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Performance Fees and Expense Ratios

The Investment Company Institute has analyzed trends in mutual fund fees and expenses in a series of reports over the past five years.¹ This research has found that the total cost of investing in mutual funds has declined significantly since 1980. In addition, research shows that mutual fund expenses generally exhibit economies of scale: Large funds have lower expense ratios than small funds, and expense ratios of individual funds tend to decline as assets increase. Similar results have been reported in other studies.²

The General Accounting Office (GAO) recently published a widely cited study with results seemingly inconsistent with those earlier studies. The GAO's study, which updated a study of mutual fund expenses it had produced in June 2000, found that the average expense ratio³ of 46 large equity funds rose nearly 8 percent between 1998 and 2001 even as assets of these funds increased during the same period.⁴

The GAO's 2003 study, though technically correct, omitted an important explanation. This issue of *Fundamentals* shows that the increase in the average

expense ratio of the 46 equity mutual funds studied by the GAO was due entirely to "performance fees." Ten of the funds in the GAO's sample have management contracts that in part link their expense ratios to fund performance. Owing to relatively weak performance, the expense ratios of those 10 funds were depressed in 1998. In contrast, by 2001 those same 10 funds had been experiencing relatively strong performance, leading to higher expense ratios. On net, the performance-related swing in the expense ratios of these 10 funds from 1998 to 2001 caused the average expense ratio of the 46 large funds to increase. If the effects of performance fees are excluded, the average expense ratio of the 46 funds declined from 1998 to 2001 (Figure 1).

The Effect of Performance Fees on Expense Ratios

A fund's payments to its investment adviser for investment advisory, administrative, and other services typically account for the majority of its

¹ See John D. Rea and Brian K. Reid, "Trends in the Ownership Cost of Equity Mutual Funds," *Perspective*, Vol. 4, No. 3, November 1998 (www.ici.org/pdf/per04-03.pdf); John D. Rea and Brian K. Reid, "Total Shareholder Cost of Bond and Money Market Mutual Funds," *Perspective*, Vol. 5, No. 3, March 1999 (www.ici.org/pdf/per05-03.pdf); John D. Rea, Brian K. Reid, and Travis Lee, "Mutual Fund Costs, 1980–1998," *Perspective*, Vol. 5, No. 4, September 1999 (www.ici.org/pdf/per05-04.pdf); Investment Company Institute, "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals*, Vol. 11, No. 4, September 2002 (www.ici.org/pdf/fm-v11n4.pdf).

² For example, in a June 2000 report entitled *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, the GAO found that the asset-weighted average expense ratio of the 46 largest equity mutual funds in existence from 1990 to 1998 declined 12 percent during that period as assets increased. In a December 2000 report, the U.S. Securities and Exchange Commission reported that large funds typically had lower expense ratios than small funds, and that fee levels of many of the largest mutual funds fall automatically as fund assets surpass a given level. In 2001, Michele LaPlante, ("Influences and Trends in Mutual Fund Expense Ratios," *Journal of Financial Research*, vol. XXIV, no. 1, Spring 2001, pp. 45–63) found that average expense ratios of mutual funds generally declined from 1994 to 1998 when funds are grouped by broad investment objectives (such as domestic equity, international equity funds, corporate bond, municipal bond, and so on).

³ Throughout this paper, average refers to an asset-weighted average.

⁴ General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure*, March 2003, available at www.gao.gov, pp. 6–8.

figure 1

Average Expense Ratios for 46 Large Equity Mutual Funds,¹ 1998–2001

	1998	1999	2000	2001
Expense Ratio ²	65	63	67	69
Performance Fee	-3	-3	0	2
Expense Ratio less Performance Fee	68	66	67	67
Memo: Assets (billions of dollars)	831	1,024	1,189	1,000

¹ The 46 large equity funds are the largest stock and hybrid funds as of February 1999 that had been in existence since 1990. For funds with multiple share classes, the largest share class was used. The list of these 46 large funds was obtained from the GAO, and constitutes the same sample that the GAO used in its 2003 study. However, the figures shown are compiled by the Investment Company Institute from data provided by Lipper Associates, Inc. and is supplemented by annual reports of selected funds.

² The GAO reported that the average expense ratio for the 46 funds was 70 basis points in 2001. ICI finds an average expense ratio of 69 basis points for 2001 for the same 46 large funds, relying on expense ratios and assets from ICI's own database and annual reports of selected funds. This resulted in minor differences between ICI's and the GAO's average expense ratio and assets.

note: Figures are asset-weighted averages.

sources: Lipper Associates, Inc., Investment Company Institute

operating expenses.⁵ Advisory fees are usually computed as a percentage of fund assets; many funds employ a declining rate structure under which the percentage fee rate decreases at designated breakpoints as assets increase.⁶

Advisory fees of some funds, including several of the largest equity funds, are also adjusted based on the fund's performance. Fees adjusted in this manner are known as "performance fees." With performance fee arrangements, the advisory fee rate is increased whenever the fund's return exceeds a stated benchmark over a specified period. The fee rate is symmetrically reduced when the fund's performance falls short of the benchmark.⁷

Performance fees can significantly affect a fund's expense ratio. A fund with performance fees that has performed better than its benchmark will see a rise in its advisory fee and thus its expense ratio; conversely, a fund with performance fees that has performed poorly relative to its benchmark will experience a drop in its advisory fee and expense ratio.

The GAO's 2003 study found that the average expense ratio of the 46 large equity funds in its sample rose from 65 basis points⁸ in 1998 to 70 basis points in 2001.⁹ However, 10 of the funds in the GAO's sample had performance fee arrangements, and these arrangements accounted for all of the increase reported by the GAO. Owing to weak performance relative to their benchmarks, the expense ratios of the 10 funds with performance fees were depressed in 1998. Consequently, performance fees reduced the average expense ratio of the 46 funds by 3 basis points in 1998. In contrast, by 2001, the 10 funds with performance fees had generally outperformed their benchmarks, thus boosting their expense ratios. As a result, in 2001, performance fees added 2 basis points to the average expense ratio of the 46 equity funds in the GAO sample.

The swing in performance fees between 1998 and 2001 totaled 5 basis points overall and thus accounted for the increase in the average expense ratio of the 46 funds during this period. Removing the performance fee component from the expense ratio results in a decline of 1 basis point in the average expense ratio of these funds.¹⁰

⁵ Operating expenses refers to a fund's expenses other than Rule 12b-1 fees. Rule 12b-1 fees are used primarily to compensate sales professionals, such as broker-dealers, for assistance given to buyers of fund shares.

⁶ See John D. Rea, Brian K. Reid, and Kimberlee W. Millar, "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds," *Perspective*, Vol. 5, No. 5, December 1999, p. 4 (www.ici.org/pdf/per05-05.pdf).

⁷ Under the Investment Advisers Act (1940), any performance fee charged to a mutual fund (other than a fund all of whose shareholders are "qualified clients" as defined by the SEC) must be a "fulcrum fee." A fulcrum fee is one that increases or decreases *proportionately* with the investment performance of the fund as compared to the specified benchmark. In other words, the performance fee must be applied in a symmetric manner.

⁸ One basis point equals 0.01 percent.

⁹ The GAO reported that the average expense ratio for the 46 large funds was 70 basis points in 2001. However, Figure 1, which is ICI's calculation of the expense ratio of the same 46 large funds, finds the average expense ratio for the 46 funds to be 69 basis points in 2001. Although the GAO provided ICI with the names of the 46 funds used in its study, ICI obtained expense and asset data on the 46 funds from its own database. This resulted in some minor differences between ICI's and the GAO's computations for the average expense ratio and assets. Sources of data used by ICI are from Lipper Associates, Inc. and were supplemented by annual reports of selected funds.

¹⁰ Alternatively, if the 10 funds with performance fees are excluded from the analysis, the average expense ratio for the remaining 36 funds declines by 2 basis points from 1998 to 2001.