INVESTMENT COMPANY INSTITUTE

RESEARCH FUNDAMENTALS

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Fees and Expenses of Mutual Funds, 2005

Key Findings

- **Mutual fund fees and expenses fell to their lowest levels in more than a quarter century during 2005:** Stock fund investors on average paid 113 basis points in fees and expenses, a drop of 4 basis points from 2004. Fees and expenses on bond funds fell to 90 basis points in 2005, a decline of 2 basis points.
- **The drop in fees and expenses continued a trend observed since the early 1980s:** The fees and expenses paid by bond and stock fund investors have dropped more than 50 percent since 1980.
- **Lower expense ratios drove average fees and expenses downward:** Stock fund asset-weighted expense ratios fell for the third consecutive year, while average bond fund expense ratios fell for the second year. The average sales loads that investors paid remained unchanged.
- **Increased investor demand for low-cost funds accounted for more than half of the decline in the asset-weighted average expense ratio:** A drop in expense ratios at many mutual funds also contributed to the reduction in average expense ratios.

Mutual Fund Fees and Expenses Continue Downward Trend in 2005

The average fees and expenses that investors paid on mutual funds fell in 2005 to their lowest levels in more than 25 years. Investors paid 113 basis points on average to invest in stock funds, a 4 basis-point decline from 2004. Average fees and expenses on bond funds dropped 2 basis points to 90 basis points, and those on money market funds dropped 1 basis point to 41 basis points.

The reduction in mutual fund fees and expenses in 2005 continued a downward trend that has been in place since at least 1980 (Figure 1). The decline has been most pronounced among stock and bond funds—where average fees and expenses have dropped by more than 50 percent since 1980. The average fees and expenses of money market funds, which are lower than those of stock and bond funds, have fallen about 25 percent since 1980.

Sean Collins, ICI Senior Economist, prepared this report.

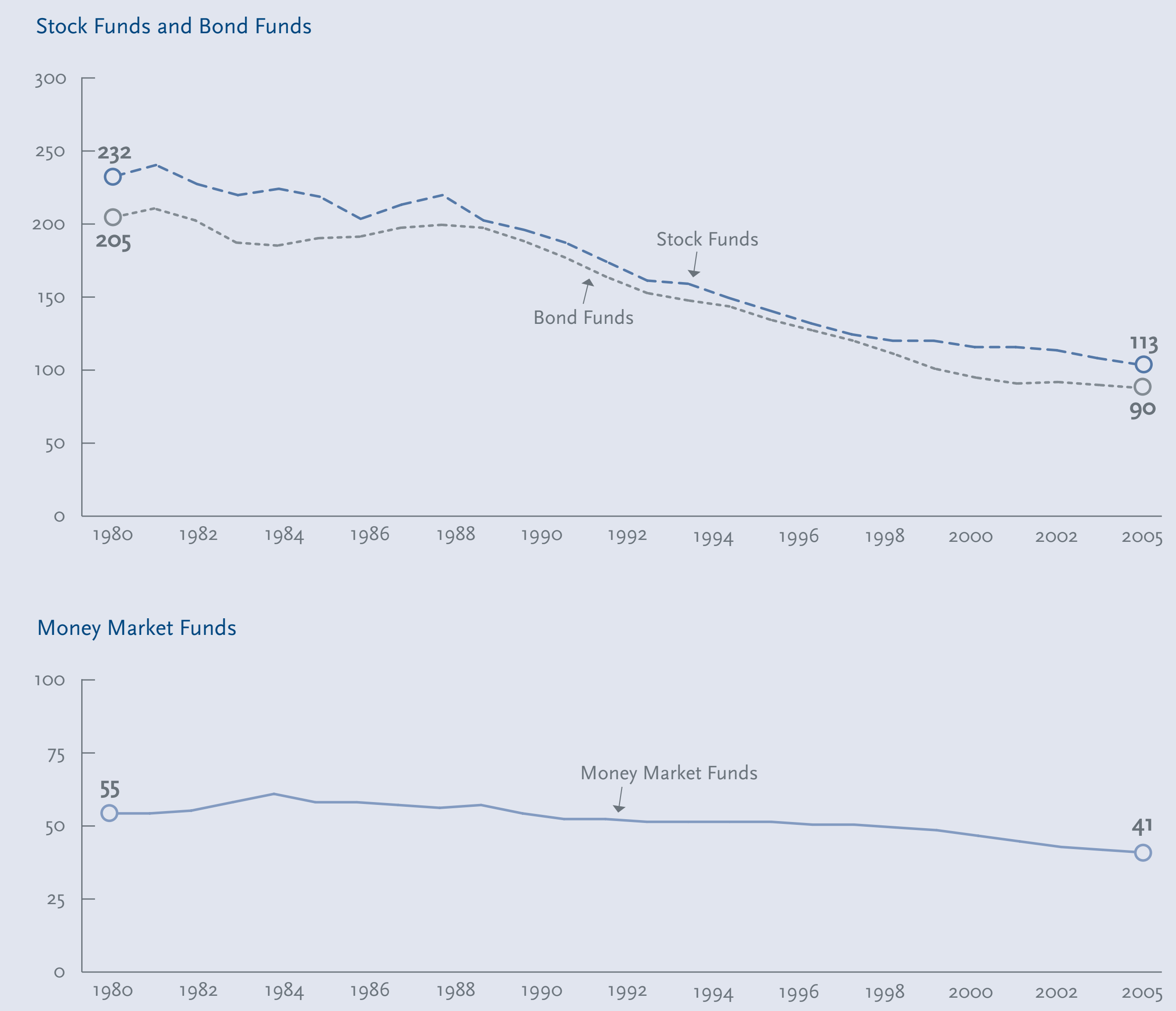
How ICI Measures Average Mutual Fund Fees and Expenses

Mutual fund investors incur two primary kinds of fees and expenses when investing in mutual funds: sales loads and ongoing expenses. Sales loads are one-time fees that investors pay either at the time of purchase (front-end loads) or, in some cases, when shares are redeemed (back-end loads). Ongoing expenses are paid from fund assets and investors thus pay these expenses indirectly. Ongoing fund expenses cover portfolio management, fund administration, shareholder services, distribution charges known as 12b-1 fees, and other operating costs.

Figure 1

Mutual Fund Fees and Expenses Have Declined Substantially Since 1980

Basis points, selected years



Note: Fees and expenses are measured as an asset-weighted average.

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A variety of factors affect a mutual fund's fees and expenses, including its investment objective, its asset size, the average account balance of its investors, and whether it is a "load" or "no-load" fund. Load funds are sold through intermediaries, such as brokers or registered financial advisers who provide investors with financial planning, advice, and ongoing service. Load fund investors pay for these services through some combination of front- or back-end loads and 12b-1 fees. Investors who do not use a financial adviser (or who pay the financial adviser directly for services) purchase no-load funds, which have no front- or back-end load fees and have low or no 12b-1 fees. Because load funds come bundled with financial planning and advice, they typically have higher fees and expenses than no-load funds.

To understand trends in mutual fund fees and expenses, it is helpful to combine one-time sales loads and ongoing expenses into a single measure of fund ownership costs. ICI arrives at 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.[1] This measure gives more weight to those funds with the most assets in order to accurately assess the fees and expenses actually paid by investors.[2]

Stock Fund Fees and Expenses

The average fees and expenses paid by stock fund shareholders fell 4 basis points in 2005, following a 5 basis-point decline in 2004 (Figure 2). From 1980 to 2005, stock fund fees and expenses declined 119 basis points, a reduction of more than 50 percent.

Historically, reductions in stock fund fees and expenses have mainly reflected lower payments for one-time sales loads. However, over the past few years, most of the decline in stock fund fees and expenses resulted from lower stock fund expense ratios (Figure 2).

The decline in the average expense ratio of stock funds in 2005 owed primarily to two factors: an increase in the popularity of low-cost funds and investors incurring lower expense ratios in the funds that they already owned (Figure 3). Of the two factors, the increase in the market share of low-cost funds was slightly more important.[3]

Figure 2

Drop in Fund Expense Ratios Drove Down Fees and Expenses in 2005

Basis points, 2000–2005

	Stock Funds						Bond Funds						Money Market Funds					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Total Fees and Expenses	128	124	124	122	117	113	103	97	93	94	92	90	49	47	45	43	42	41
One-Time Load Fees (annualized)	30	25	24	23	22	22	27	22	20	20	20	20	-	-	-	-	-	-
Total Expense Ratio	98	99	100	99	95	91	76	74	73	74	72	70	49	47	45	43	42	41

Note: Total fees and expenses, one-time load fees, and total expense ratio are measured as asset-weighted averages.

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Increase in Popularity of Low-Cost Stock Funds

When low-cost funds gain market share, the asset-weighted average expense ratio of those funds will decline. This principle was at work in 2005. Stock fund assets typically have been concentrated in low-cost funds (Figure 4). This pattern has been accentuated in the past few years as investors increasingly skewed their purchases of new fund shares toward funds with very low expense ratios. For example, of the $136 billion in net new cash flow to stock funds in 2005, 30 percent ($41 billion) went to those funds with expense ratios of less than 50 basis points, up from 22 percent in 2003 (Figure 5).

Figure 3

Two Major Factors Contributed to the Drop in Average Expense Ratio of Stock Funds in 2005

Basis-point drop due to each factor

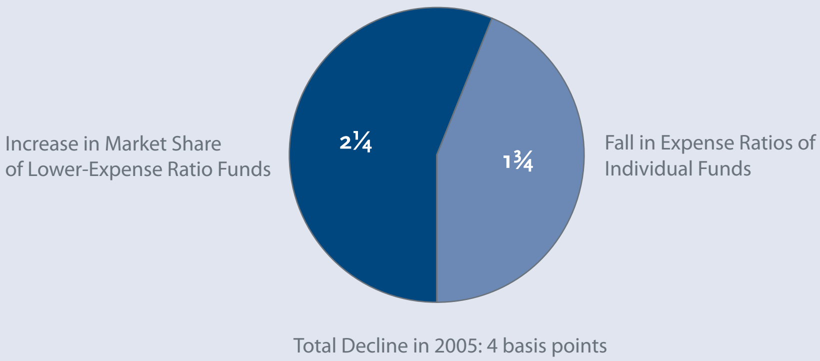

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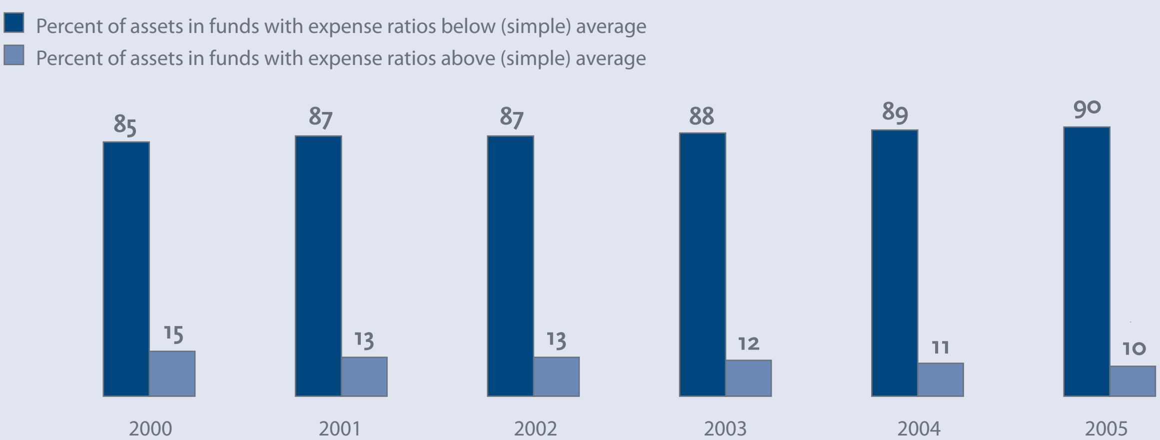
Figure 4

Stock Funds with Below-Average Expense Ratios Hold 90 Percent of Assets

Percent of total equity fund assets, 2000–2005



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Institutional funds, which typically have very low expense ratios, were responsible for half ($68 billion) of the $136 billion in new cash flowing to stock funds in 2005. The vast majority of the assets in these funds are held by individual investors, either through 401(k) accounts, trust accounts, or other arrangements. True institutional investors—such as banks, insurance companies, nonfinancial businesses, and nonprofit organizations, who invest for their own purposes rather than as fiduciaries or as intermediaries for others—hold little of the assets of stock funds, just 7 percent in 2005.

Asset Growth Leads to Lower Expense Ratios at Individual Stock Funds

Expenses ratios fell at many individual funds in 2005, in large part because of asset growth. The assets of stock funds rose $556 billion, owing to the $136 billion in net new cash flow and capital gains stemming from solid performance in equity markets both domestically and abroad. The growth in assets was spread widely, with 65 percent of individual stock funds experiencing asset growth during the year.

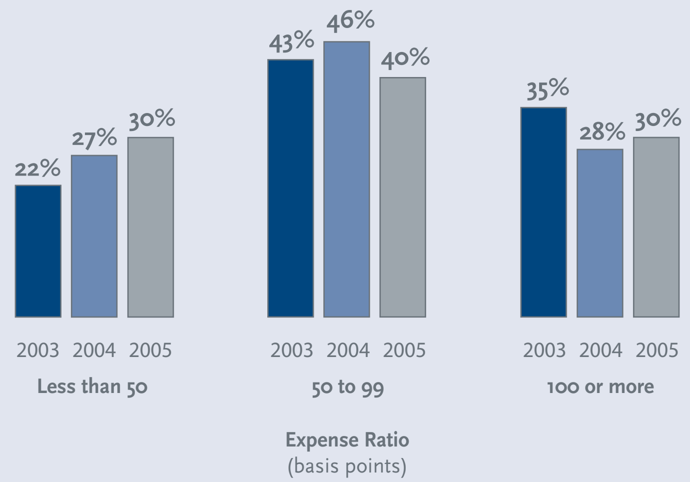
Asset growth resulted in lower expense ratios at individual equity funds for a number of reasons:

- **Effect on advisory fees:** As a rule, asset growth tends to reduce the advisory fees of a given mutual fund, whether that fund is a stock, bond, or money market fund. Some mutual funds have "breakpoints" in their advisory contracts that automatically lower their advisory fees as fund assets grow. Even if a fund's advisory contract does not have breakpoints, the fund's adviser (in conjunction with the fund's board) may cut a fund's advisory fee as its assets grow. Moreover, regardless of asset growth, advisers may cut their fees for competitive reasons or may institute fee waivers, both of which lower a fund's expense ratio. All of these factors helped to lower the expense ratios of stock funds in 2005.

Figure 5

New Cash Flow to Lowest-Cost Stock Funds Increased in 2005

Percent of annual net new cash flow for years 2003 to 2005



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- **Effect on transfer agent fees:** Asset growth helps reduce transfer agent fees, which represent a significant portion of fund expense ratios. Transfer agent fees—fees that mutual funds pay for shareholder services such as basic individual shareholder account maintenance, call centers that help investors purchase or redeem shares, and other services—tend to add less to a fund's expense ratio as its assets rise, especially when asset growth is matched by an increase in shareholders' account balances. Paralleling developments in the stock market, average account balances in stock funds fell significantly from 1999 to 2002 (Figure 6), putting upward pressure on transfer agent fees. As the stock market recovered, average account balances rose and by 2005 had almost reached their 1999 peak. The recovery in average account balances has helped relieve upward pressure on transfer agent fees and thus fund expense ratios. On an asset-weighted basis, stock fund transfer agent fees fell from an estimated 18 basis points in 2002 to 15 basis points in 2005. This 3 basis-point decline accounted for one-third of the 9 basis-point decline in the asset-weighted average expense ratio of equity funds from 2002 to 2005.

- **Effect on other ongoing fees:** Asset growth tends to lower fund expense ratios because, as a fund's assets grow by a given percent, some of its fees, such as audit and registration fees, typically rise by a smaller percent. Consequently, such fees add less to a fund's expense ratio as its assets rise.

Legal Settlements and Performance Fees Had Minimal Effects on Overall Expense Ratios

The expense ratios of some mutual funds either rose or fell in 2005 in response to two additional factors: "performance fees"[4] and fee cuts agreed to in legal settlements stemming from late trading or market timing issues. While these factors led to sizeable changes in the expense ratios of a certain number of funds, the influence on the overall asset-weighted average expense ratio of stock funds in 2005 was negligible.[5]

Figure 6

Average Equity Fund Account Balances Rose as Stock Market Recovered

Thousands of dollars, 1995–2005

Source: Investment Company Institute

Bond Fund Fees and Expenses

The average fees and expenses that shareholders paid for investing in bond funds fell 2 basis points in 2005, to 90 basis points. Since 1980, bond fund fees and expenses have declined 115 basis points (Figure 1), a reduction of 56 percent.

As with stock funds, the 2005 decline in bond fund fees and expenses owed to a fall in the asset-weighted average expense ratio of bond funds (Figure 2). The drop in the average expense ratio, in turn, resulted almost wholly from an increase in the market share of low-cost bond funds: of the 2 basis-point decline in the average expense ratio of bond funds in 2005, 1¾ basis points stemmed from an increase in the market share of lower-cost bond funds.

In 2005, the assets of bond funds rose $67 billion, in part reflecting net new cash flow of $31 billion. Growth in the assets of individual bond funds and explicit fee cuts among individual bond funds accounted for the remaining ¼ basis point of the 2 basis-point decline in the average expense ratio of bond funds.

Money Market Fund Fees and Expenses

The average fees and expenses paid by money market fund investors fell 1 basis point in 2005, to 41 basis points. From 1980 to 2005, money market fees and expenses declined 14 basis points (Figure 1), a 25 percent reduction.

This 25 percent reduction in money fund fees and expenses is due in part to a dramatic increase in the share of money fund assets held in institutional money market funds. Institutional money funds, on average, have lower expense ratios than retail money market funds.[6] As a result, any increase in the institutional share of money fund assets tends to lower the asset-weighted average expense ratio of all money market funds. The share of money fund assets held in institutional funds has, in fact, more than doubled in the past 15 years, from just 20 percent in 1990 to 55 percent in 2005.

Two factors helped foster this shift. First, during the 1990s institutional money funds grew rapidly as businesses and other institutions became increasingly aware of the benefits that institutional money funds offered in terms of scale economies, liquidity, diversification, and monitoring of credit risk. Second, growth in retail money funds has been slowed by changes in brokerage firms' cash management policies for their retail accounts. Since the late 1990s, brokerage firms have relied less on money market funds and more on bank money market deposit accounts as cash management vehicles for their retail clients.

Notes

[1] For more details, 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).

[2] Except where noted, fees and expenses reported in this article are measured as asset-weighted averages. An asset-weighted average is the appropriate way to measure the fees that investors actually pay through mutual funds. Simple averages can overstate the importance of fees and expenses in funds in which investors hold few dollars.

[3] The contribution analysis in Figure 3 is determined by first calculating the amount by which the asset-weighted average expense ratio of equity funds would have declined if the expense ratio of each and every equity fund had remained unchanged between 2004 and 2005. This contributed 2¼ basis points (labeled in Figure 3 as "Increase in Market Share of Lower-Expense Ratio Funds") to the 4 basis-point reduction in the asset-weighted average expense ratio of equity funds. By definition, the remaining 1¾ basis points must owe to changes in fund expense ratios between 2004 and 2005 (labeled in Figure 3 as "Fall in Expense Ratios of Individual Funds").

[4] Some mutual funds have performance fee contracts, which in part link their expense ratios to fund performance. For such funds, when fund performance exceeds a given benchmark, the fund's expense ratio increases, rewarding the fund's adviser for good performance. Similarly, when performance falls below the stated benchmark, the fund's expense ratio falls. In 2005, equity funds with performance fee contracts tended to outperform their benchmarks, somewhat boosting their expense ratios.

[5] In 2004, eight mutual fund advisers made legal settlements in which they agreed to reduce fees for a period of five years; in 2005, two more advisers reached similar legal settlements in which they agreed to reduce fees by roughly $15 to $20 million each year for five years. The fee cuts associated with these additional legal settlements would have lowered the asset-weighted average expense ratio of all equity funds by about 1/10 of a basis point in 2005. At the same time, however, mutual funds paid performance fees of about $18 million in 2005, which would have boosted the asset-weighted average expense ratio of all equity funds by 1/10 of a basis point. All told, therefore, performance fees and fee cuts associated with the legal settlements had very minimal effects and offset one another.

[6] Money market funds designed for retail investors typically require low minimum initial investments, usually $500 to $2,500. In contrast, institutional money market funds—which are marketed to businesses, pension plans, state and local governments, and other institutions—require much higher minimum initial investments, often well in excess of $1 million. It should also be noted that institutional money funds, in contrast with long-term institutional mutual funds (or institutional share classes of long-term mutual funds), are primarily the assets of true institutional investors.