ICI VIEWPOINTS

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Factors Contributing to the Decline of Expense Ratios in 2015

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ICI recently released its annual update on the expense ratios of mutual funds, showing expense ratios to be at their lowest levels in at least 20 years. Specifically, equity, bond, and hybrid mutual fund expense ratios all fell in 2015, while those of money market funds remained constant. Because we received a number of requests for additional details, we decided to create this *ICI Viewpoints* post.

Deconstructing the Asset-Weighted Average Expense Ratio

One issue, which we take up here, is precisely why expense ratios fell in 2015. The numbers we produce are asset-weighted averages across funds in a category. These averages could fall because the expense ratios of individual funds declined, or because fund assets shifted toward lower-cost funds, or both. Other possibilities are that new, lower-cost funds entered the market or that older, higher-cost funds left. So, which reason—or combination of reasons—was it?

To answer this question, we break the asset-weighted average expense ratio down into two components. The first component calculates the amount by which the asset-weighted average expense ratio declined because the expense ratios of individual funds fell. We do this by calculating what the asset-weighted expense ratio would hypothetically be if the expense ratios of individual funds had changed as they actually did between 2014 and 2015 but their assets remained unchanged.

Suppose, for instance, that the asset-weighted average expense ratio in reality declined by 4 basis points, while the hypothetical average that holds assets constant fell by 1 basis point. This would indicate that the asset-weighted average declined by 1 basis point because the expense ratios of individual funds declined.

The second component is just the difference between the fund's expense ratio and the first component. In other words, the second component accounts for all other factors that could have affected the asset-weighted average, including assets shifting toward lower-cost funds, higher-cost funds closing up, or lower-cost funds entering the business.

So, continuing with our hypothetical example, if the asset-weighted average fell 4 basis points and 1 basis point of that reflected declines in the expense ratios of individual funds, then the second component—reflecting factors such as assets shifting toward lower-cost funds—would account for 3 points of the 4-basis-point decline.

As it turns out, this analysis provides a mixed picture for 2015, with the results depending on the fund category. The average expense ratio for equity funds fell by 2 basis points in 2015 (see table below). Our analysis shows that this was primarily due to assets moving toward lower-cost funds (and other factors, laid out in the second footnote below), rather than the decline of individual fund expense ratios.

The outcome is similar for bond funds: the asset-weighted average expense ratio fell by 3 basis points, which almost entirely reflected a shift toward lower-cost funds (and other factors).

The results are rather different for hybrid funds. The asset-weighted average expense ratios of these funds fell by 1 basis point, with the majority of this fall—three-quarters of a basis point—attributable to declines in the expense ratios of individual hybrid funds.

Contributions Toward Declining Expense Ratios in 2015
Basis points

Category	Expense ratio 2014	2015	Total decline	Decline due to lower expense ratios in 2015[1]	Decline due to other factors[2]
Equity	70	68	2	0.20	1.80
Bond	57	54	3	0.05	2.95
Hybrid	78	77	1	0.75	0.25

[1]Tabulations are based on a consistent sample where a share class must exist in both 2014 and 2015.

[2]Other factors include movement to lower-cost funds, opening of new lower-cost funds, and closing of older higher-cost funds.

Note: Expense ratios are measured as asset-weighted averages. Data exclude mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

About Half of Equity, Bond, and Hybrid Fund Share Classes Saw Lower Expense Ratios in 2015

Another question we received was, what proportion of individual funds saw lower expense ratios? To answer this question, we had to determine whether or not each individual share class experienced a lower expense ratio. The table below shows the outcome: more than half of all the share classes of equity and hybrid funds saw lower expense ratios in 2015, while slightly less than half (46 percent) of bond funds experienced a decline in their expense ratios.

This means, of course, that about half of the share classes in each category had expense ratios that were either unchanged or perhaps rose a bit. This is not especially surprising. We have frequently noted that the expense ratios of individual funds typically rise and fall with their assets. If the assets in a given fund decline—either because of changes in overall market conditions, or because investors redeem shares, or both—the expense ratio of that fund is likely to rise, and vice versa. And, in any given year, some funds experience increases in assets while others see declines.

Majority of Fund Share Classes Experienced Lower Expense Ratios in 2015

Percentage of total share classes by fund category

	Percentage of share classes for which expense ratios in 2015:		
Category	*Fell*	*Were unchanged*	*Rose*
Equity	52	13	35
Bond	46	17	37
Hybrid	52	14	34

Note: Tabulations are based on a consistent sample where a share class must exist in both 2014 and 2015.

Sources: Investment Company Institute and Lipper

Of course, even as we look at these details, one overarching trend remains clear—the expense ratios paid by mutual fund investors continued to fall in 2015, as they have done for at least 20 years. The reasons for the decline in 2015, as in recent years, reflected a mix of two major factors: first, shareholders continued to shift assets toward lower-cost funds and, second, the expense ratios of some individual funds declined. No matter how you look at it, fund investors overall paid lower expense ratios.

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