Mutual Fund and Pension Fund Fee Levels Are Similar, ICI Research Study Finds, January 2004

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ICI Says a Three-Year-Old Article, Cited Recently by the New York Attorney General, Is Flawed and Misleading

Washington, DC, January 6, 2004 - A comprehensive economic study published today by the Investment Company Institute demonstrates that portfolio management fee levels at mutual funds and pension funds are quite similar. The ICI study refutes suppositions about pension fund and mutual fund fees first advanced in an Iowa law journal article and more recently cited by New York Attorney General Eliot Spitzer.

ICI economists discovered serious deficiencies in the Iowa article's methodology for evaluating the cost of managing investment portfolios. With respect to mutual funds, the ICI found that the Iowa article includes expenses unrelated to managing a mutual fund's investment portfolio. Conversely, with respect to pension plans, the Iowa article omits expenses that are directly relevant to managing pension portfolios. Sean Collins, the ICI economist who authored the study, said "because mutual funds and pension plans are structured so differently, an accurate comparison of their respective portfolio management costs requires a rigorous effort to isolate and evaluate each and every component of these costs."

ICI President Matthew Fink said "the Iowa article's flaws led to an 'apples-to-oranges' comparison that produced incorrect and seriously misleading conclusions." According to Fink, the ICI's concerns about the impact of the article's deficiencies have been borne out, as the article has been cited several times recently, including by the New York Attorney General.

Fink reiterated his view that government officials should be "vigorous and relentless" in pursuing wrongdoing by mutual funds. He also emphasized that enforcement and regulatory actions must be based on reliable facts and carefully reasoned analysis. "The ICI study is based on sound and thorough empirical evidence that documents and analyzes the cost of structural differences between mutual funds and pension plans. The Iowa article is surprisingly deficient in accounting for these differences. Initially, I viewed the Iowa article and its erroneous conclusions as unfortunate. More recently, as some government officials and others have been induced to rely on it, I increasingly view it as irresponsible."

The ICI study is entitled "The Expenses of Defined Benefit Pension Plans and Mutual Funds." Among its key findings are the following:

- Mutual funds and pension plans incur similar fees for the management of their investment portfolios. This finding, which directly contradicts the Iowa article's central thesis, is based on an 'apples-to-apples' analysis of pension plan and mutual fund fees for portfolio management services. The ICI found that such fees average 31 basis points (or 0.31 percent) for mutual funds and 28 basis points (or 0.28 percent) for pension plans. See pp. 7-8.
- Although pension plans on average have lower total operating expenses than mutual funds, mutual funds enjoy much lower expenses on a per-account basis. In 1998, public pensions plans incurred average expenses of $335 per account. Mutual funds incurred average expenses of $148 per account, more than 50 percent lower. The ICI study finds that five factors account for this divergence. Most notably, mutual funds manage "vastly more accounts" – including many with much lower balances than pension plans – facts that simultaneously increase a mutual fund's total operating expenses while lowering per-account costs. See pp. 8-11.
- The operating expenses of mutual funds declined as the assets they managed grew, reflecting the impact of economies of scale. See pp. 11-17.
- Despite some surface similarities, "mutual funds and pension plans have markedly different business objectives and

organizational structures," and "operate under dissimilar legal and regulatory frameworks." See pp. 3-5.

- The Iowa article reaches erroneous conclusions because its methodology for comparing portfolio management fees for mutual funds and pension plans is badly flawed. The Iowa article's mutual fund fee data includes more than the cost of providing portfolio management, and thus undermines its attempt to compare these costs accurately. See pp. 5-7.

A summary of the ICI's views about comparing the cost of mutual and pension funds follows.

The Iowa law journal study was co-authored by John Freeman and Stewart Brown. See "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," 26 Iowa Journal of Corporation Law 609 (Spring 2001).

Comparing the Cost of Managing Pension Plan and Mutual Fund Investment Portfolios

The wrong way …

is to look at similar labels and assume they mean the same thing. Pension plans and mutual funds both label some key costs as "investment advisory fees." The words happen to be identical, but the term is defined in dramatically different ways. Simply comparing the "investment advisory fees" of pension plans and mutual funds is thus the wrong way to evaluate their costs. Unfortunately, this is the way the authors of the Iowa law journal article chose to proceed.

The right way …

is to make certain you are comparing the same functions and services, "apples to apples." The ICI study describes how to do this in a way that avoids the errors made by the authors of the Iowa article. As described on the following page, the right way involves examining the fees incurred when some mutual fund managers hire unrelated third parties, or subadvisors, to help manage a mutual fund's investment portfolio. The services a subadvisor provides to a mutual fund are often similar to the services an investment management firm provides to a pension plan.

Despite some similarities, pension plans and mutual funds differ in important and fundamental ways.
They (a) have different missions, (b) serve different clienteles, (c) provide different services, (d) operate differently (often due to different laws and regulations), and (e) report their expenses in different ways. Assuming that mutual fund and pension plan fee levels should be similar is therefore questionable. Several distinctions are not well known; others are misunderstood. The ICI study finds that these factors account for virtually all of the difference in the average level of portfolio management fees of pension plans and mutual funds.

For pension plans, the "investment advisory fee" is used narrowly. It reflects the cost of selecting and monitoring a fixed amount of portfolio investments.

The fee represents what it costs a pension plan to hire an investment management firm to select and oversee the securities in a portion of a pension fund's portfolio. That's it. No other service is typically provided. The pension plan's administrators usually hire multiple "external" investment management firms. Each firm is assigned sole responsibility for selecting securities within the requisite asset class. The firm is given a fixed amount of the pension plan's assets to manager for a period of time set out in a contract. The investment management firm need not concern themselves with providing services to individuals who participate in the plan or any other matter.

For mutual funds, the "investment advisory fee" is used broadly. It covers a diverse range of shareholder services and legal obligations that go beyond selecting portfolio investments.

Unlike most pension plans, the "investment advisory fee" for mutual funds typically covers services that extend far beyond the selection and monitoring of portfolio securities each day. Mutual fund managers usually oversee all of a mutual fund's assets, not just a narrow slice.

- Responsibility for allocating assets: Most mutual fund managers continually make asset allocation decisions (e.g., how much in large-cap, how much in growth etc.). Pension plan investment managers do not bear this responsibility; thus it is not part of their "investment advisory fee." Determining how to allocate pension plan assets, a critically important responsibility, is typically done by the pension plan administrator. Many administrators hire pension consultants and other professional advisors for assistance in making these decisions. Yet none of these costs, which can be quite substantial, are reflected in a pension plan's "investment advisory fee." By contrast, all of these costs are counted in a mutual fund's "investment advisory fee."

- Responsibility for providing services to individuals: Most mutual fund managers provide extensive services to fund shareholders. Many of these services are reflected in a mutual fund's "investment advisory fee." Investment managers hired by pension plans, however, provide few if any services to pension beneficiaries; their contractual responsibilities are limited to selecting and overseeing securities. Among the services mutual fund managers often provide that investment managers to pension funds do not are: (a) toll free and Internet access to trained representatives, 365 days a year; (b) maintaining detailed information for every current and former shareholder; (c) preparing and distributing account statements, (d) preparing shareholder reports and prospectuses; and (d) compiling and distributing tax information. There are many others.

- Responsibility for complying with legal duties and regulatory obligations. Mutual funds are subject to a substantial number of federal statutory and regulatory requirements. A mutual fund's "investment advisory fee" often reflects the cost of complying with these laws. Compliance duties include adhering to exacting regulations for prospectuses and shareholder reports, and filing these documents with government agencies. There are many, many others, including requirements to assist the fund's board in fulfilling its duty to shareholders, developing anti-money laundering policies and implementing consumer privacy protections.
- Responsibility for daily cash flows and maintaining liquidity. Completely unlike a firm managing investments for a pension plan, mutual fund managers must account for the fact that investors purchase and redeem new fund shares each day. This produces a challenge unknown to an investment manager hired by a pension plan -- constantly changing amounts of money to invest. In addition, to meet daily redemptions, fund managers must constantly adjust the fund's liquidity. Increasingly, mutual fund managers must also evaluate the tax consequences of possible changes in the fund's portfolio. A mutual fund's "investment advisory fee" often reflects the costs borne to fulfill these responsibilities. Firms that manage securities for a pension plan typically are not faced with any of these costs.

The right way to compare pension plan and mutual fund costs. In a nutshell, the right way to evaluate pension plan and mutual fund costs is to make certain you are comparing the same functions and services, "apples to apples." The ICI study describes how to do this in a way that avoids the errors made by the authors of the Iowa article. It involves examining the fees incurred when some mutual fund managers hire unrelated third parties, or subadvisors, to help manage a mutual fund's investment portfolio. This trend has grown in recent years. The hired firm is usually referred to as a "subadvisor." The subadvisor's principal responsibility is to select and oversee a portfolio of securities representing all or part of the mutual fund's assets.

A subadvisor's relationship to a mutual fund resembles an investment manager's relationship to a pension plan.

Responsibilities are generally limited to selecting and overseeing a portfolio of securities pursuant to a contract. Subadvisors usually need not provide any shareholder services. Because a mutual fund subadvisor and pension plan investment manager both provide virtually the same service to those who hired them, examining the costs of their respective services provides a fair, 'apples to apples' comparison.

Mutual fund subadvisors and pension plan investment managers charge "investment advisory fees" that are virtually identical.

The ICI study compared the fees charged by mutual fund subadvisors to the fees reportedly paid to investment managers at public defined benefit pension plans. The comparison found that

- for small- and medium-sized investment portfolios, mutual fund subadvisory fees are lower than those reported for investment managers at large public pension funds.
- for larger portfolios, the fees paid by large public pension funds to external managers are slightly lower than the fees paid to mutual fund subadvisors. Overall, these fees average 28 basis points for public pension funds and 31 basis points for sub-advised mutual funds.

Overall fees at mutual funds with subadvisors are generally the same as at mutual funds without them.

If mutual funds with subadvisors generally had lower "investment advisory fees," then it's reasonable to assume they would generally have lower overall fee levels than other mutual funds. In fact, overall fee levels at mutual funds with subadvisors are about the same at funds without them. This suggests that funds without subadvisors generally incur similar costs as funds with subadvisors for the selection and oversight of portfolio securities. Since the ICI study demonstrates that mutual fund subadvisory fees are generally the same as what pension plans incur to employ investment managers, it can be fairly inferred that mutual funds as a whole incur, on average, about the same amount for the selection and oversight of portfolio securities as defined benefit pension plans.
