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Mutual Funds, Fee Transparency, and Competition

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The mutual fund industry has attracted widespread media attention in recent months. A day rarely passes without a story about alleged fund misdeeds or proposed remedies. The breadth of the scandal raises a serious question about the need for actions that might strengthen and protect the public's trust in the integrity of mutual funds. In light of these concerns, the Securities and Exchange Commission and Congress are considering remedies aimed at reducing the likelihood of future abuses.

The scandal has also brought scrutiny to fund fees and costs, raising questions about the adequacy of competition as a disciplinary force. Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary John Snow pointed to this concern when they urged legislators, as they consider possible reforms, to "make sure that the fees associated with mutual funds are subject to competitive tests of the market place." The issue centers on whether the rules governing fee disclosure ensure that mutual fund fees are exposed to these tests.

One reason the mutual fund market may not be adequately competitive is that not all investors have what would be considered "sufficient" information, and such a deficiency can result in undesirable outcomes, like some investors paying more for identical products. Changes imposed on the mutual fund marketplace need to address this information deficiency, and new rules for improved disclosure are a step in the right direction.

■ Mutual Fund Basics

Mutual funds are investment companies that collect savings from many individual investors and invest those savings in a wide range of financial assets or securities. The funds' pooling of individual savings makes it possible for small investors to obtain fractional shares of many different securities and thereby enables them to gain the benefits of diversification and lower transaction costs. For households with limited wealth, mutual funds provide one of the only practical means to own a diversified portfolio of stocks and bonds. It is well established that owning such a portfolio provides significant advantages for building a retirement nest egg.

Mutual funds come in many varieties. For, example, there are mutual funds for stocks, bonds, money market instruments, and combinations of them—commonly called hybrids. Many varieties exist within these general classes. Some stock funds, for example, invest broadly in an effort to produce yields close to market indexes, such as the S&P 500 or the Wilshire 5000. Others differentiate according to prespecified investment criteria such as size (large, medium, or small firms), and style (value, growth, or blend). Moreover, some funds specialize in sectors of the economy, such as information technology or biomedicine, while others may invest in international portfolios.

When held over long periods of time, broad portfolios of stocks and bonds have produced returns that substantially exceed the interest rate paid on less risky

Mutual funds enable small, less experienced investors to hold diversified portfolios of stocks and bonds at relatively low costs. Though the mutual fund market is competitive in many ways, fees can vary substantially for what are essentially identical products. This may be due to bundling of services, but it may also reflect some confusion on the part of less experienced investors, which inhibits comparative shopping among funds. Suggested reforms for improved fee disclosure seek to make fees more transparent for less informed investors and should improve competitive discipline among funds.

assets such as short-term U.S. Treasury bills or bank deposits. So, to the extent that mutual funds have made it possible for the small investor to participate in the stock and bond markets, they have enabled small investors—in principle at least—to earn higher returns on their savings.

The virtues of mutual funds have become widely recognized, with household participation increasing dramatically over the last 25 years. Fund assets have increased from less than \$1 trillion in 1980 to more than \$7 trillion today. Stock funds currently account for about \$3.5 trillion—or half the value of all funds. The sheer magnitude of these numbers suggests that the ongoing reassessment of the adequacy of market discipline is no small matter.

■ Elements of Competition

Highly competitive markets are generally characterized by four basic elements: First, they often have many buyers and sellers. Having many participants reduces the power of anyone (buyer or seller) to dictate his own price. Second, no barriers prevent buyers or sellers from freely entering or exiting the market. The openness of a market to newcomers provides a potential threat of competitive discipline, even in situations where the number of buyers and sellers may be limited. Third, a standard good is sold. This allows buyers to make what are commonly called apples-to-apples comparisons. And fourth, buyers have sufficient information about the goods sold to determine their relative worth.

Markets for commodities such as wheat are often cited as an example of markets with these characteristics. Because the wheat market is competitive, buyers can expect to pay a competitive price when purchasing a bushel of wheat. Moreover, the price will be the same for all buyers and sellers in that market. This is the law of one price, and it is a hallmark of highly competitive markets.

The mutual fund market clearly exhibits the first two characteristics. There are thousands of mutual funds for sale and tens of millions of households that buy them. New funds are launched almost daily.

A little less obvious is that all of these funds provide a standard product. Despite the variety of mutual funds, each category typically has a reasonably standardized benchmark. In its annual review of mutual funds, for instance, *Money* magazine identifies 41 distinct peer groups for stocks and 55 for bond funds. Mutual fund investors can thus compare fund performance and costs within peer groups. Within these groups mutual funds are reasonably homogeneous. Importantly, each peer group typically has many buyers and sellers and free entry of new sellers.

Where the mutual fund market may deviate from the competitive paradigm is in terms of the fourth characteristic—sufficiently informed buyers. With mutual funds, investors often lack information the fund managers have. This information gap is inherent in the nature of the mutual fund industry. Investors rely on the fund manager to make decisions that are in their best interest, but their ability to monitor whether the fund

is performing as well as the competition is limited. Even investors who have the means to monitor fund performance may choose not to if the costs exceed the expected benefits.

■ Do Investors Have Sufficient Information?

Investors as a rule have less information than fund managers, but whether they have what they need to understand the differences among funds, and thus what they should be willing to pay for them, is subject to debate. The evidence tends to support the view that some investors are not as informed as they should be when it comes to mutual funds, especially where fees are concerned.

S&P 500 index funds offer one of the simplest vehicles for addressing this question. Like any index fund, an S&P 500 index fund buys shares of securities in proportion to the securities' representation in the index being tracked. Because the S&P 500 index is value weighted, a fund tracking it buys shares in each S&P 500 company in proportion to that firm's outstanding equity value. Transaction costs are limited, because as the fund grows, the fund manager rarely sells stock. Index funds are thus one of the lowest-cost ways for small investors to participate in the stock market.

Of all types of mutual funds, an S&P 500 index fund is perhaps most like a pure standard good. Returns on different funds' portfolios are virtually identical. Moreover, because these funds hold the same securities in the same proportions, their risk characteristics are essentially identical. If this market is competitive, fees should be low and about the same for all funds in the market. For the most part, the S&P 500 index fund market is dominated by a few low-cost, low-turnover funds that consistently produce returns closely in line with the index—a result one expects from a highly competitive market.

But according to a recent study,¹ the market also supports a number of funds that persistently yield less than their peers. Moreover, the study demonstrates that expenses are the key determinant in overall fund performance. In fact, the gross returns on portfolios held by funds are virtually identical as expected, but the added costs associated with higher expense ratios—the ratio of fees to assets—reduce net returns by a like amount. Although it is easy to identify which S&P 500 funds have high costs and are thus likely to exhibit

poor performance, the high-cost funds persist and even grow—an outcome not consistent with the competitive market paradigm.

It might seem puzzling that investors in an S&P 500 fund could be uninformed about the fund's costs or investment performance. Current regulations require that expense ratios be prominently displayed in a fund's prospectus. Moreover, other costs not associated with fees are usually small for an index fund and do not materially affect a fund's relative performance.

While the study's authors view the existence of persistent performance differentials in S&P index funds as evidence that some investors are uninformed, another explanation is possible. Investors might hold persistently lower-yielding funds because they are bundled with other services from a broker or financial advisor. For example, the financial advisor might answer questions and give advice without charge—a service of value to the small investor. In such a case, investors are paying for the extra value.

The terms of these sorts of arrangements are not easily observed, and it would take some investigation to determine whether they existed. But while we don't have data to refute that explanation, results from surveys on financial literacy suggest many investors do not fully understand the implications of alternative fee structures in the format they are currently disclosed.²

■ Improving Fee Disclosure

If investors are confused about mutual fund fees, it's not too hard to see why. The range of alternative fee structures is wide, and the way fees are disclosed makes comparison difficult. Fees that appear in expense ratios are of two types, operating expenses and distribution fees. Neither operating expenses nor distribution fees are explicitly billed to the investor. Rather, they are deducted from fund assets, as are brokerage fees incurred in managing the portfolio. Thus, they reduce returns by an equal percentage amount.

Operating expenses include fund administration, shareholder servicing, and investment management. In the case of index funds, investment management is minimal. Distribution fees have been permitted since 1980 under what is known as Rule 12b-1. Before 12b-1 fees, all funds were sold through brokers and carried one-time sales charges

FIGURE 1 DOLLAR COST IMPLICATIONS OF ALTERNATIVE FEE STRUCTURES

	Cumulative Proceeds with 7% Total Return before Costs		
	Fund A: Low cost ^a	Fund B: Moderate cost ^b	Fund C: High cost ^c
Initial investment	\$10,000	\$10,000	\$10,000
5 years	\$13,908	\$13,023	\$12,939
10 years	\$19,343	\$17,759	\$16,911
25 years	\$52,037	\$45,034	\$37,753

Notes: **a.** With no load, 0.18 percent expense ratio. **b.** With 4.5 percent front-end load, 0.6 percent expense ratio. **c.** With 1 percent front-end load, 1.5 percent expense ratio, including 0.65 percent 12b-1 fee.

known as front-end loads. These loads were paid by the investor to brokerages at the point of sale. The 12b-1 rule enabled the creation of a new share class, which could be sold by a mutual fund directly to investors with no load. (Many funds still charged redemption fees, though—also called back-end loads—for shares redeemed before a specified period.) Unlike loads, 12b-1 fees are paid out of fund assets and reduce investor returns. More significantly, they are ongoing.

The 12b-1 fee was intended as a temporary measure to allow funds to recoup marketing and advertising costs associated with launching the new share class. Today, 12b-1 fees are a common component of the expenses for many funds and are largely used to pay for the sale of fund shares through brokers and financial advisors.

After the introduction of 12b-1 fees, mutual funds began to offer different classes of shares for the same fund. One class might, for instance, involve a front-end load but no 12b-1 fee. Another may have no front-end load but impose 12b-1 fees and have redemption fees that diminish to zero over five-year periods. Other classes of shares have combinations of loads and 12b-1 fees. It seems apparent that even sophisticated investors may become bewildered by the choice of share class.

The SEC and Congress are proposing to standardize disclosure of fees and loads in terms of the dollar cost for a given initial investment over comparable holding periods. Surveys suggest inves-

tors find it easier to make comparisons between funds if costs are disclosed in this way. To appreciate how dollar cost comparisons simplify the choice investors face, consider figure 1. Figure 1 illustrates the dollar-cost-based format in terms of cumulative returns on three different S&P 500 index funds. It assumes an initial investment of \$10,000 and a steady portfolio return of 7 percent per year (before costs). Fund A has neither a load nor a 12b-1 fee and has very low operating expenses—a fee structure similar to the large, dominant index funds in the market. Fund B has a high front-end load but a moderate expense ratio. Fund C has a small load but a high expense ratio, which includes a 12b-1 fee. Though the differences seem small, their cumulative impact can be substantial over one's lifetime.

The comparison also demonstrates the pernicious effect that high 12b-1 fees would have for an investor who chooses to hold Fund C over a long period. Though the front-end load is smaller than that of Fund B, the recurring nature of the 12b-1 fee is amplified through a compounding effect.

The SEC is currently seeking comments on the need for additional changes to Rule 12b-1. Specifically, it seeks comments on whether distribution costs should be deducted directly from shareholder accounts rather than from fund assets. This would make distribution costs more transparent in that the cost would appear in each shareholder statement. At the request of SEC chairman William Donaldson, the proposal will also seek comments on whether Rule

12b-1 should be abolished altogether. This would effectively eliminate share classes and force funds to compete on loads, which are much easier to understand.

■ Problem Solved?

Perhaps the most important virtue of mutual funds is that they enable small, less experienced investors to hold diversified portfolios of stocks and bonds at relatively low cost. Recent investor surveys suggest, however, that mutual fund fees may not be disclosed in a format that easily allows novice investors to do comparative shopping among funds. Many of the proposals for improved disclosure—some already implemented—go far in making fees more transparent for less informed investors and hence will likely improve competitive discipline among mutual funds.

It is unclear whether improvements to disclosure rules alone can solve the problem in a cost effective way. Chairman Greenspan and Treasury secretary Snow also urged Congress to measure the benefits of any proposed change against its costs. It seems that there will be a continuing need for improved financial education among households and that such education must come from other sources. Hopefully, this *Economic Commentary* is a contribution toward this end.

■ Footnotes

1. Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse. 2004. "Are Investors Rational?" *Journal of Finance* 59: 1, 261–88.

2. The study by Elton, Gruber, and Bosse also points to the absence of any mechanism for arbitrage as an important reason high-cost funds may persist. Hence, uniform investors do not benefit from the existence of sophisticated investors. In the case of mutual funds, the only thing a well-informed investor can do is buy the high-performing funds and avoid the poorly performing ones. To distinguish the two, every investor has to be informed.

■ Recommended Reading

Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse. 2004. "Are Investors Rational?" *Journal of Finance* 59: 1, 261–88.

Ed Nosal and Tan Wang. 2004. "Arbitrage: The Key to Pricing Options," Federal Reserve Bank of Cleveland *Economic Commentary*, January 1.

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The views expressed here are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System or its staff.

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