

TIME MAY CHANGE ME

MUTUAL FUNDS' MANAGEMENT FEE CHANGES

OCTOBER 2011

EXECUTIVE SUMMARY

- This report explores the extent to which mutual funds in the UK and Europe have changed their annual management fees over the past ten years, and the size of such changes.
- In the UK, of those funds that have changed their management fees over this period, 80% increased them. This figure rises to more than 90% when looking solely at actively managed equity funds.
- When actively managed equity funds in the UK raised their fees it was by an average of 30 basis points.
- For a European perspective, this research examined funds domiciled in the cross-border centres of Luxembourg and Ireland. Of those funds that have changed their management fees here, 70% increased them.
- For actively managed equity funds sold cross-border, where management fees were changed, 80% were upwards. When looking at bond funds, the proportion that increased their fees was lower, at 60%.
- Where fees were raised it was by an average of 28 basis points for actively managed equity funds and by 17 basis points for bond funds in the cross-border universe.
- Analysis is also provided on the issue of fees and expenses changing in relation to fund assets and explains how in Europe management fees remain largely stable irrespective of fund size, but in the US they often vary as assets rise.
- Finally the different dynamics at work that have resulted in the report's findings are discussed – and what it might take for these to change.

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AUTHORED BY:

ED MOISSON

HEAD OF UKI & CROSS-BORDER RESEARCH

LIPPER

ED.MOISSON@THOMSONREUTERS.COM

LIPPER



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INTRODUCTION

“ Ch-ch-ch-changes
 Don't want to be a richer man
 Ch-ch-changes
 Just gonna have to be a different man
 Time may change me
 But I can't trace time ”
 (David Bowie, 1971)

Previous research has shown that for actively managed funds in the UK and those sold cross-border around Europe annual management fees have been on the rise for retail investors over the past ten to fifteen years.¹

Reasons for higher fees include the rising cost of distribution in continental Europe, the growing power of platforms in the UK, more specialised funds laying claim to higher fees, the cost burden of regulation and the desire to increase revenues.

But the reason why the industry average has risen is because of the dual process of new funds setting their fees at or above the current average, together with existing funds that change their fees pushing them up (rather than down).

It is this second factor that will be explored in this unique report: to what extent have funds changed their management fee levels over the past ten years, and how big have such changes been?

The universe of products assessed is open-ended mutual funds domiciled in the UK, Luxembourg or Ireland and for which fund accounts have been analyzed.² This universe was then restricted to equity funds (split between actively and passively managed), bond funds, mixed asset funds and money market funds, so that reasonable comparisons could be made not just across one market, but also for different asset classes. Also for comparison purposes, this universe was restricted to the main retail share class of each fund.

It is also worth noting that, because Lipper's Total Expense Ratios (TERs) are calculated rather than collected, we are reliant on fund accounts in order to review fee and expense levels. As a result, at the time of going to press, 2010 data reflects approximately two thirds of the relevant fund universes.



REUTERS/Leonhard Foeger

¹ For example, see Ed Moisson, 'Fee trends in European funds' (December 2008).

² With thanks to Jinnie Ho and Darren Thomas, Lipper's TER experts, for creating this database.

UNITED KINGDOM

In the ten years assessed, 196 funds were found to have changed their annual management fee, 80% of which were increases (156 funds). Funds changing their fees therefore represent around 15% of the total universe of funds currently available to UK investors.

Looking solely at actively managed equity funds, 132 funds changed their management fee (accounting for two thirds of the whole universe that changed fees) and over 90% increased the fee (121 funds). When three funds that first lowered and then later raised their fees are excluded,³ the proportion of funds increasing their management fees rises to 94%.

Where fees were increased for actively managed equity funds, the average rise was 30 basis points (for example, from 1.2% to 1.5%), while for those funds that lowered their fees (11 funds), this was by an average of 24 basis points.

On the passive side, index tracking funds provide better news for cost-conscious investors with 79% of the 14 funds that changed their fees actually lowering them. These reductions were 31 basis points, on average and dominated by HSBC's lowering of the fees

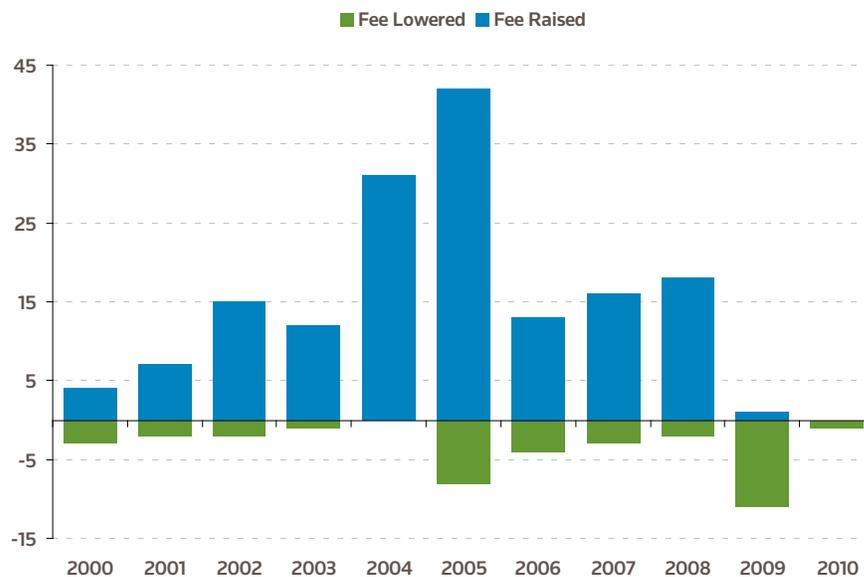
on a range of seven funds in 2009, in some cases from levels above 1% that had been in place for ten years.

Interestingly, although those bond funds that changed their fees were less likely to raise them (72% of funds did so), where changes took place, the amount was similar to equity funds, with the average rise being 28 basis points and the average reduction being 21 basis points.

For money market funds, all nine changes in management fees were downwards, averaging 27 basis points. Having said this, two funds reduced their fees twice in this ten-year period. It is worth noting that the number of money market funds for retail investors in the UK is very small, so even these few changes represent a relatively high proportion of the asset class.

Setting these changes into an historical context, the number of changes each year since 2000 can be seen in figure 1. Broadly an increasing number of funds raised their management fees between 2000 and 2005, this fell back in 2006 before rising again through 2008. However such activity has tailed off dramatically in 2009 and 2010.

FIGURE 1 NUMBER OF FEE CHANGES IN THE UK - ALL ASSET CLASSES



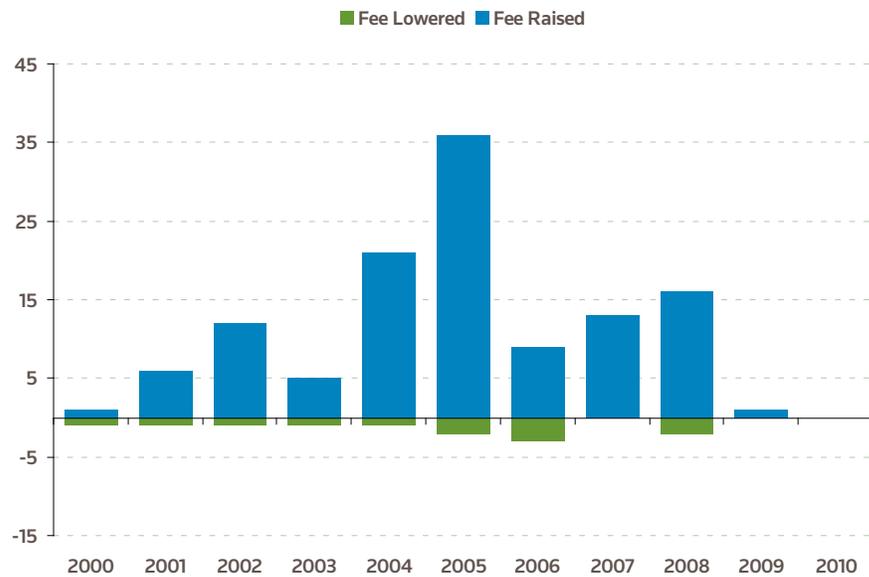
SOURCE: LIPPER, A THOMSON REUTERS COMPANY

³ Namely Artemis Income, Royal London UK Equity Income, and SVM Continental Europe.

Generally the inverse pattern can be seen for funds lowering their fees, with a decreasing number doing so between 2000 and 2005, a rapid rise in 2005 before falling again through 2008. This inverse pattern continued into 2009, when there was again a rise in the number of funds lowering their fees. Activity was very muted in 2010 across the board, although this looks to have picked up again in 2011 (for example, JPMorgan, Standard Life and Henderson).

This same approach can be used to look solely at actively managed equity funds (figure 2), which broadly reflect changes seen for all asset classes as most activity has been focused on the equity side. The most significant difference is the more limited number of funds lowering their fees, reflecting the comments made earlier that such moves have primarily been made by money market and index tracking funds.

FIGURE 2 NUMBER OF FEE CHANGES IN THE UK - ACTIVELY MANAGED EQUITY FUNDS



SOURCE: LIPPER, A THOMSON REUTERS COMPANY

EUROPEAN CROSS-BORDER

For a European perspective, this analysis also covers funds domiciled in Luxembourg and Ireland, the primary centres for selling funds cross-border into multiple markets around Europe – and beyond.

In the ten years assessed, 1,549 funds were found to have changed their annual management fee, 70% of which were increases (1,080 funds). Funds changing their fees therefore represent around 26% of the total universe of the same asset classes currently available to retail investors in these two domiciles. When funds that changed their fees twice are excluded (225 funds), this proportion is 22%.

Looking solely at actively managed equity funds, 784 funds changed their management fee (accounting for just over half of the whole universe that changed fees) and 80% increased the fee (628 funds).

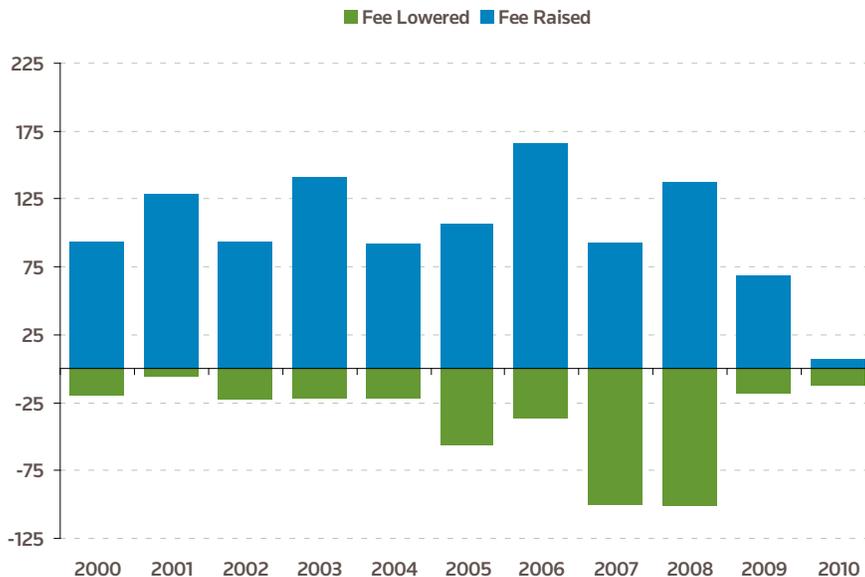
Where fees were increased for actively managed equity funds, the average rise was 28 basis points (median of 25 bp's), while for those funds that lowered their fees, this was by an average of 39 basis points (median of 28 bp's).

On the passive side, index tracking equity funds and exchange traded funds (ETFs) are grouped together, revealing that 16 funds changed their fees, although perhaps surprisingly only nine funds lowered them.

A similar picture is found for money market funds, with 57% of funds that changed their fee levels opting to lower them (71 out of 124 funds). As with passively managed equity funds, cost sensitivity is likely to be high in this asset class, but even so this is clearly not the only factor at play in the cross-border universe, as a significant minority increased their fees in the past ten years.

On the bond funds side, there is a majority of funds that increased their fees, but this is less pronounced than for equities (as was also the case in the UK), reflecting the greater cost-sensitivity in this asset class. Of 480 bond funds that changed their management fees, 288 increased them (60%). Where the fee was raised, it was by 17 basis points (median of 10 bp's) and where the fee was lowered the average was 26 basis points (median of 20 bp's).

FIGURE 3 NUMBER OF FEE CHANGES IN LUXEMBOURG & IRELAND - ALL ASSET CLASSES

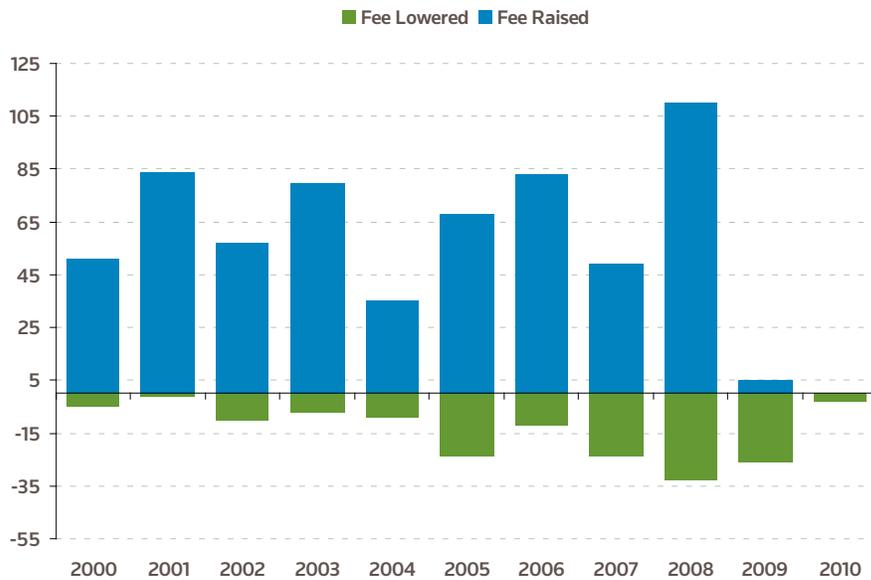


SOURCE: LIPPER, A THOMSON REUTERS COMPANY

Looking at historical trends (figure 3), there is a far less clear pattern than was seen in the UK, probably reflecting the fact that these funds are sold into different markets with differences in cost sensitivities. What is most noticeable has been the general increase in the number of funds lowering their management fees between 2001 and 2008 (although this fell back sharply in 2009).

As was seen earlier, the number of funds lowering their fees is underpinned by products other than actively managed equity funds and this is reinforced in figure 4: the number of funds lowering their fees remains small throughout. Having said this, the improving trend of more funds lowering fees is also reflected in the equity arena and, more than this, the decline in such activity in 2009 was nowhere near as pronounced as in figure 3.

FIGURE 4 NUMBER OF FEE CHANGES IN LUXEMBOURG & IRELAND - ACTIVELY MANAGED EQUITY FUNDS



SOURCE: LIPPER, A THOMSON REUTERS COMPANY

CHANGES RELATED TO FUND ASSETS

An important aspect related to the main analysis in this report is the issue of management fees changing in relation to fund assets, rather than over time. To illustrate this, I would like to tell you a story. It's one about the tempestuous relationship between fund managers and their investors, a tale of envy, desire and basis point negotiations. You may have spotted by now that this is not the plot for this season's latest blockbuster.

My story has recently gained a little extra spice with two old-fashioned heroes riding into view. One from the West - Omaha - and the other from the East - well, his father hailed from Russia - with both willing to make a little less money in order to help their fellow citizens. Warren Buffett and Stuart Rose are not alone; others in France and Germany are also saddling up.

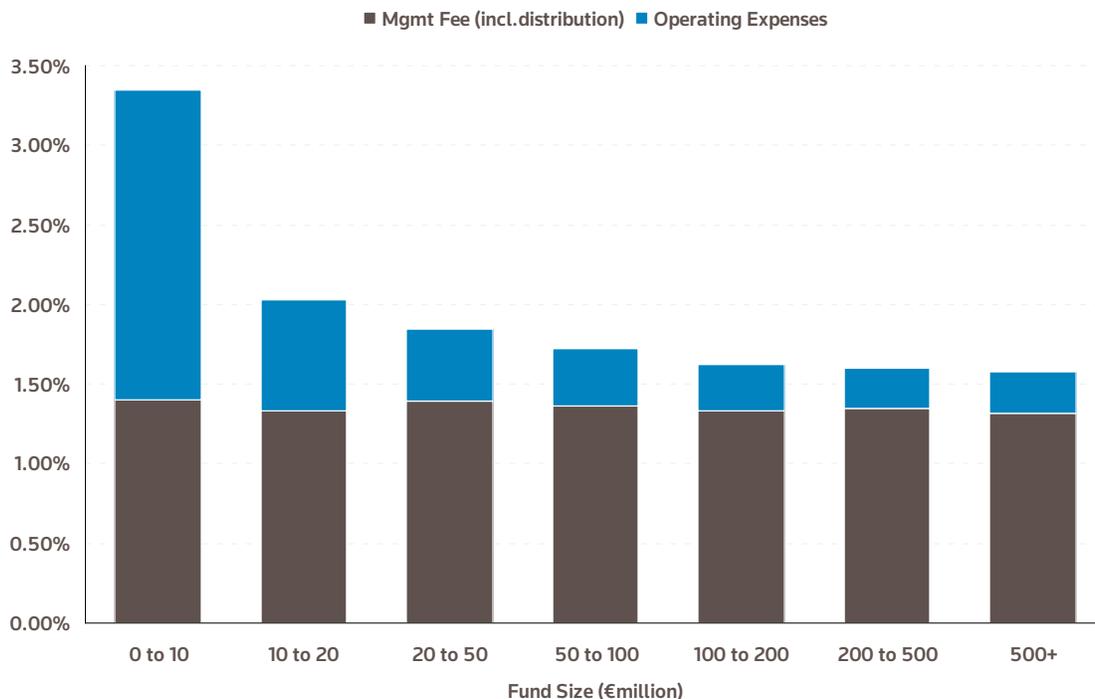
Yet these horsemen seem to be heading in the opposite direction from those in the European funds

industry. There is one aspect that I'd like to look at to explore this: the fees generated by funds in relation to their assets. And in this case Europe and the US look pretty different.

One of the implicit benefits of investing in a mutual fund is that investors enjoy lower annual charges as a result of a fund's success in increasing assets, in other words that costs fall as more investors join - economies of scale.

The following chart illustrates these economies of scale in action for funds sold across Europe. But although the disproportionately high expenses borne by the smallest funds does mean that average total expense ratios (TERs) fall as assets rise, crucially, such economies of scale do not continue through further asset rises among larger funds.

FIGURE 5 AVERAGE TERS FOR EUROPEAN CROSS-BORDER EQUITY FUNDS BY SIZE



SOURCE: LIPPER, A THOMSON REUTERS COMPANY

⁴ With thanks to Reuters' Joel Dimmock for reviewing this chapter.

⁵ New York Times, 14 August 2011 — r.reuters.com/nyw73s

⁶ BBC Hard Talk, 9 September 2011 — r.reuters.com/pyw73s

When comparing the UK to continental Europe there appears, at first, to be a different approach. But on closer scrutiny one can see that the apparent lack of economies of scale being passed on to investors largely reflect the fact that the smallest funds in the UK tend not to let expenses get out of control and create disproportionately high TERs.

The more important issue, and one where one begins to question whether European or UK fund companies are acting in investors' best interests, is that any economies of scale achieved for investment management fees are not passed on to retail investors.

This contrasts sharply with practice in the US.

Taking US large cap funds to illustrate this (i.e. this is not directly comparable with the European data), the relationship between fund assets and management fees can be seen as an 'n'-shape. Management fees (excluding distribution fees, known as 12b-1 fees) are low when funds are smaller because the management company waives most of the fee. Then, as the fund grows, the company waives less so the average fee is higher. Finally the fund reaches levels where real

economies of scale kick in - and so-called 'breakpoints' are applied - so management fees drop again.

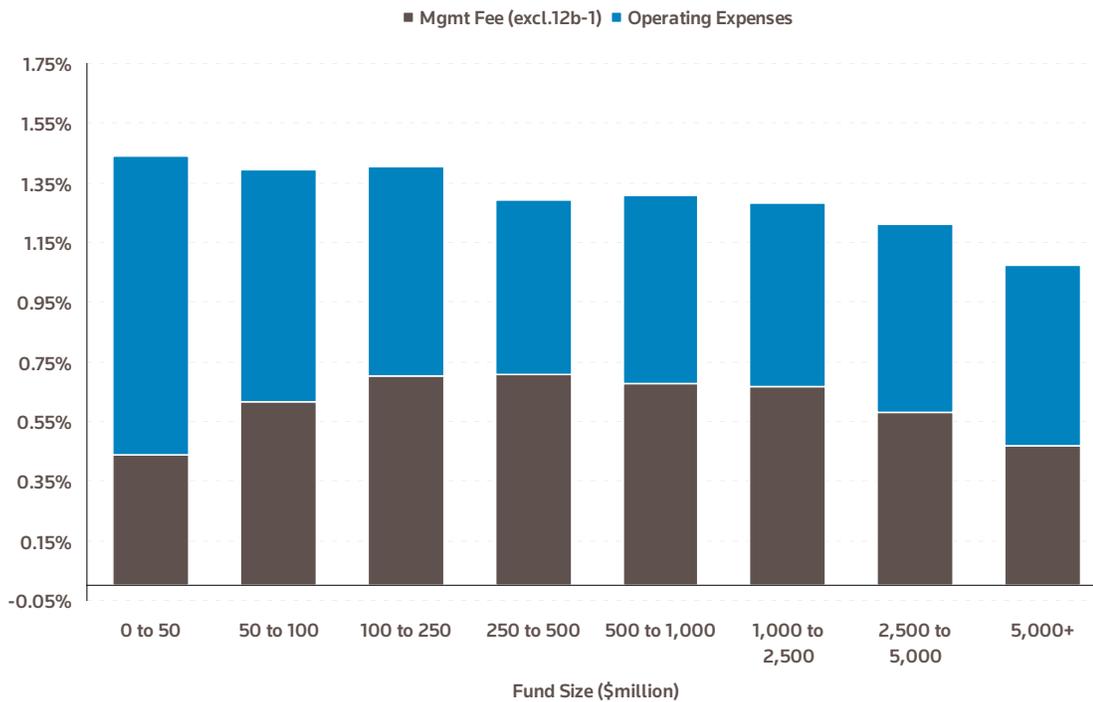
In contrast to Europe, the rate of decline in average TERs increases as assets rise. However, it's worth noting that many European managers would not want individual funds to reach the sizes commonly seen in the US - even if the companies they work for might see the appeal.

But the story does not end there.

One area that has barely been scrutinised in public is the growing practice of fixing TERs. Such moves have been trumpeted as a triumph for transparency - investors know what the annual operating costs borne by their funds will be every year.

But the flipside to this is whether the motivation for such a practice is the interests of investors or the revenues of the fund company. The positive aspect of fixing the TER is that if assets fall dramatically, the TER will not rise.

FIGURE 6 AVERAGE TERs FOR US-DOMICILED US LARGE CAP FUNDS BY SIZE



Having said this, as many of the groups who take this approach are larger it is not unreasonable to assume that the fixed expenses have been set at levels the companies can afford. In this situation, the fund company earns management fees higher than the percentage quoted.

In other words, if the operating expenses incurred (in sterling terms) are lower than the fixed percentage, then the remaining money is taken as revenue - not paid back to the investor.

So if a fund with a fixed TER of 1.65 percent, including a management fee of 1.5 percent, has assets of 100 million pounds and bears back-office costs of 100,000 pounds in one year, then the management fee revenue earned will be 1.55 million pounds (or 1.55 percent).

The TER stays the same, so the client knows what costs his fund is bearing, but the fund company takes home a larger slice of the pie. Mmmm.

One of the key drivers behind this transatlantic divide is the interpretation of fiduciary responsibility in relation to fees. Without such an interpretation in Europe, without regulations for anyone to act in this way, and without a compelling business case for companies to change this situation (which the Retail Distribution Review might bring about in the UK), then however logical it might seem that annual charges borne by investors should fall as fund assets rise, it is unlikely that they will do so.

Meanwhile, Warren and Stuart ride off into the sunset, still paying the same tax.



REUTERS/China Photo

CONCLUSIONS

This report set out to find the extent to which funds have changed their annual management fees over the past ten years. Reflecting the make-up of the UK and European cross-border industries, the majority of funds that have changed their fees in this analysis are actively managed equity funds.

These funds set out to differentiate themselves by the allure of future returns as well as the brand/service they can offer. An inherent part of many of these funds' marketing propositions is that an investor needs to pay more in order to get more. With such a perspective, for an actively managed fund to charge less could, not unreasonably, be taken as a sign that investors will get less. The flip-side to this is that some fee rises have been justified by recent good performance, and one can anticipate similar moves in future.

Needless to say this justification for fee rises opens up other questions, for example, regarding differing fee levels across a company's range of funds⁷ or the use of performance-related fees⁸, although obstacles have come in this latter area, such as the FSA rumblings on product intervention⁹ or Hargreaves Lansdown's decision to segregate funds with performance fees in their Wealth 150 list.

If an actively managed fund does not sell, companies tend not to cut their fees, they cut their losses – particularly among companies that have reasonably wide ranges of funds. This reinforces the view that getting distribution fees (or trail commission) levels right is a key part of generating inflows. Besides, the reduced drag on fund returns of lower annual costs is over the longer term, so any eye-catching performance boost cannot be relied upon in the short term.

Not surprisingly the picture for index tracking funds – where the importance of lower fees is clear – is very different. Cost-sensitive investors are very likely to take such a disposition into their selection of passive over actively managed funds and therefore "voting with their feet" acts as pressure on passive funds to lower their fees.

Accompanying this is the product provider's perspective that margins are likely to be lower on such funds and so increasing assets becomes even more important, and lowering fees can be an effective means to achieve this. This is all the more so in an environment where lower fund returns are not just more common in the wake of the financial crisis, but also increasingly being predicted for the coming years. In the UK, the same FSA paper¹⁰ serves as a reminder that index tracking funds do not automatically equate to low fees and this has been highlighted with the size of some fee reductions in recent years.

For fixed income, a comment from one asset manager that "every basis point counts when it comes to returns" seems at least as relevant today as when it was



REUTERS/Eric Thayer

⁷ See Ed Moisson, 'Fee, Fi, Fo, Fum' (December 2009)

⁸ See Ed Moisson, 'Paying for pain or pleasure?' (August 2010)

⁹ FSA Discussion Paper 11/1, 'Product Intervention' (January 2011) - section 6.28

¹⁰ FSA, op. cit. - section 3.39

made.¹¹ This asset class certainly does seem to be one where lower management fees – or squeezing back-office costs – are likely to be seen more often. Yet it is worth bearing in mind that for Europe as a whole bond fund sales have been much better than for equities in 2011. For those funds that achieve greater inflows there will be less pressure on fees.

Money market funds fit broadly within this same camp, albeit that this asset class remains much less a retail-oriented product, most notably in the UK, but also in many Continental European countries. Attitudes to fees are generally very different for retail and institutional investors.¹²

Continuing this retail versus institutional dimension, downward pressure on fees for the latter (in various asset classes) has broadly been successful because of the clout of these investors (i.e. the size of their investments). Even in the index tracking arena, retail investors' apparent clout is primarily driven by providers choosing to actively market themselves on the back of cuts to fee levels.

With this in mind there are two key drivers that could change the trends observed: carrot (business incentives) and stick (regulation). At one extreme, regulation could mean providers being required to lower their fees – of course this smacks of state intervention rather than the free market at work. But more palatable variations on this theme have previously been seen in the UK, such as the capping of fees with CAT standard ISAs and stakeholder Child Trust Funds. Another approach could be for regulators to promote an interpretation of fiduciary responsibility that relates to fees, but so far there has been no real indication in Europe that this might happen.

The regulatory initiative that is likely to shake up fund fees in the UK – with versions of this being implemented and/or discussed in Continental Europe – is the Retail Distribution Review (RDR). The most immediate change that has begun to take place is the greater use of differentiated pricing through increased use of multiple share classes. At the same time one cannot assume that the total costs (both direct and indirect) to retail investors will fall as a result of such changes.

Turning to business incentives, it remains the case that in the funds industry “non-price competition” dominates, i.e. more funds have not led to lower annual costs for retail investors. It is only when the role of intermediaries in the industry is considered, and the potential upward pressure on fees and expenses that results, can such dynamics be understood, resulting in the trends – both historically and in relation to fund size – revealed in this report.

ABOUT LIPPER

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¹¹ “Jeder Basispunkt zählt, wenn es um die Rendite geht”, Schroders' Achim Küssner quoted by Dow Jones, 30/04/2008

¹² See Ed Moisson, ‘Zen and the art of mutual fund maintenance’ (July 2010)