interests of investors with those of the manager."



SOURCE: REUTERS/ELOY ALONSO

10) Unlike 'fulcrum' fees found in the US, see Lipper, Paying for Performance (June 2008).

11) For detailed analysis of performance fee structures, please ask for more information on Lipper's Benchmarking Performance Fees report and database.

INVESTORS' PERCEPTION OF FUND COSTS

Understanding investors' perception of fund costs is sometimes overlooked, with the debate instead focussing on what is disclosed or how different funds compare.

Perceptions of cost are obviously not always instinctive. There is not a single price tag for a mutual fund – there cannot be – and many investors may even think of the 'cost' as the amount they have invested in a mutual fund. Others may think of the cost as simply the initial charge. Of course investors may be right to think of funds in this way and to be content as long as returns they receive are acceptable or in line with their expectations over a certain timeframe.

But many investors do worry about the fees paid to fund companies when their funds' returns are low or negative. It is at this time that Seneca's words echo down the ages: *sera parsimonia in fundo est* (thrift is too late at the bottom of your purse¹²).

For investors to become more pro-active on fees, greater understanding of the 'drag' effect of charges over the longer term would seem to be needed. In the same way the 'mutual' nature of funds is perhaps lacking among retail investors: 0.5% may not seem much to a retail investor with €10,000, but the same investor probably has little awareness that it means €2.5m each year for the manager of a €500m fund.

Or perhaps investors' cost sensitivity is as cyclical, as that of fund companies? Business costs are likely to be cut when markets are tougher to try and maintain profitability levels, rather than as a result of a desire to act in the best interests of long-term investors. (TERs are more likely to rise as fund assets fall, rather than vice-versa).

The question might well be posed as to whether someone else ought to be acting on behalf of investors in relation to the fund's fee and expense levels – a fiduciary responsibility. Such a role is undertaken by a mutual fund's board of directors in the US, a majority of whom must be independent of the company managing the fund.¹³ While fund boards may well examine fee levels in Europe, such an undertaking is very much up to individual directors to interpret as they see fit.

Interestingly, when OEICs (open-ended investment companies) were created in the UK the potential to create independent directors was enshrined, but if any OEICs have chosen to take this course they remain below the radar. OEICs instead rely on the fund company itself to act as the Authorised Corporate Director (ACD). Staying in the UK, closed-ended funds (commonly known as investment trusts) espouse the

"Seneca's words echo down the ages: sera parsimonia in fundo est"

¹²) Seneca, *Epistulae morales ad Lucilium*.

¹³) The way that fee levels are assessed by the fund board is currently being examined by the US Supreme Court.

benefits of having independent directors as one of the reasons for this sector’s relatively low annual charges — although the lack of annual distribution fees and relatively high average fund sizes plays a significant part.

In contrast, the US regulator (Securities & Exchange Commission) has been very clear in its views and why oversight of fund company decisions is necessary: “the role of fund directors is particularly critical in the mutual fund context because almost all funds are organized and operated by external money-management firms, thereby creating inherent conflicts of interest and potential for abuse.”¹⁴

FIGURE 3 DRAG EFFECT OF FUND CHARGES

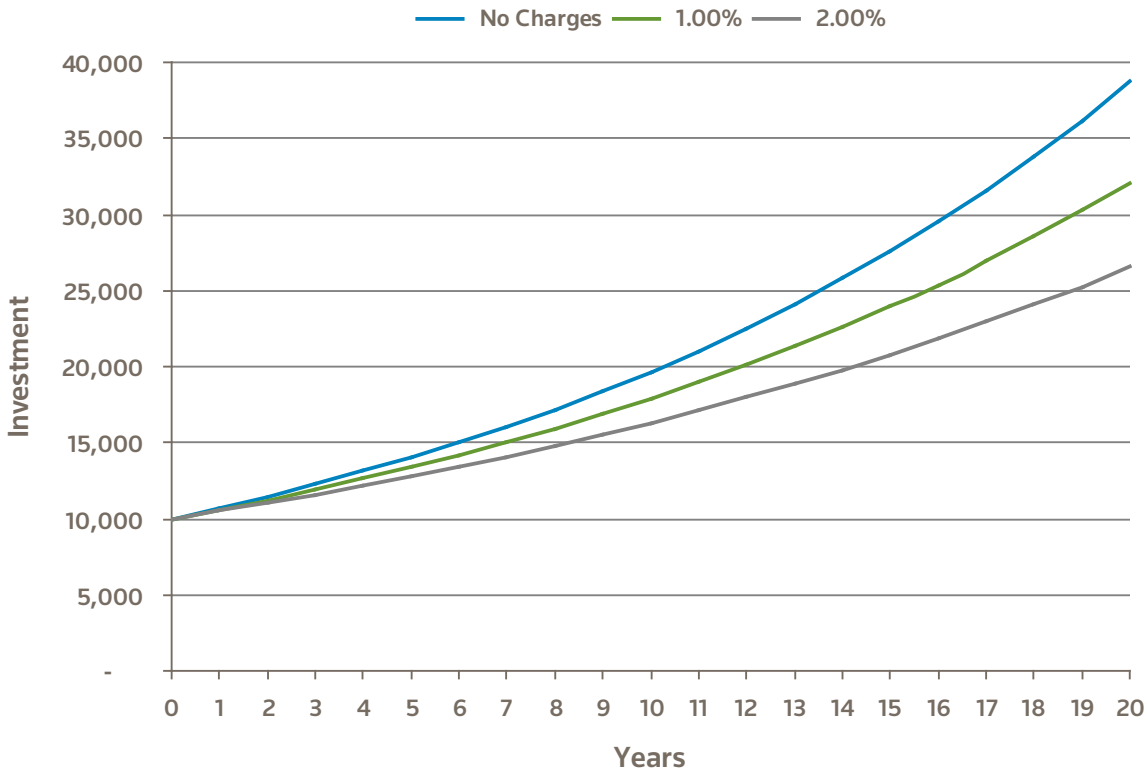


Figure3 illustrates the drag effect of annual fund charges on a manager’s performance of 7% p.a.

14) William Donaldson, then Chairman of the SEC, 7 January 2004.

LIVING HAPPILY EVER AFTER?

This paper has used new analysis of fees and expenses data to shine a light into different corners of the funds industry. The final comments below reflect on the key areas where changes could be achieved.

While it may be that investors have to pay more to get better returns (although such analysis lies outside the scope of this report), currently the majority of those umbrella ranges assessed have their fees set at a company level, not at individual fund level. This would suggest an investor can just as easily pay more and get less.

This first finding is even more relevant as it relates to those companies with larger fund ranges, precisely the same types of companies that control the vast majority of European industry assets and so determine the fees that most investors pay. Generally larger funds do not continue to pass on economies of scale to investors as their assets rise, most notably in relation to management fees. If fees are to fall, this will have to change.

These findings pose questions relating to scale, investor attitudes, and fund governance.

Looking at the issue of scale, one cannot assume that the current reduction in the number of funds (if this trend turns out to be more deep-seated) will lead to lower costs for retail investors. There will remain a large number of small companies, while distribution (and its associated costs) for the larger companies will remain paramount.

Having said this, there are more indications of lower annual fees in some areas, although this is not across the board and is not fundamentally changing industry conventions. Any notion of a 'price war' is premature.

Caution in predicting lower industry-wide fees is supported by the greater willingness of fund companies to establish performance-related fees. Such fees are not new, but their use is rising, so the current lack of understanding will become

“There continue to be lower cost funds available for those investors willing to look”

increasingly problematic. The appropriateness of fee benchmarks is just one area of particular concern.

Of course there continue to be lower cost funds available for those investors willing to look. This simply adds to the broader conclusion that retail investors remain largely insensitive to fund costs. This may be justified — certainly if investors are happy with the service/products they receive — and there may well be no sound business case for fund companies to change their attitudes to the fees they charge. This latter point goes to the heart of predicting a continued upward trend in industry fee levels.

The options for those overseeing the industry range from, at one end of the scale, the liberal view of providing relevant information to investors and then letting 'the market' decide what fees are appropriate, to the other end of the scale, where the regulator's involvement increases dramatically to decide either the way that fees are charged or even how high fees can be. Requiring fund directors to interpret their fiduciary responsibility as relating to the fees their shareholders bear can be seen as a middle course between the two extremes. It certainly seems both relevant and timely to consider this more closely.