# Section 5:
# Mutual Fund Fees and Expenses

Mutual fund investors, like investors in all financial products, pay for services they receive. This section provides an overview of mutual fund fees and expenses.


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Mutual fund investing involves two primary kinds of fees and expenses: sales loads and ongoing expenses. Sales loads are one-time fees—paid directly by investors either at the time of share purchase (front-end loads) or, in some cases, when shares are redeemed (back-end loads). Ongoing fund expenses cover portfolio management, fund administration, daily fund accounting and pricing, shareholder services such as call centers and websites, distribution charges known as 12b-1 fees, and other miscellaneous costs of operating the fund. Unlike sales loads, ongoing expenses are paid from fund assets and thus investors pay them indirectly. A fund's expense ratio is its annual ongoing expenses expressed as a percentage of fund assets.

Fund expenses vary depending on many factors, including the type, level of assets, and average account size of the particular fund. Whether funds are distributed directly to shareholders or through intermediaries—who provide investors with initial and ongoing investment advice and service—also affects fees and expenses.

To understand trends in mutual fund fees and expenses, it is helpful to capture and combine major fund fees and expenses in a single measure. ICI created such a measure by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads. This measure gives more weight to those funds that have the most investor assets.

**For the latest ICI research on fund fees and expenses, visit the Institute's website at**

WWW.ICI.ORG/ISSUES/FEE/INDEX.HTML

## Trends in Mutual Fund Fees and Expenses

Mutual fund fees and expenses that investors pay have trended downward over the past 25 years. In 1980, investors in stock funds, on average, paid fees and expenses of 2.32 percent. By 2005, that figure had fallen by half to 1.13 percent. Fees and expenses paid on bond funds have declined by a similar amount.

Several reasons explain the dramatic drop in the fees and expenses that investors incur. First, shareholders pay much less in sales loads than they did in 1980. For example, the maximum front-end load that an investor might pay has fallen from an average of 8 percent to 5 percent. The front-end loads that shareholders actually paid have fallen even more, from 5.6 percent in 1980 to only 1.25 percent in 2005. A key factor in the steep decline in loads paid has been the growth of mutual fund sales through employer-sponsored retirement plans, since load funds often do not charge loads for purchases of fund shares through such retirement plans.

### More Info: Trends in Fees and Expenses

*See the October 2005* Fundamentals *at www.ici.org/pdf/fm-v14n6.pdf for more information on the 25-year downward trend in mutual fund fees and expenses.*

### Fees and Expenses of Stock and Bond Mutual Funds Declined Over 25 Years

*(percent, selected years)*

**Stock Funds***

**Bond Funds***

**asset-weighted average of annual expense ratios and annualized loads for individual funds*

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Another reason for the decline in the fees and expenses of investing in mutual funds has been the growth in sales of no-load funds. Again, much of the increase in no-load sales has occurred through the employer-sponsored retirement plan market. In addition, no-load sales have expanded through mutual fund supermarkets and discount brokers.

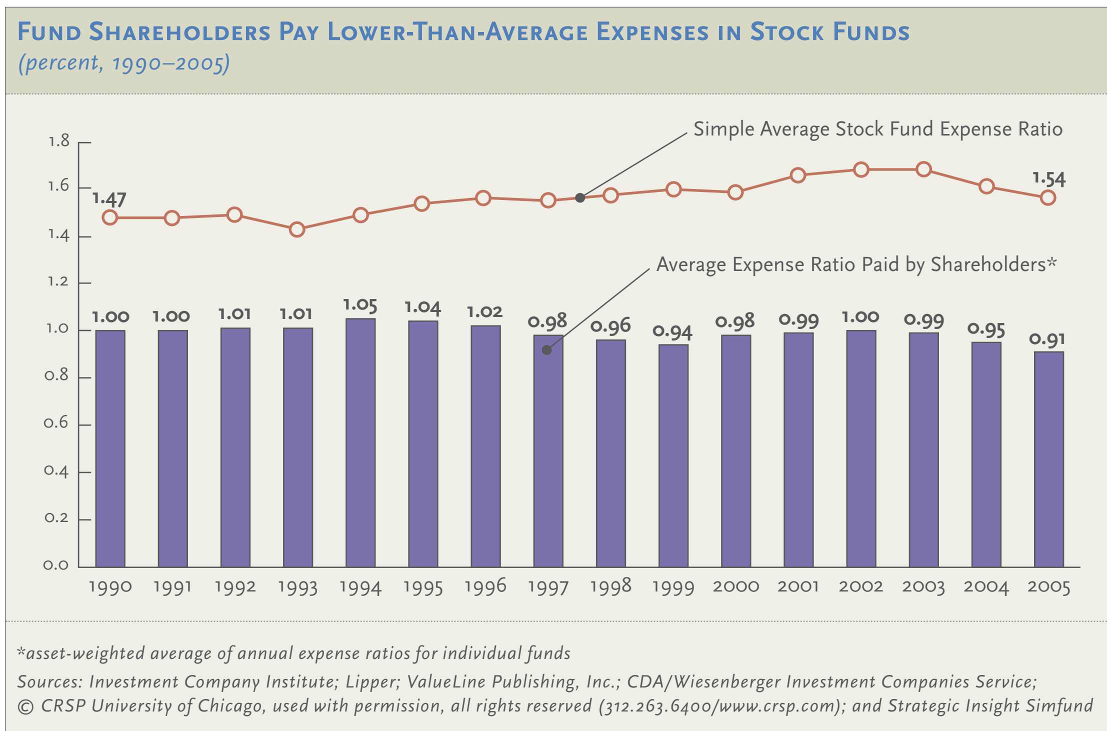
Finally, mutual fund fees have been pushed down by economies of scale and intense competition within the mutual fund industry. This is true even though the demand for mutual fund services increased sharply over the past 25 years. For example, from 1980 to 2005, the number of households owning mutual funds rose from 4.6 million to 53.7 million and the number of shareholder accounts rose from just 12 million to more than 275 million.

Ordinarily, such a sharp increase in the demand for fund services would have tended to limit decreases in fund fees. This effect, however, was more than offset by the downward pressure on fund fees from intense competition among existing fund sponsors, the entry of new fund sponsors into the industry, and economies of scale resulting from the growth in fund assets.

## Shareholder Demand for Lower-Cost Funds

ICI research indicates that mutual fund shareholders are predominantly invested in funds with low expense ratios. This concentration of low-cost funds can be seen by comparing the average expense ratio charged by mutual funds with the average expense ratio mutual fund shareholders actually paid.

**Fund Shareholders Pay Lower-Than-Average Expenses in Stock Funds**
*(percent, 1990–2005)*




*asset-weighted average of annual expense ratios for individual funds

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The average expense ratio of stock funds (as measured by a simple average across all stock funds) was 1.54 percent in 2005. The average expense ratio that stock fund shareholders actually paid (the asset-weighted average expense ratio across all stock funds) was considerably lower, just 0.91 percent. This indicates that the expense ratios actually paid by investors were on average lower than those available in the mutual fund marketplace.

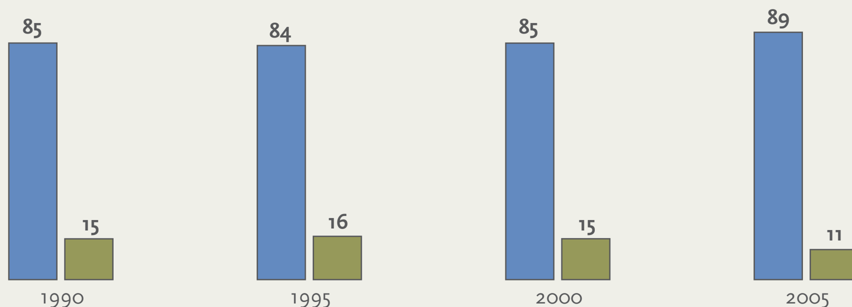
Another way to illustrate that investors tend to hold mutual funds with low expense ratios is to identify where they hold their mutual fund assets. In 2005, nearly 90 percent of stock fund assets were in funds with below-average expense ratios.

## Financial Adviser Compensation

Many mutual fund investors use and pay for the services of a professional financial adviser. ICI research finds that approximately 80 percent of mutual fund investors seek professional advice when buying mutual fund shares outside of retirement plans at work. Financial advisers typically devote time and attention to prospective investors before they make an initial purchase of funds and other securities. The adviser generally meets with the investor, identifies financial goals, analyzes existing financial portfolios, determines an appropriate asset allocation, and recommends funds to help achieve these goals. Advisers also provide ongoing services, such as periodically reviewing investors' portfolios, adjusting asset allocations, and responding to customer inquiries.

### Stock Funds With Below-Average Expense Ratios Hold Nearly 90 Percent of Assets
*(percent, selected years)*

Percent of Assets in Funds With Below (Simple) Average Expense Ratios
Percent of Assets in Funds With Above (Simple) Average Expense Ratios

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## A Look at the Fees and Expenses of S&P 500 Index Mutual Funds

There are more than 8,000 mutual funds available to investors and no two are identical. Mutual funds vary in terms of size, investment objective, and the services they provide to shareholders and, consequently, in the fees and expenses that they charge.

The variety of S&P 500 index mutual funds illustrates this concept. All S&P 500 index mutual funds, by far the most common type of index mutual fund, share the goal of mirroring the return on the S&P 500 index, a well-known, unmanaged index of 500 large-cap stocks. As a result, S&P 500 index mutual funds all hold essentially identical portfolios.

Nevertheless, S&P 500 funds differ from one another in important ways. Some S&P 500 funds are very large—among the largest of any mutual funds—while other S&P 500 funds are quite small. Average account balances also range widely for S&P 500 index funds, from about $2,000 for some retail funds to over $100 million among S&P 500 funds that cater to institutions. These funds also differ in terms of certain fees that investors may pay directly (such as account maintenance fees), minimum initial investments, and other features. Finally, some S&P 500 funds are sold bundled with advice (load funds), while others are not (no-load funds).

*(continued on next page)*

### Investor Assets Are Concentrated in S&P 500 Index Mutual Funds With the Lowest Expense Ratios

*(percent of total assets of S&P 500 index mutual funds, 2005)*

*Sources: Investment Company Institute and Lipper*

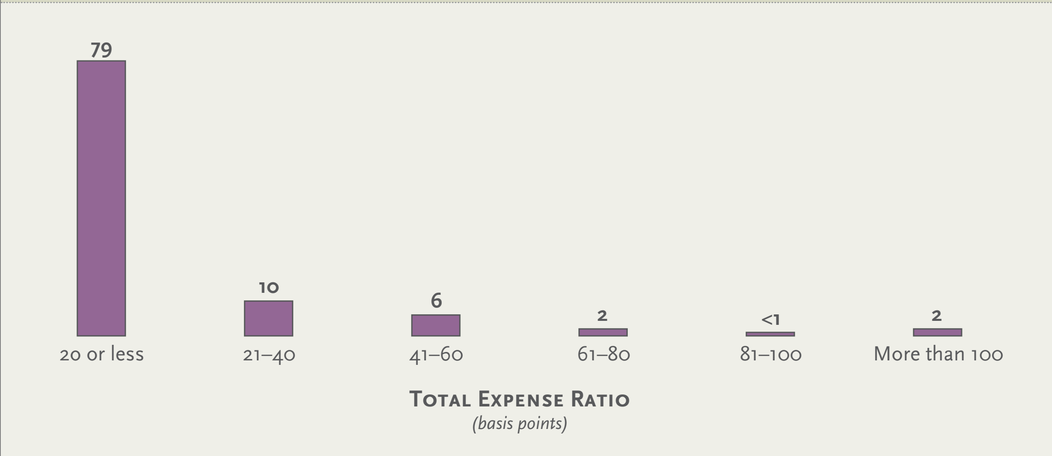
Because S&P 500 index funds are not all identical, their expense ratios differ. Large funds and funds with high average account balances tend to have lower-than-average expense ratios because of economies of scale. Funds sold bundled with advice tend to have higher expense ratios than comparable funds sold without advice in order to compensate financial advisers for the planning, advice, and ongoing service that they provide to clients. Retail investors who purchase no-load funds either do not use a financial adviser or use a financial adviser but pay the adviser directly.

Investors favor the least costly S&P 500 funds. For example, in 2005, the great majority of the assets that investors held in S&P 500 index funds were held in low-cost funds (those with expense ratios of 20 basis points or less). Similarly, low-cost funds have garnered the bulk of investors' net new purchases of shares of S&P 500 index mutual funds. From 1997 to 2005, about 80 percent of the total net new cash flow to S&P 500 funds went to those funds with expense ratios of 20 basis points or less.

For more information about S&P 500 index funds, see the August 2005 *Perspective* at www.ici.org/pdf/per11-03.pdf.

### Investors' Net New Purchases of S&P 500 Index Mutual Funds Are Concentrated in Least Costly Funds

*(percent of net new cash flow of S&P 500 index mutual funds, 1997–2005)*




*Sources: Investment Company Institute and Lipper*

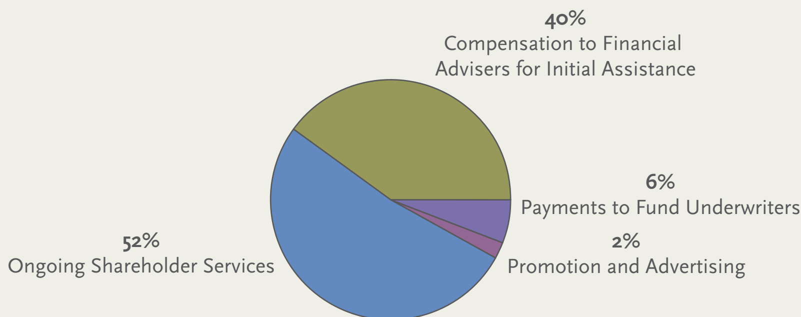
Until about 25 years ago, fund shareholders could only compensate financial advisers for their assistance through a front-end sales load—a one-time, upfront payment made to financial advisers for both current and future services. After 1980, when the U.S. Securities and Exchange Commission (SEC) adopted Rule 12b-1 under the Investment Company Act of 1940, funds and their shareholders had greater flexibility in compensating financial advisers. The adoption of this rule, and subsequent regulatory action, established a framework under which mutual funds pay for some or all of the services that financial advisers provide to shareholders through so-called 12b-1 fees.

This framework also allows mutual funds to use 12b-1 fees to compensate other financial intermediaries, such as retirement plan recordkeepers and discount brokerage firms, for services provided to fund shareholders, and to pay for advertising, marketing, and other sales promotion activities.

Nevertheless, most of the 12b-1 fees collected by funds are used to compensate financial advisers and other financial intermediaries for assisting fund investors before and after purchases of fund shares. Furthermore, only a small fraction of the 12b-1 fees that mutual funds collect is used for advertising and promotion.

### Most 12b-1 Fees Used to Pay for Shareholder Services

*(percent of 12b-1 fees collected, 2004)*

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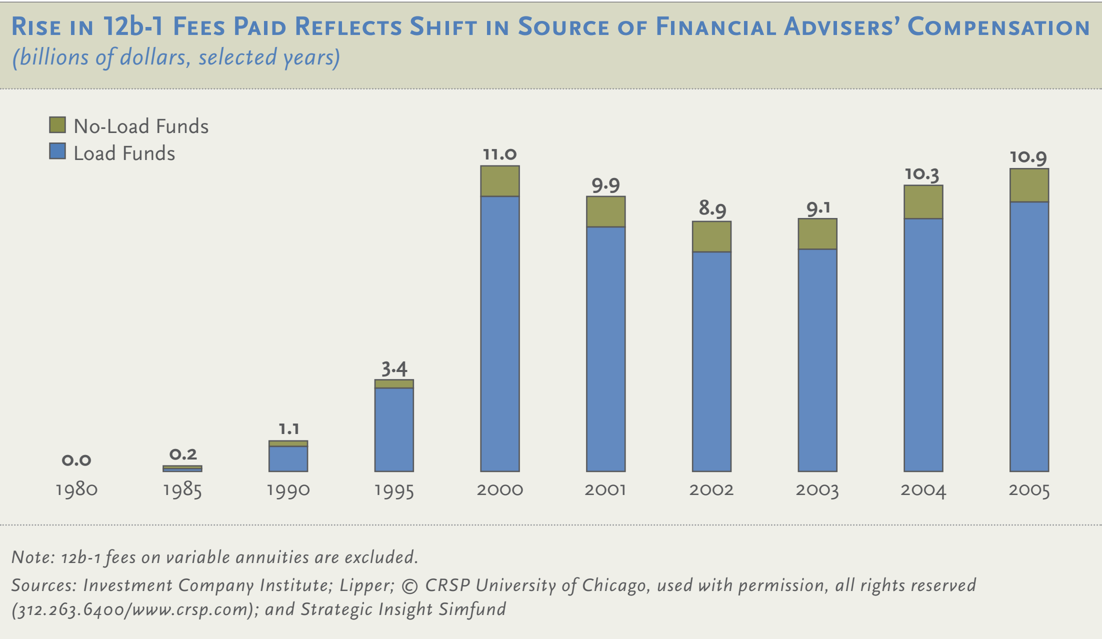
The amount of 12b-1 fees that shareholders pay through mutual funds has risen from a few million dollars in the early 1980s to almost $11 billion in 2005. This increase, in part, reflects the 60-fold growth in mutual fund assets and the 12-fold increase in the number of households owning funds since 1980. The increase in total 12b-1 fees also reflects a shift by mutual funds and their investors from front-end sales loads to 12b-1 fees as a mechanism to compensate financial advisers. As funds have added 12b-1 fees, the typical front-end sales load has declined from 8 percent in 1980 to 5 percent in 2005. Most load funds now also offer classes of shares that have 12b-1 fees but no front-end loads.

**Rise in 12b-1 Fees Paid Reflects Shift in Source of Financial Advisers' Compensation**
*(billions of dollars, selected years)*




*Note: 12b-1 fees on variable annuities are excluded.*

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