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Suggested citation: Gallagher, Emily. 2014. "Trends in the Expenses and Fees of Mutual Funds, 2013." ICI Research Perspective 20, no. 2 (May).

Trends in the Expenses and Fees of Mutual Funds, 2013

KEY FINDINGS

- » **On average, equity fund expenses fell 3 basis points to 74 basis points in 2013.** Bond fund expenses averaged 61 basis points, and those of hybrid funds averaged 80 basis points. Expense ratios of money market funds declined by 1 basis point to 17 basis points.
- » **In 2013, the average expense ratio paid by investors in funds of funds—mutual funds that invest in other mutual funds—fell from 83 basis points to 80 basis points.** The total expense ratio of a fund of funds includes both the expenses that it pays directly out of its assets and the expenses of the underlying funds in which it invests. Since 2005, the average expense ratio for investing in funds of funds has fallen 21 basis points.
- » **Expense ratios of target date mutual funds averaged 58 basis points in 2013.** Over the past five years, the expense ratios of target date funds have fallen 9 basis points. This paper discusses the factors behind this development.
- » **The average expense ratios for actively managed equity funds and index equity funds fell in 2013.** Over the past 10 years, the average expense ratio of actively managed equity funds has declined 21 basis points, compared with a decline of 13 basis points for index equity funds. Investor interest in lower-cost equity funds, both actively managed and indexed, has fueled this trend, as has asset growth and the resulting economies of scale.
- » **Load fee payments have decreased.** In 2013, the average maximum sales load on equity funds offered to investors was 5.3 percent. But the average sales load investors actually paid on equity funds was only 1.0 percent, owing to load fee discounts on large purchases and fee waivers, such as those on purchases through 401(k) plans. Average load fees paid by investors have fallen nearly 75 percent since 1990.

Mutual Fund Expense Ratios Have Declined Substantially over the Past Decade

Fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, certain kinds of distribution charges (known as 12b-1 fees), and other operating costs. A fund's expense ratio, which is shown in the fund's prospectus and shareholder reports, is the fund's total annual expenses expressed as a percentage of its net assets. Unlike sales loads, fund expenses are paid from fund assets.

Many factors affect a mutual fund's expenses, including its investment objective, its assets, the average account balance of its investors, the range of services it offers, fees that investors may pay directly, and whether the fund is a load or no-load fund.

On an asset-weighted basis, average expenses* paid by mutual fund investors have fallen substantially (Figure 1).¹ In 2003, equity fund investors incurred expenses of 100 basis points, on average, or \$1.00 for every \$100 in assets. By 2013, that average had fallen to 74 basis points. Bond and hybrid fund ratios also have declined. The average bond fund expense ratio fell from 75 basis points to 61 basis points, and the average hybrid fund expense ratio fell from 90 basis points to 80 basis points.² The average expense ratio for money market funds dropped from 42 basis points to 17 basis points.³

Equity Funds

Equity fund expense ratios declined for the fourth straight year in 2013, following a rise of 4 basis points in 2009. This pattern was not unexpected, given stock market developments since 2007 and the fact that fund expense ratios often vary inversely with fund assets. Indeed, some fund costs—such as transfer agency fees, accounting and audit fees, and director fees—are more or less fixed in dollar terms, regardless of fund size. When fund assets rise, these relatively fixed costs make up a smaller proportion of a fund's expense ratio.

Consequently, asset growth tends to contribute to declines in fund expense ratios. During the stock market downturn from October 2007 to March 2009, equity fund assets decreased markedly (Figure 2, dashed line with an inverted scale), leading expense ratios to rise slightly in 2009. As the stock market recovered, however, equity fund assets rebounded and equity expense ratios fell. Since 2010, equity funds' assets have grown nearly 39 percent and their expense ratios have fallen 9 basis points.

Three additional factors have contributed to lower average expenses of equity and other long-term funds. First, investors have shifted toward no-load share classes, particularly institutional no-load share classes, which tend to have below-average expense ratios. This is due in large part to a change in how investors compensate brokers and other financial professionals (see "Mutual Fund Load Fees" on page 16). The average expense ratio of equity funds also has declined as a result of growth in index fund investing (see page 6).

* Unless otherwise noted, this paper calculates average expenses on an asset-weighted basis. See note 1 on page 21.

FIGURE 1

Average Expense Ratios for Mutual Funds Have Fallen

Basis points, 2000–2013

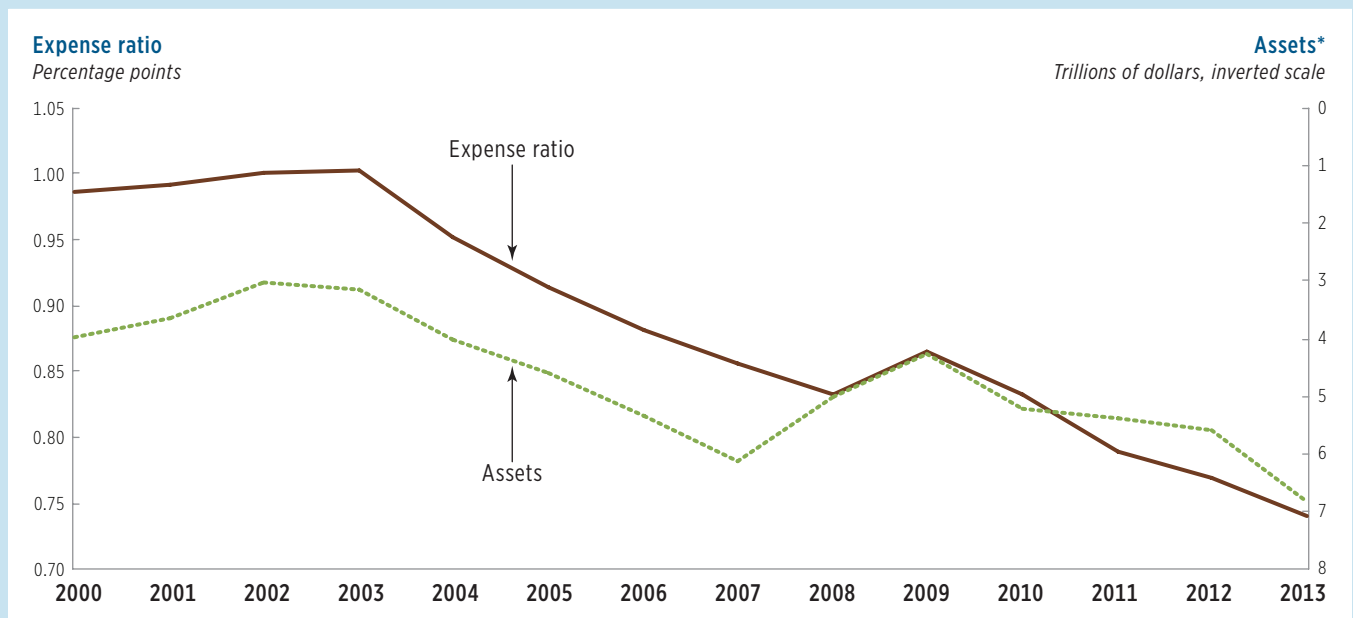
Year	Equity	Hybrid	Bond	Money market
2000	99	89	76	49
2001	99	89	75	46
2002	100	89	74	44
2003	100	90	75	42
2004	95	85	72	42
2005	91	81	68	42
2006	88	78	67	40
2007	86	77	64	38
2008	83	77	61	35
2009	87	84	64	33
2010	83	82	63	24
2011	79	80	62	21
2012	77	79	61	18
2013	74	80	61	17

Note: Expense ratios are measured as asset-weighted averages. Figures 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

FIGURE 2

Equity Fund Expense Ratios Are Inversely Related to Equity Fund Assets



* Assets are plotted as a two-year moving average.

Note: Figure excludes 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

Second, expense ratios of individual equity funds have declined. In 2013, 57 percent of the share classes of equity funds saw their expense ratios decline, and another 13 percent saw no increase. This, no doubt, has resulted from both economies of scale and competition across the vast array of funds from which investors can choose.

Third, fund expenses vary by investment objective. Equity fund assets historically have been, and continue to be, concentrated in “blend” funds (Figure 3), especially in large-cap blend funds, one of the least costly fund types. Expense ratios tend to be higher for funds whose investment objectives include growth stocks or emerging markets—

and also for funds that specialize in particular sectors, such as healthcare or real estate. Equity funds that invest in blend stocks have average expense ratios of 50 basis points. And at year-end 2013, funds with this investment objective accounted for nearly 36 percent of equity mutual fund assets. Large-cap blend equity funds (not shown in Figure 3), which are a subcategory of blend equity funds and include S&P 500 index funds, have even lower average expense ratios—35 basis points. Despite growth in funds specializing in sectors that cost more to manage, such as emerging markets stocks, continued interest in domestic large-cap blend funds has contributed substantially to a lower average expense ratio for equity funds.

FIGURE 3

Fund Expenses Vary by Investment Objective

Selected investment objectives, 2013

Fund type and investment objective	Asset-weighted average expenses <i>Basis points</i>	Total net assets* <i>Billions of dollars</i>	Net new cash flow* <i>Billions of dollars</i>
Equity funds	74	\$7,764	\$160
Blend	50	2,785	34
Growth	85	1,377	-29
Value	83	1,220	-13
Emerging markets	108	306	33
Sector	83	297	16
Alternative strategies	134	51	9
Hybrid funds	80	1,270	73
Bond funds	61	3,265	-80
Investment-grade: multi-, intermediate-, and long-term	48	1,094	-88
Municipal	57	498	-58
High-yield	81	412	54
Investment-grade: short- and ultra short-term	43	261	23
Multi-sector, multi-term	84	173	21
Mortgage-backed	50	120	-36
Inflation-protected	42	95	-32
Money market funds	17	2,718	15

* Components do not add to the total because, for brevity, some investment objectives are not shown. For example, among equity funds, four investment objectives with assets totaling \$1,728 billion are not shown.

Note: Data exclude mutual funds that invest primarily in other mutual funds. Data include index mutual funds but exclude ETFs.

Sources: Investment Company Institute and Lipper

Hybrid Funds

Assets in hybrid funds (which invest in a mix of equities and bonds) have more than tripled since 2000, to \$1.27 trillion, potentially helping to lower fund expense ratios through economies of scale. But since falling 9 basis points from 2000 to 2011, the average expenses of hybrid funds have stabilized at around 80 basis points—despite a 50 percent increase in assets over the last three years alone.

One reason that the average expense ratio of hybrid funds has remained largely stable since 2011 is that a quarter of net flows into hybrid funds over the last three years has been directed to “alternative strategies” funds, which ICI includes in the hybrid category. The investment charters of these funds often allow them to engage in short-selling of securities or to undertake other investment strategies such as investing in futures and commodities. Such strategies, while offering fund investors the advantage of diversification across a wider range of asset classes, can be more costly to undertake. Since 2010, alternative strategy funds have attracted \$52 billion in flows, or 95 percent of their year-end 2010 assets.

Bond Funds

After falling 1 basis point in each of the three previous years, the average bond fund expense ratio remained unchanged in 2013, at 61 basis points. Several factors kept average bond fund expense ratios stable in 2013.

One factor was the change in bond fund assets. Through economies of scale, fund expense ratios tend to fall when fund assets rise, and vice versa. From year-end 2000 to year-end 2012, bond fund assets more than quadrupled, increasing each year except 2008. Partly as a result of this asset growth, average bond fund expenses fell over the same period. In 2013, however, bond fund assets declined to \$3.3 trillion, about 3 percent below the year-end 2012 level. The relatively small decline in bond fund assets in 2013 was insufficient to lift the average expense ratio of bond funds.

In 2013, developments in monetary policy heavily influenced bond fund flows, which typically are highly correlated with bond performance. Bond performance is in turn driven largely by the U.S. interest rate environment. In

2013, the Federal Reserve remained committed to a highly accommodative monetary policy, holding short-term interest rates low and continuing to purchase fixed-income securities on a large scale (through the third round of a program known as quantitative easing, or QE3). Long-term interest began rising in May, however, due to a favorable employment report and comments from Federal Reserve officials that the markets interpreted as a sign that the Federal Reserve might soon begin scaling down its purchases under QE3. Long-term interest rates continued to rise in June and early July following subsequent economic data releases and comments by Federal Reserve officials.

These events led some investors to reallocate some of their investments into bond funds with different investment objectives. In theory, a reallocation could alter average expense ratios because funds with different investment objectives have different average expenses. For example, as long-term interest rates rose in 2013, investors seeking to avoid capital losses redeemed shares in bond funds with longer investment horizons and increased their investments in ultra short-term and short-term investment-grade bond funds, as well as in bond funds with greater flexibility to invest in multiple sectors and/or multiple maturities (Figure 3). On net, however, the reallocation of assets within bond funds did not affect the overall average expense ratio of bond funds. Indeed, bond funds with net inflows in 2013 had average expenses of 59 basis points, only slightly below that of bond funds with net outflows (62 basis points). Furthermore, the scale of this reallocation was too small to make the slight difference in expenses translate to a change in overall average bond fund expenses.

Another reason that bond fund expense ratios were unchanged in 2013 is that bond fund assets remained concentrated in lower-cost funds. Bond funds with expense ratios in the lowest quartile continued to manage the majority—60 percent in 2013—of bond funds’ total net assets. Further, index bond funds (discussed in the next section) received \$33 billion in net cash in 2013, up from \$28 billion in 2012. Thus, investor interest in lower-cost funds and competition among fund sponsors has continued to hold down fund expenses overall, even as bond fund assets fell slightly.

Index Funds

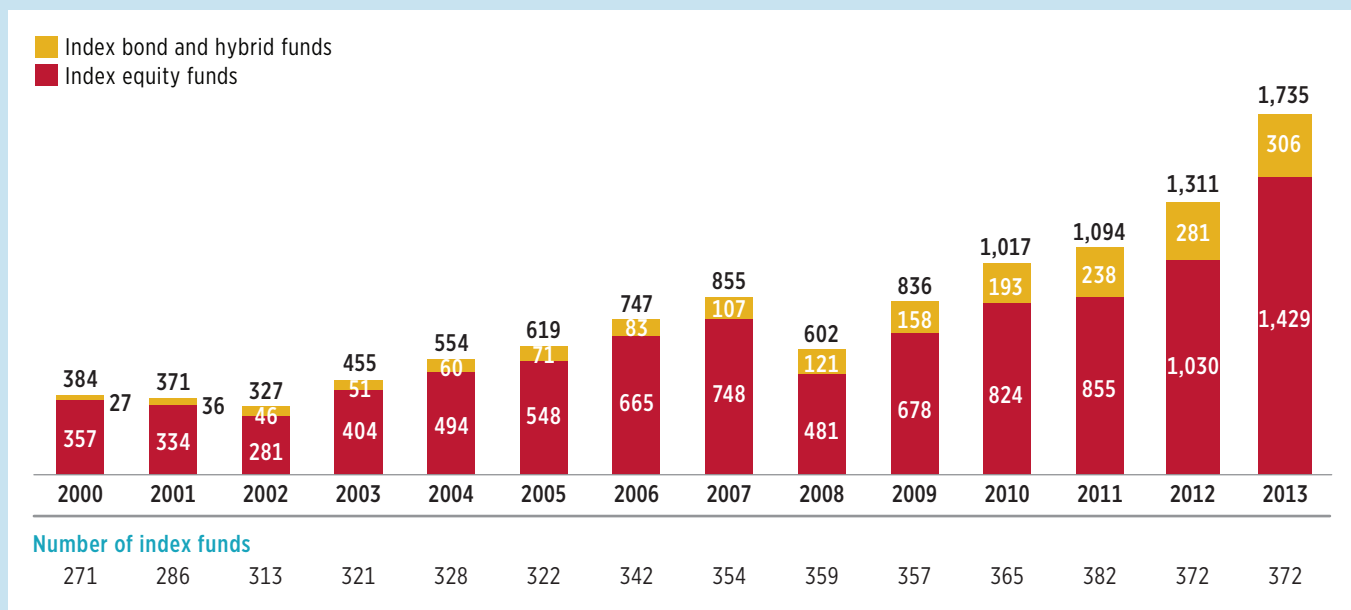
Growth in index funds has contributed to the decline in equity and bond fund expense ratios. Index fund assets more than quadrupled from 2000 to 2013, from \$384 billion to \$1.735 trillion (Figure 4).⁴ Consequently, index funds' share of long-term mutual fund assets nearly doubled, from 7.5 percent to 14.1 percent. Assets in index bond and index hybrid funds have grown in recent years, but in 2013 index equity funds still accounted for the lion's share (82 percent) of index fund assets.

Index funds tend to have below-average expense ratios for several reasons. The first is their approach to portfolio management. An index fund generally seeks to replicate the return on a specified index. Under this approach, often referred to as *passive management*, portfolio managers buy and hold all, or a representative sample of, the securities in their target indexes. By contrast, under an active management approach, managers have more discretion to increase or reduce exposure to sectors or securities within their funds' investment mandates. This approach offers investors the chance to earn superior returns. However, it also entails more-intensive analysis of securities or sectors, which can be costly.

FIGURE 4

Total Net Assets of Index Funds Have Increased Substantially in Recent Years

Billions of dollars; year-end, 2000–2013



Note: Data exclude ETFs and funds that invest primarily in other funds. Components may not add to the total because of rounding.

A second reason index funds tend to have below-average expense ratios is their investment focus. Historically, the assets of index equity funds have been concentrated most heavily in large-cap blend funds that target U.S. large-cap indexes, notably the S&P 500. Assets of actively managed equity funds, on the other hand, have been more widely distributed across stocks of varying capitalization, international regions, or specialized business sectors. Managing portfolios of mid- or small-cap, international, or sector stocks is generally acknowledged to be more expensive than managing portfolios of U.S. large-cap stocks.

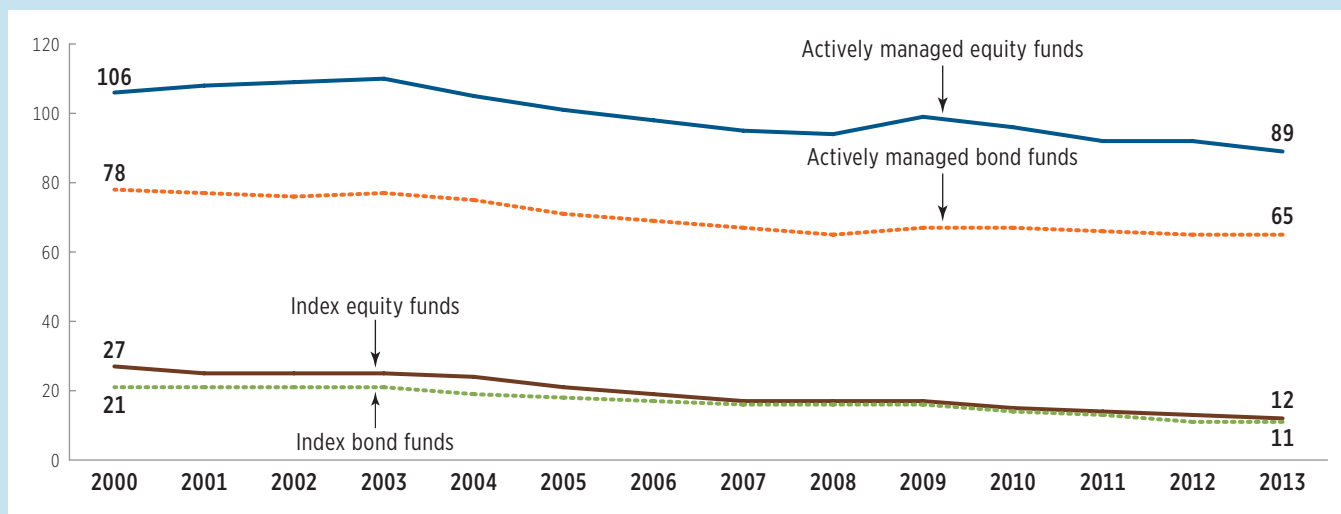
Third, index funds are larger on average than actively managed funds, which helps reduce fund expense ratios through economies of scale. In 2013, the average index equity fund held \$4.4 billion in assets, nearly triple the \$1.5 billion for the average actively managed equity fund.

Finally, index fund investors who hire financial professionals might pay for that service out-of-pocket, rather than through the fund's expense ratio (see "Mutual Fund Load Fees" on page 16). Actively managed funds more commonly bundle those costs in the fund's expense ratio.

FIGURE 5

Expense Ratios of Actively Managed and Index Funds

Basis points, 2000–2013



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

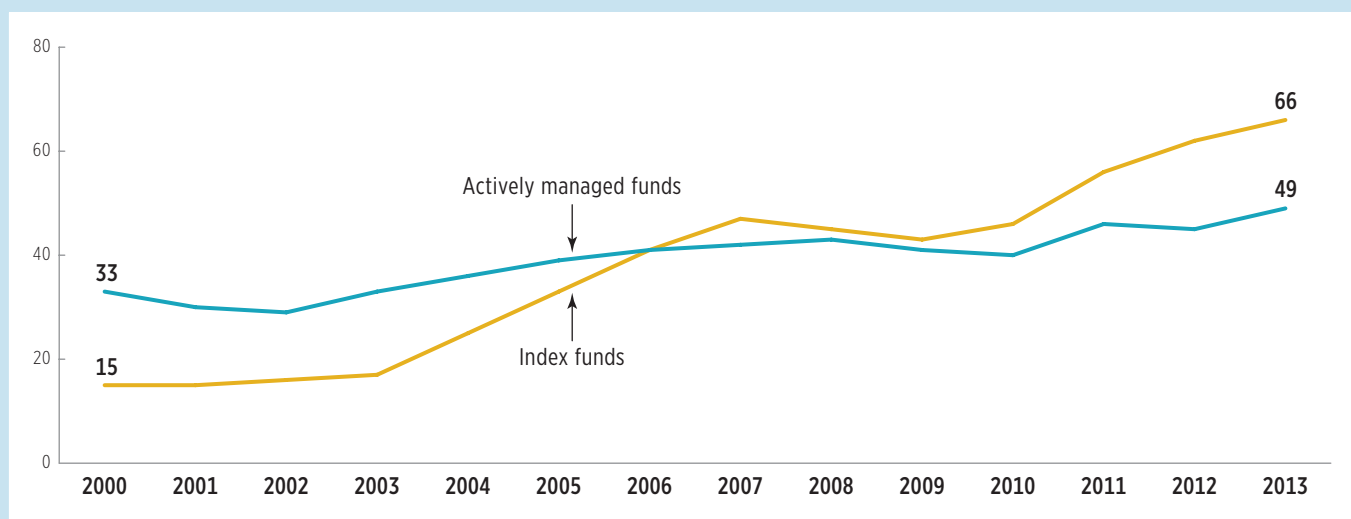
Sources: Investment Company Institute and Lipper

These reasons, among others, help explain why index funds generally have lower expense ratios than actively managed funds. Note, however, that both index and actively managed funds have contributed to the decline in the overall average mutual fund expense ratio (Figure 5). Average expense ratios have fallen for both index and actively managed funds—and by roughly the same amount. From 2000 to 2013, the average expense ratio of index equity funds fell 15 basis points, similar to the 17 basis point decline for actively managed equity funds. Over the same period, the average expense ratio of index bond funds and actively managed bond funds fell 10 and 13 basis points, respectively.

In part, the downward trend in the average expense ratios of both index and actively managed funds reflects investors' increasing tendency to buy lower-cost funds. Investor demand for index funds is disproportionately concentrated in the very lowest-cost funds. In 2013, for example, 66 percent of index equity fund assets were held in funds with expense ratios that were among the lowest 10 percent of all index equity funds (Figure 6). This phenomenon is not unique to index funds, however. The proportion of assets in the lowest-cost actively managed funds has also risen.

FIGURE 6

Percentage of Total Net Assets Held in Equity Funds with Expense Ratios in the Lowest Decile
2000–2013



Note: The lowest decile is based on the distributions of actively managed and index equity fund expense ratios in 2013 and is fixed across time.
Sources: Investment Company Institute and Lipper

Money Market Funds

The average expense ratio of money market funds fell to 17 basis points in 2013, a 1 basis point drop from 2012.⁵

Money market fund expense ratios have remained steady or fallen each year since 1994.

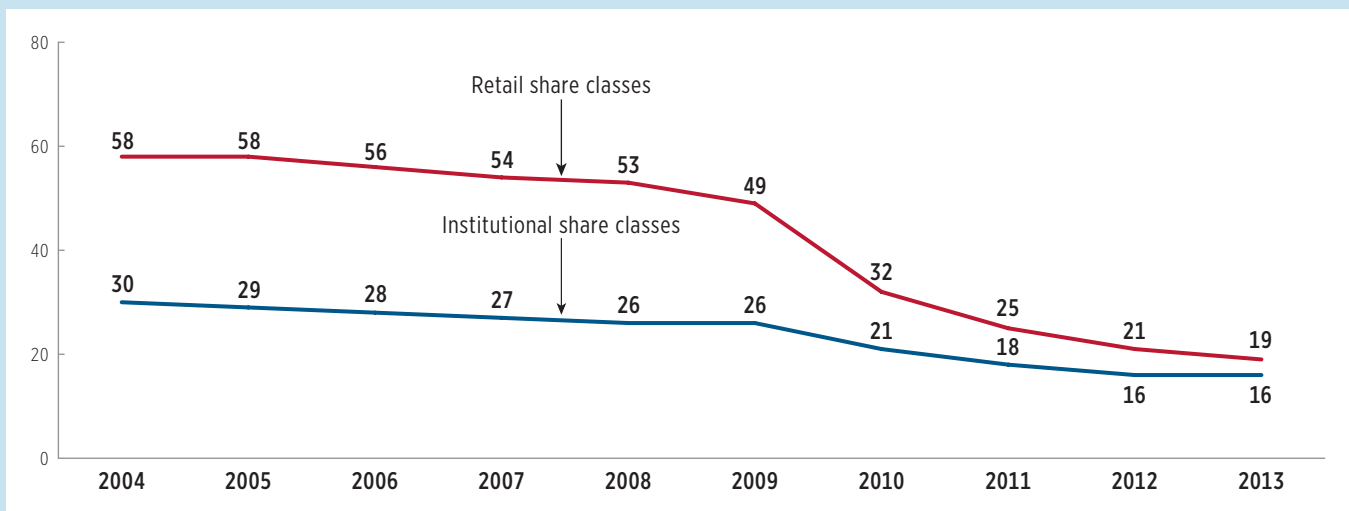
Declines in money market fund expense ratios from 2004 to 2009 reflected a number of factors. First, the average expense ratio of retail share classes of money market funds

declined 9 basis points (Figure 7). The average expense ratio of institutional share classes declined by less, only 4 basis points. At the same time, however, the market share of institutional share classes increased substantially (Figure 8). Because institutional share classes serve fewer investors with larger average account balances than do retail share classes, they tend to have lower expense ratios. Thus, the increase in the institutional market share helped reduce the average expense ratio of all money market funds.

FIGURE 7

Expense Ratios of Institutional and Retail Money Market Fund Share Classes

Basis points, 2004–2013



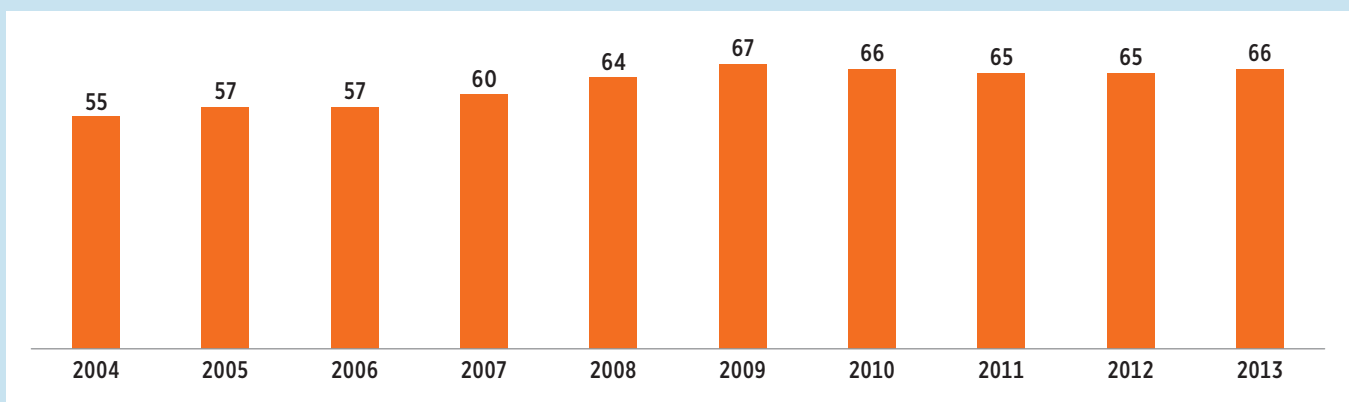
Note: Expense ratios are measured as asset-weighted averages. Figure excludes mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE 8

Market Share of Institutional Share Classes of Money Market Funds

Percentage of all money market fund assets, 2004–2013



By contrast, the market share of institutional share classes of money market funds has decreased slightly since 2009, indicating that other factors have been pushing down the average expense ratios of these funds—primarily developments stemming from the current low interest rate environment.

In 2007 and 2008, to stimulate the economy and respond to the financial crisis, the Federal Reserve sharply reduced short-term interest rates. By early 2009, the federal funds rate and yields on U.S. Treasury bills had hit historic lows, both hovering just above zero. Yields on money market funds, which closely track short-term interest rates, also tumbled (Figure 9). The average gross yield (the yield before deducting fund expense ratios) on taxable money market funds has remained below 25 basis points since February 2011 and fell to a low of 13 basis points at the end of 2013.

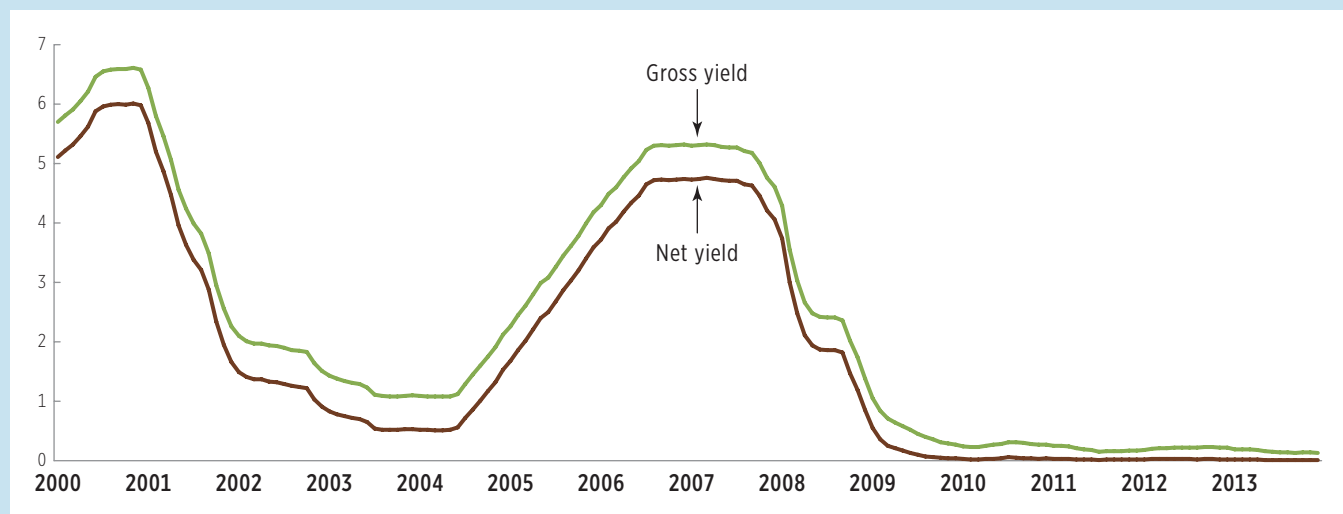
In this setting, money market fund advisers increased expense waivers to ensure that net yields (the yields after deducting fund expense ratios) did not fall below zero. Waivers raise a fund’s net yield by reducing the expense ratio that investors incur. Historically, money market funds often have waived expenses, usually for competitive reasons. For example, in 2006, before the onset of the financial crisis, 62 percent of money market fund share classes were waiving at least some expenses (Figure 10). By the end of 2013, that figure had risen to 99 percent.

Fund advisers and their distributors pay for these waivers, forgoing profits and bearing more, if not all, of the costs of running the funds. Money market funds waived an estimated \$5.8 billion in expenses in 2013, more than four times the amount waived in 2006 (Figure 11). These waivers substantially reduced revenues of fund advisers. If gross yields on money market funds rise, advisers might reduce or eliminate waivers, which could cause expense ratios to rise somewhat.

FIGURE 9

Taxable Money Market Fund Yields

Percent; monthly, January 2000–December 2013

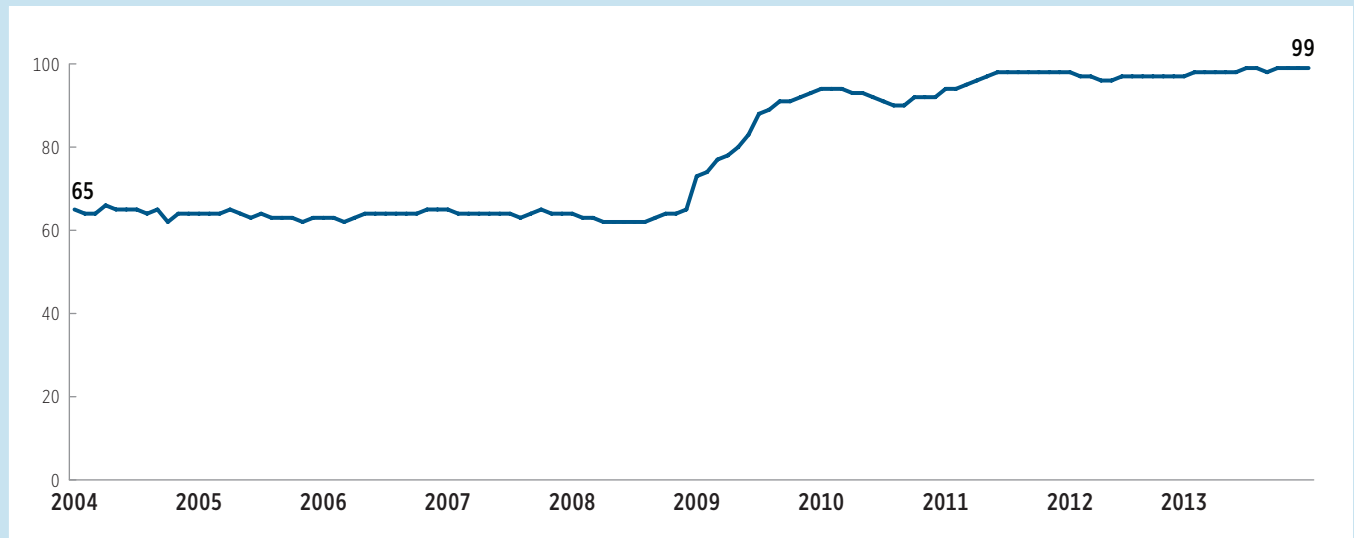


Source: iMoneyNet

FIGURE 10

The Percentage of Money Market Fund Share Classes That Waive at Least Some Expenses Has Risen

Percent; monthly, January 2004–December 2013

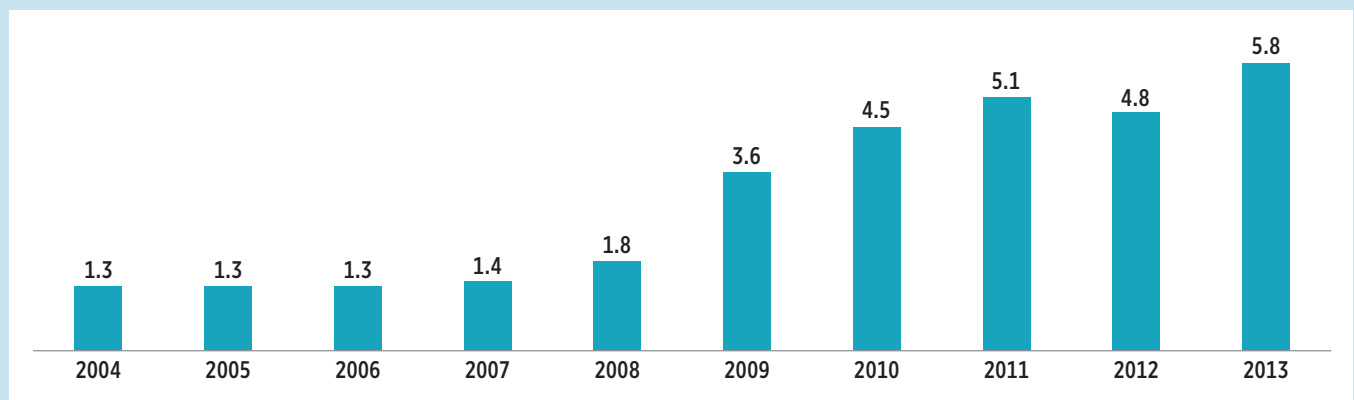


Sources: Investment Company Institute and iMoneyNet

FIGURE 11

Money Market Funds Waived an Estimated \$5.8 Billion in Expenses in 2013

Billions of dollars, 2004–2013



Sources: Investment Company Institute and iMoneyNet

Funds of Funds

Funds of funds are mutual funds that invest in other mutual funds.⁶ The market for funds of funds has expanded considerably in recent years. By year-end 2013, there were 1,267 funds of funds with \$1,594 billion in assets (Figure 12).

Approximately 88 percent of the assets in funds of funds were in hybrid funds of funds, which are funds that invest in a mix of equity, bond, and hybrid mutual funds. From 2005 to 2013, the average expense ratio of funds of funds fell more than 20 percent, from 101 basis points to 80 (Figure 13).⁷

FIGURE 12

Funds of Funds Have Grown Rapidly in Recent Years

Number of funds of funds, 2008–2013

Year-end	Total	Equity	Hybrid	Bond
2008	860	129	721	10
2009	953	139	803	11
2010	988	152	817	19
2011	1,094	162	905	27
2012	1,163	168	959	36
2013	1,267	172	1,054	41

Total net assets of funds of funds; billions of dollars, 2008–2013

Year-end	Total	Equity	Hybrid	Bond
2008	\$487.4	\$63.1	\$423.0	\$1.3
2009	680.2	58.7	619.5	2.1
2010	917.5	84.5	821.5	11.5
2011	1,042.5	84.9	937.1	20.5
2012	1,283.1	97.8	1,149.9	35.4
2013	1,593.7	133.9	1,405.0	54.9

Note: Components may not add to the total because of rounding.

FIGURE 13

Expense Ratios of Funds of Funds

Basis points, 2005–2013

Year	Asset-weighted average	Simple average	Median
2005	101	156	152
2006	96	144	139
2007	94	144	135
2008	89	140	134
2009	91	138	131
2010	87	133	128
2011	83	129	123
2012	83	126	119
2013	80	123	115

Sources: Investment Company Institute, Lipper, and Morningstar

Target Date Mutual Funds

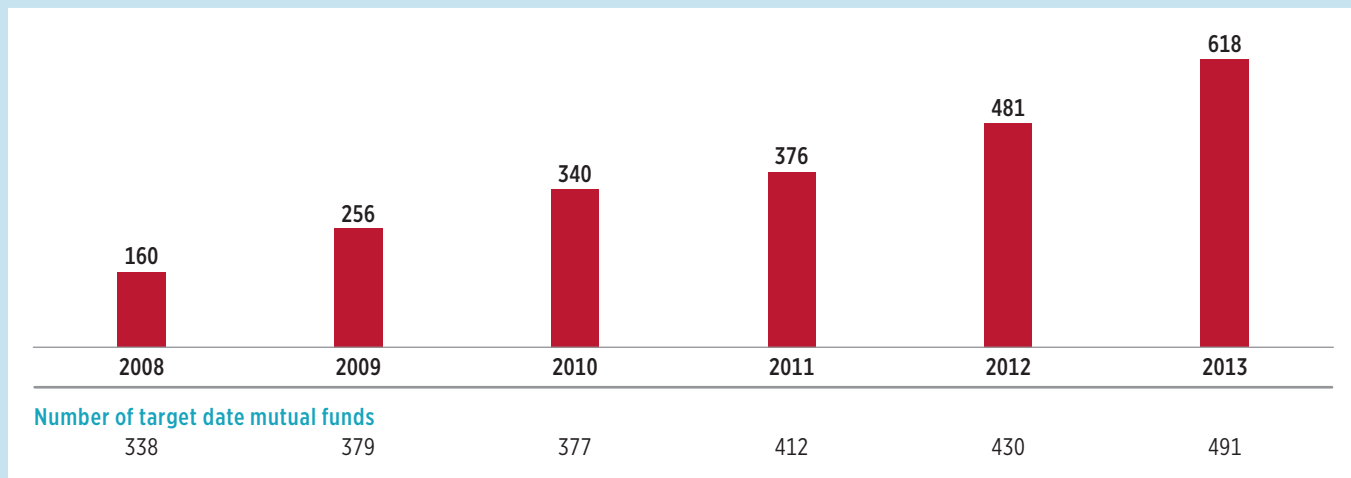
Much of the growth in funds of funds stems from investor interest in target date mutual funds, which invest in a mix of stocks, bonds, and other securities. Target date mutual funds usually invest through a fund-of-funds structure (97 percent of target date mutual funds are funds of funds, and 37 percent of funds of funds are target date mutual funds), meaning they primarily hold and invest in shares of other mutual funds and exchange-traded funds. Typically, a target date mutual fund provides investors more exposure to fixed income and less to equity as it approaches and passes its target date, which is identified in the fund's name. At year-end 2013, target date mutual funds had \$618 billion in assets (Figure 14).

Target date mutual fund sponsors consider how investment outcomes can be affected by risks attributable to the stock market, interest rates, inflation, and longevity across extensive investment and withdrawal horizons. Fund sponsors approach this challenge in varying ways, which can influence target date funds' expense ratios. The investment mix, or glide path, that a target date mutual fund follows reflects each sponsor's philosophy on how best to meet investors' financial goals in retirement. To this end, a target date fund can invest in a wide variety of asset classes, including domestic and foreign stocks and bonds, commodities, and money market securities. A fund manager who weighs longevity risk more heavily might maintain a greater equity allocation later in the fund's life cycle in

FIGURE 14

Target Date Mutual Fund Assets Have Nearly Quadrupled Since 2008

Billions of dollars; year-end, 2008–2013



Note: Data include mutual funds that invest primarily in other mutual funds.

order to generate capital growth even after the fund's target date. By contrast, a fund manager who concentrates more on reducing market risk in retirement might hold a more conservative portfolio near the fund's target date, perhaps by investing a larger portion of the fund's portfolio in fixed-income securities.

Fund sponsors also might differ in how they operate the glide path and select underlying funds. Some target date mutual funds embrace a more passive management style, largely automating the glide path and perhaps making minor adjustments along the way. In some cases, all the target date funds in a particular fund sponsor's series of target date funds hold a similar set of underlying funds, just in different proportions depending on the target date. Some target date mutual funds invest primarily by holding investments in underlying index funds in which the proportion of fund assets in the underlying funds changes over time in a largely predetermined manner. Other fund managers take a more active role, allocating assets along a glide path but altering the allocation in the face of changing risks—for example, due to a changing outlook for inflation.

The number of sponsors managing more than \$5 billion in target date fund assets has tripled since 2008, signaling an appetite for competitive differentiation.

The strong investor demand for target date mutual funds likely reflects a number of factors. Investors appreciate the diversification and glide-path features of target date mutual funds, which are especially attractive for individuals saving for retirement in 401(k) plans and individual retirement accounts (IRAs).⁸ Additionally, target date funds often are recognized as a qualified default option for 401(k) plans under regulations issued by the U.S. Department of Labor.⁹ As a result, newly hired employees have become more likely to invest their 401(k) contributions in target date funds. At year-end 2012, for example, 43 percent of the account balances of recently hired participants in their twenties was invested in target date funds, compared with 40 percent in 2011, 35 percent in 2010, and 16 percent in 2006.¹⁰

The average expense ratio of target date funds has declined sharply since 2008, when investors on average paid 67 basis points (Figure 15). By 2013, the average expense ratio had fallen 13 percent to 58 basis points.

FIGURE 15

Expense Ratios of Target Date Mutual Funds

Basis points, 2008–2013

Year	Asset-weighted average	Simple average	Median
2008	67	123	118
2009	67	120	114
2010	65	114	111
2011	61	111	109
2012	58	107	104
2013	58	105	102

Sources: Investment Company Institute and Lipper

This might in part reflect the strong growth in the assets of target date funds, which through economies of scale helps reduce underlying fund expense ratios. To a large extent, however, it reflects normal demand and supply pressures.

On the demand side, target date fund investors, like investors in other funds, tend to invest more heavily in lower-cost target date funds. In 2012, for example, target date funds with expense ratios in the bottom decile attracted inflows amounting to 17 percent of their assets, nearly twice the rate (9 percent) of flows going to target date funds with expense ratios in the top decile. By the end of 2013, 74 percent of the assets in target date mutual fund were in funds with expense ratios in the lowest quartile.

On the supply side, fund sponsors must compete for investors' dollars. Given investors' preferences for low-cost funds, sponsors face competitive pressure to provide the best product at the lowest cost. Evidence of competition can be seen by comparing the expense ratios of target date funds that have recently closed with those that have recently

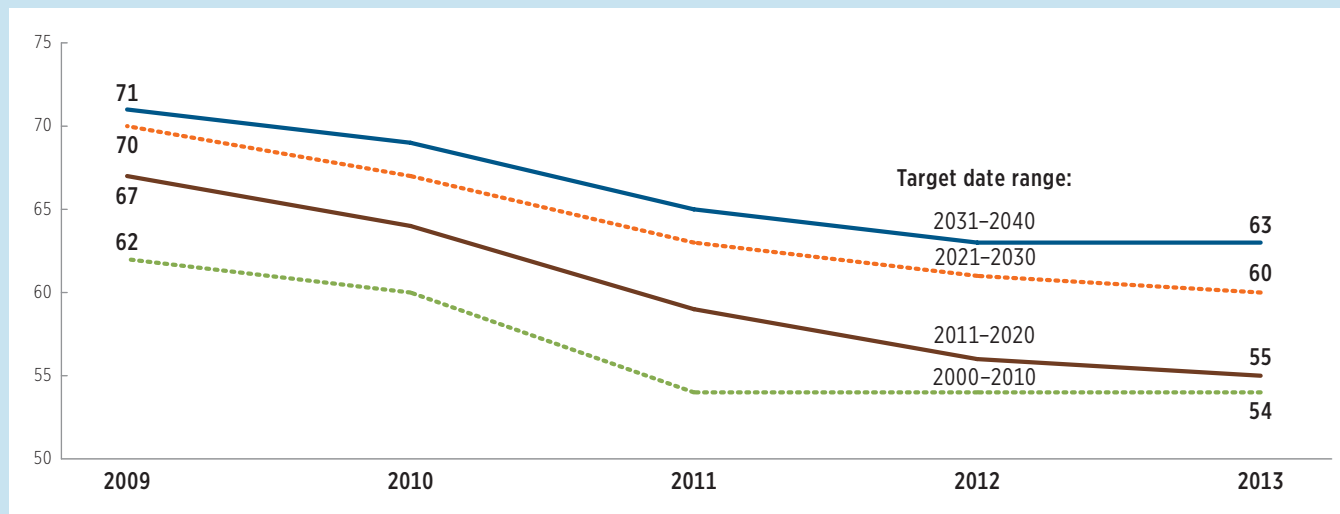
opened. Target date funds that have closed in the last two years had average expense ratios of 93 basis points, well above the average of 58 basis points for all target date funds. Meanwhile, target date funds that have opened in the last two years had average expense ratios of just 44 basis points.

Another factor that likely has added to the decline in expense ratios of target date funds is that the expense ratios of such funds tend to fall as their target date nears. Figure 16 plots the average expense ratios of target date mutual funds from 2009 to 2013, grouped by selected target date ranges. As seen, the expense ratios of target date funds in each target date range declined from 2009 to 2013. The key point in the figure, however, is that the average expense ratio is lower for target date funds that are closer to their target date. For example, in 2013, the expense ratios of funds with a target date in the 2000–2010 range averaged 54 basis points, well below the 63 basis points for funds in the 2031–2040 range.

FIGURE 16

Target Date Mutual Fund Expenses Decline as the Target Date Approaches

Basis points, 2009–2013



Sources: Investment Company Institute and Lipper

This occurs for at least two reasons. First, as a fund nears its target date, its allocation to bonds (typically through investments in underlying bond funds) rises and its allocation to equities (typically through equity funds) falls. This affects target date fund expense ratios because bond funds tend to have lower expense ratios than equity funds.

Second, risk-based allocations can influence a fund's expense ratio. As a target date fund approaches its target date and becomes more conservative, investments in higher-risk/higher-reward assets (such as emerging markets stocks and high-yield bonds) often are replaced with lower-risk/lower-reward assets (such as domestic large-cap stocks and investment-grade bonds). Emerging markets stock funds and high-yield bond funds typically have higher expense ratios than large-cap domestic equity funds and investment-grade bond funds, contributing to lower expense ratios for target date funds that are later in their life cycles.

Mutual Fund Load Fees

Many mutual fund investors pay for the services of a financial professional. These professionals typically devote time and attention to prospective investors before investors make an initial purchase of funds and other securities. Usually, the professional meets with the investor, identifies goals, analyzes the investor's existing portfolio, determines an appropriate asset allocation, and recommends funds to help achieve the investor's goals. Financial professionals also provide ongoing services, such as periodically reviewing investors' portfolios, adjusting asset allocations, and responding to customer inquiries.

Thirty years ago, fund shareholders usually compensated financial professionals through a front-end load—a one-time, up-front payment for current and future services. That distribution structure has changed significantly.

One important element in the changing distribution structure has been a marked reduction in load fees paid by mutual fund investors. The maximum front-end load fee that shareholders might pay for investing in mutual funds has changed little since 1990 (Figure 17). However, the front-end load fees that investors actually paid declined from nearly 4 percent in 1990 to roughly 1 percent in 2013. This in part reflects the increasing role of mutual funds in helping investors save for retirement. Purchases made through defined contribution plans, such as 401(k) plans, have sometimes gone to funds that normally charge front-end load fees, but funds often waive load fees on purchases made through retirement plans. Moreover, front-end load funds offer volume discounts, waiving or reducing load fees for large initial or cumulative purchases.

Another important element has been a shift toward asset-based fees for brokers and other financial professionals who sell mutual funds.¹¹ Asset-based fees are assessed as a percentage of the assets that a financial professional manages for an investor, rather than as a percentage of the dollars initially invested. Investors may pay these fees indirectly through a fund's 12b-1 fee, which is included in the fund's expense ratio. The fund's underwriter collects the 12b-1 fee, passing the bulk of it to the financial professionals. Alternatively, investors may pay the professional an asset-based fee directly. In such cases, the financial professional typically would recommend the purchase of no-load mutual funds, which have no front-end or back-end load and a 12b-1 fee of 0.25 percent or less.

In part because of the recent trend toward asset-based fees, the market shares of front-end and back-end load share classes have fallen while the share of no-load share classes has increased substantially. For example, in the past five years, front-end and back-end load share classes have had \$382 billion in outflows (Figure 18), and gross sales of back-end load share classes have dwindled almost to zero (Figure 19). As a result, the market share of these share classes fell from 26 percent of long-term mutual fund assets at year-end 2008 to 18 percent at year-end 2013 (Figure 20).

FIGURE 17

The Average Front-End Sales Loads That Investors Pay Are Well Below the Maximum Front-End Sales Loads That Funds Charge

Percentage of purchase amount, selected years

Year	Maximum front-end sales load ¹			Average front-end sales load that investors actually paid ²		
	Equity	Hybrid	Bond	Equity	Hybrid	Bond
1990	5.0	5.0	4.6	3.9	3.8	3.5
1995	4.8	4.7	4.1	2.5	2.4	2.1
2000	5.2	5.1	4.2	1.4	1.4	1.1
2005	5.3	5.3	4.0	1.3	1.3	1.0
2010	5.4	5.2	3.9	1.0	1.0	0.8
2013	5.3	5.2	3.8	1.0	1.0	0.7

¹ The maximum front-end sales load is a simple average of the highest front-end load that funds may charge as set forth in their prospectuses.

² The average front-end sales load that investors actually paid is the total front-end sales loads that funds collected divided by the total maximum loads that the funds could have collected based on their new sales that year. This ratio is then multiplied by each fund's maximum sales load. The resulting value is then averaged across all funds.

Note: Figure excludes mutual funds available as investment choices in variable annuities and mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, Lipper, and Strategic Insight Simfund

FIGURE 18

Net New Cash Flow Was Greatest in No-Load Institutional Share Classes

Billions of dollars, 2004–2013

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All long-term mutual funds	\$210	\$192	\$227	\$224	-\$225	\$389	\$241	\$26	\$196	\$152
Load	42	22	30	10	-151	15	-60	-133	-83	-71
Front-end load ¹	48	41	44	18	-105	2	-57	-101	-67	-58
Back-end load ²	-40	-47	-47	-42	-39	-24	-27	-23	-16	-11
Level load ³	32	29	34	37	-9	36	22	-10	1	-8
Other load ⁴	1	0	0	0	1	0	2	0	-1	0
Unclassified	1	-1	-1	-2	0	0	0	0	0	6
No-load⁵	132	152	173	190	-48	345	293	181	307	277
Retail	103	80	89	84	-77	159	86	-30	32	58
Institutional	29	72	84	106	29	186	208	211	275	219
Variable annuities	36	18	24	25	-26	29	8	-21	-28	-53

¹ Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

² Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

³ Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

⁴ All other load share classes not classified as front-end load, back-end load, or level load. Primarily includes retirement share classes, known as Class R shares.

⁵ Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

Note: Components may not add to the total because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE 19

Gross Sales of Long-Term Mutual Funds Are Concentrated in No-Load Share Classes*Billions of dollars, 2004–2013*

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All long-term mutual funds	\$1,635	\$1,740	\$2,009	\$2,528	\$2,414	\$2,375	\$2,699	\$2,856	\$2,956	\$3,495
Load	517	537	600	681	632	583	591	566	531	630
Front-end load ¹	365	394	448	514	482	435	444	437	401	470
Back-end load ²	47	33	27	23	20	10	7	4	3	3
Level load ³	97	102	119	138	125	135	135	121	122	147
Other load ⁴	7	6	5	3	5	2	5	3	4	4
Unclassified	1	1	1	2	1	0	1	0	0	6
No-load⁵	881	978	1,151	1,528	1,473	1,522	1,790	1,981	2,132	2,580
Retail	593	625	743	962	866	900	1,021	1,035	1,066	1,248
Institutional	289	353	409	565	607	622	769	946	1,067	1,332
Variable annuities	237	225	258	320	308	270	318	308	293	285

¹ Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

² Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

³ Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

⁴ All other load share classes not classified as front-end load, back-end load, or level load. Primarily includes retirement share classes, known as Class R shares.

⁵ Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

Note: Gross sales exclude reinvested dividends. Components may not add to the total because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE 20

Total Net Assets of Long-Term Mutual Funds Are Concentrated in No-Load Shares*Billions of dollars, 2004–2013*

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
All long-term mutual funds	\$6,194	\$6,864	\$8,059	\$8,914	\$5,770	\$7,797	\$9,027	\$8,935	\$10,350	\$12,299
Load	2,197	2,347	2,683	2,864	1,770	2,253	2,440	2,254	2,435	2,769
Front-end load ¹	1,570	1,728	2,026	2,190	1,374	1,749	1,881	1,749	1,890	2,144
Back-end load ²	334	271	241	204	102	98	78	50	39	32
Level load ³	275	322	392	448	284	396	459	438	493	568
Other load ⁴	16	17	15	10	8	8	18	16	11	16
Unclassified	2	9	8	13	2	2	4	2	2	8
No-load⁵	3,056	3,478	4,152	4,705	3,147	4,413	5,297	5,431	6,519	7,917
Retail	2,199	2,452	2,875	3,205	2,030	2,820	3,280	3,203	3,733	4,484
Institutional	857	1,026	1,276	1,500	1,117	1,592	2,016	2,228	2,787	3,433
Variable annuities	941	1,039	1,225	1,346	854	1,131	1,291	1,250	1,396	1,614

¹ Front-end load > 1 percent. Primarily includes Class A shares; includes sales where front-end loads are waived.

² Front-end load = 0 percent and contingent deferred sales load (CDSL) > 2 percent. Primarily includes Class B shares.

³ Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes Class C shares; excludes institutional share classes.

⁴ All other load share classes not classified as front-end load, back-end load, or level load. Primarily includes retirement share classes, known as Class R shares.

⁵ Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

Note: Components may not add to the total because of rounding. Data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute and Lipper

By contrast, level load and no-load share classes have seen net inflows and rising assets over the past 10 years.¹² Although demand for level load share classes has weakened in recent years, these funds have experienced modest inflows and growth in assets over the last decade. No-load share classes—those with neither a front-end nor a back-end load fee and a 12b-1 fee of no more than 0.25 percent—have accumulated the bulk of the inflows to long-term funds over the past 10 years. In 2013, no-load share classes accounted for 64 percent of long-term fund assets, compared with 49 percent in 2004.

Within no-load funds, the assets of both retail and institutional share classes have grown considerably over the past 10 years. However, assets in no-load institutional share classes have grown faster, rising from 28 percent of the assets in no-load share classes in 2004 to 43 percent in 2013.

Some movement toward no-load funds can be attributed to “do-it-yourself” investors. But two other factors likely explain most of the shift. First, sales of no-load share classes through sales channels that compensate financial professionals with asset-based fees outside mutual funds

(for example, through mutual fund supermarkets, discount brokers, fee-based professionals, and full-service brokerage platforms) have increased. Second, assets and flows to institutional no-load share classes have been bolstered by 401(k) plans and other retirement accounts, which often invest in institutional no-load share classes. The shift toward no-load share classes has been important in driving down the average expense ratio of mutual funds.

Conclusion

Expense ratios of equity funds declined in 2013 as a result of lower expense ratios of individual funds, economies of scale gained through asset growth, increased demand for index funds, and a continuing shift by investors in both actively managed and index funds toward lower-cost funds. Expense ratios of bond funds were unchanged in 2013. Strong asset growth and competitive pressures, fueled by individuals saving for retirement and new target date fund entrants, has put downward pressure on target date mutual fund expenses. Expenses on funds nearing their target date are especially low, due primarily to their greater allocation to fixed-income securities.

Additional Reading

- » “**The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2012.**” Investment Company Institute. Available at www.ici.org/pdf/per19-04.pdf
- » “**Inside the Structure of Defined Contribution / 401(k) Plan Fees: A Study Assessing the Mechanics of the ‘All-In’ Fee.**” Investment Company Institute. Available at www.ici.org/pdf/rpt_11_dc_401k_fee_study.pdf
- » “**The U.S. Retirement Market, Fourth Quarter 2013.**” Investment Company Institute. Available at www.ici.org/research/stats/retirement/ret_13_q4
- » **ICI Resources on 401(k) Plans.** Investment Company Institute. Available at www.ici.org/401k
- » **ICI Resources on 12b-1 Fees.** Investment Company Institute. Available at www.ici.org/rule12b1fees

Notes

- ¹ ICI uses asset-weighted averages to summarize the expenses and fees that shareholders pay through mutual funds. In this context, asset-weighted averages are preferable to simple averages, which would overstate the expenses and fees of funds in which investors hold few dollars. ICI weights each fund's expense ratio by its year-end assets.
- ² Funds that invest primarily in other funds are not included in this section and are analyzed separately in a later section.
- ³ To assess the expenses and fees incurred by individual shareholders in long-term funds, this paper includes both retail and institutional share classes of long-term mutual funds. Including institutional share classes is appropriate because the vast majority of the assets in the institutional share classes of long-term funds represent investments made on behalf of retail investors, such as through defined contribution plans, IRAs, broker-dealers investing on behalf of retail clients, 529 plans, and other accounts (such as omnibus accounts).
- ⁴ Exchange-traded funds are excluded from this analysis.
- ⁵ Investors generally do not pay sales loads for investing in money market funds.
- ⁶ Some funds of funds also invest in exchange-traded funds.
- ⁷ A 2006 Securities and Exchange Commission rule requires a fund of funds to include both direct and indirect expenses in the expense ratio reported in its prospectus fee table. The expense ratios shown in Figure 13 account for both the expenses that a fund pays directly out of its assets (direct expenses) and the expenses of the underlying funds in which it invests (acquired fund fees or indirect expenses).
- ⁸ As of December 2013, 90 percent of target date mutual fund assets were held in IRAs and defined contribution retirement plans. See Investment Company Institute 2014.
- ⁹ When plan participants are enrolled automatically or otherwise do not specify how their contributions should be allocated among plan investment choices, the plan sponsor is permitted to invest the contributions in a qualified default investment alternative (QDIA). The Pension Protection Act of 2006 mandated that QDIAs include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or both. The Department of Labor QDIA regulation (29 CFR 2550.404c-5) allows three types of investments to be used as long-term QDIAs: target date funds (also called lifecycle funds), balanced funds, and managed accounts. These may be mutual funds, collective investment trusts, or separately managed accounts. This section focuses only on target date mutual funds.
- ¹⁰ In the EBRI/ICI 401(k) database, from which this statistic was generated, *funds* includes mutual funds, collective investment trusts, separately managed accounts, and any pooled investment products invested in the security indicated. See Holden, VanDerhei, and Alonso 2008; Holden et al. 2011; Holden et al. 2012; and Holden et al. 2013.
- ¹¹ See, for example, Damato and Pessin 2010.
- ¹² A level load is an annual 12b-1 fee of more than 0.25 percent.

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