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RESEARCH FUNDAMENTALS

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Trends in the Fees and Expenses of Mutual Funds, 2008

Key Findings

- **Mutual fund fees and expenses fell to their lowest levels in more than a quarter century in 2008.** Stock fund investors on average paid 99 basis points in fees and expenses, a drop of 2 basis points from 2007 (a basis point is one one-hundredth of a percentage point). Fees and expenses on bond funds fell 3 basis points, while those on money market funds fell 1 basis point.
- **The drop in fees and expenses this past year continued a trend observed since the early 1980s.** The fees and expenses paid by stock and bond fund investors have dropped by more than 50 percent in each category since 1980.
- **The decline in fees and expenses of stock funds in 2008 partly reflected lower sales charges paid by investors.** In 2008, the average maximum sales charge, or "load," on stock funds offered to investors was 5.3 percent. But the average sales load investors actually paid was just 1.1 percent, owing to load fee discounts on large purchases and fee waivers such as those on purchases through 401(k) plans.
- **The decline in stock fund fees and expenses also reflected lower expense ratios.** The average expense ratio, or a fund's total expenses expressed as a percentage of assets, on stock funds fell 1 basis point in 2008. Over the past five years, the average expense ratio paid by investors in stock funds has fallen about 15 percent, reflecting an increase in the popularity of lower-cost funds.

Mutual Fund Fees and Expenses Continue Downward Trend in 2008

The average fees and expenses that investors paid on mutual funds fell in 2008 to their lowest levels in more than 25 years (Figure 1). Investors paid 99 basis points, on average, to invest in stock funds, a 2 basis-point decline from 2007. Average fees and expenses on bond funds dropped 3 basis points to 75 basis points. Fees and expenses on money market funds averaged 38 basis points.

The reduction in mutual fund fees and expenses in 2008 continued a downward trend that has been in place since at least 1980. The decline has been most pronounced among stock and bond funds, where the average fees and expenses paid have dropped by more than 50 percent in each category since 1980. The expenses of money market funds, which are lower than those of stock and bond funds, have fallen more than 30 percent since 1980.

Sean S. Collins, Senior Director of Industry and Financial Analysis, and Christopher Roth, Senior Research Associate, prepared this report.

How ICI Measures Average Mutual Fund Fees and Expenses

Investors in mutual funds incur two primary kinds of fees and expenses: 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).

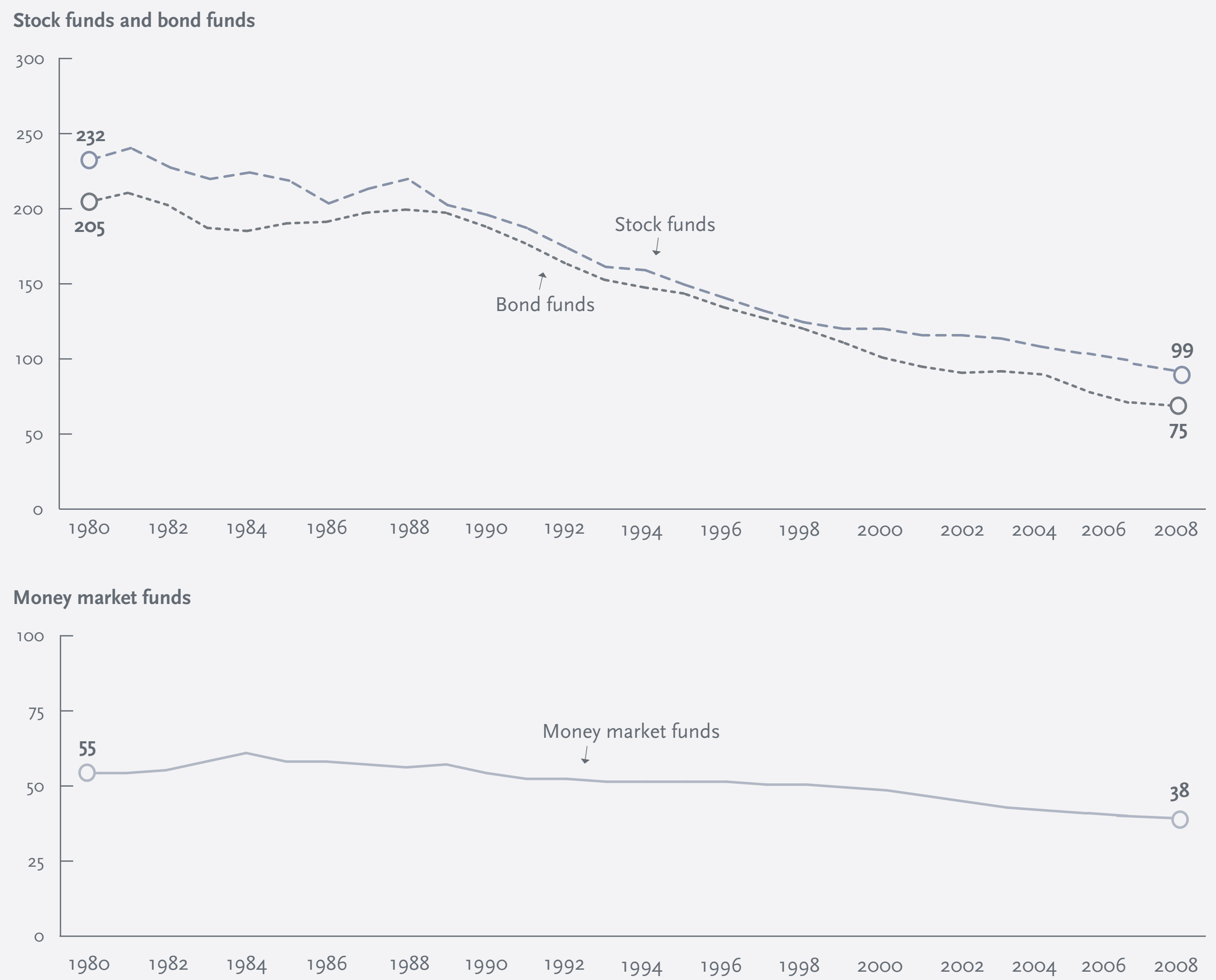
Ongoing expenses are paid from fund assets, and investors thus pay these expenses indirectly. Ongoing fund expenses cover portfolio management, fund administration and compliance, shareholder services, recordkeeping, distribution charges known as 12b-1 fees, and other operating costs.

Various factors affect a mutual fund's fees and expenses, including its investment objective, its level of 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.

Figure 1

Mutual Fund Fees and Expenses Continued to Decline in 2008

Basis points, 1980–2008



Note: Fees and expenses are measured as an asset-weighted average; figures exclude mutual funds available as investment choices in variable annuities and funds of funds.

Sources: Investment Company Institute; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; Data © CRSP University of Chicago, used with permission, all rights reserved (312/263-6400/www.crsp.com); Primary Datasource; and Strategic Insight Simfund

Load funds are sold through financial intermediaries such as brokers and registered financial advisers. These professionals help investors define their investment goals, select appropriate funds, and provide ongoing advice and service. Financial professionals are compensated for providing 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 neither front- nor back-end loads and have either low or no 12b-1 fees. Because load funds include payments to brokers or other financial professionals, they typically have higher fees and expenses than no-load funds.

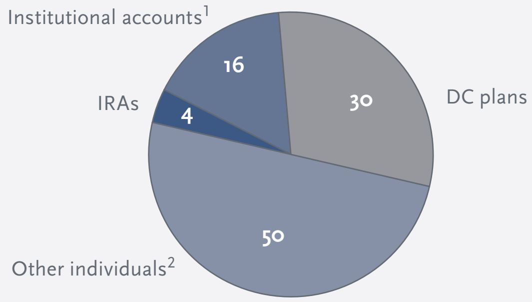
To understand trends in the cost of owning mutual funds, it is helpful to combine one-time sales loads and ongoing expenses into a single measure. ICI does this by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads.[1]

In order to summarize the fees and expenses that shareholders incur, ICI uses an asset-weighted average.[2] In addition, in order to assess appropriately the fees and expenses incurred by individual shareholders in long-term funds, the analysis includes both retail and institutional share classes of long-term mutual funds.

Figure 2

Most Assets in Long-Term Institutional Share Classes Are Attributable to Individuals

Percentage of long-term mutual fund assets in institutional share classes, year-end 2007



Assets of institutions: $268 billion
Assets of individuals: $1,409 billion
Total institutional share class assets: $1,677 billion

[1]The institutional accounts *category includes those of business corporations, financial institutions (other than fiduciary accounts), nonprofit organizations, state and local governments, funds holding mutual fund shares, and other institutional accounts not classified.*

[2]The other individuals *category includes 529 plans, accounts held in street name, estimated assets of omnibus accounts not attributable to retirement accounts, other broker/dealer accounts, and accounts administered by banks or individuals serving as trustees, guardians, administrators, or bank nominees.*

Note: Figures exclude mutual funds available as investment choices in variable annuities and funds of funds.

Source: Investment Company Institute

Institutional share classes accept investments from institutions on behalf of retail investors, such as through defined contribution (DC) plans, individual retirement accounts (IRAs), broker-dealers investing on behalf of retail clients,[3] 529 plans, and other accounts. Figure 2 shows the composition of assets held in institutional share classes of long-term mutual funds. As of December 2007, 84 percent of the assets in institutional share classes ($1,409 billion) were attributable to accounts of individuals, either through DC plans, IRAs, or other accounts. Only 16 percent of the assets in institutional share classes ($268 billion) were attributable to institutions, such as businesses, state and local governments, and non-profit organizations that are investing for their own purposes rather than on the behalf of retail investors.[4]

Stock Funds

The average fees and expenses paid by stock fund investors fell 2 basis points in 2008. This drop was a result of both lower payments for load fees and a drop in the average expense ratio of stock funds (Figure 3).

Payments for load fees fell 1 basis point in 2008, primarily because of load fee discounts, which are common among load funds. Load funds often waive sales loads on IRAs and purchases made through 401(k) plans. In addition, load funds typically offer significant discounts from maximum front-end load fees for large purchases (often $50,000 or more).

In 2008, the average maximum sales load on stock funds was 5.3 percent, but the average sales load actually paid was 1.1 percent, down slightly from 1.2 percent in 2007 (Figure 4). The average expense ratio of stock funds dropped 1 basis point in 2008, reflecting an increase in the popularity of low-cost funds.

Figure 3

Fees and Expenses Dropped for Stock, Bond, and Money Market Funds in 2008

Basis points, 2003–2008

	Stock funds						Bond funds						Money market funds					
	2003	2004	2005	2006	2007	2008	2003	2004	2005	2006	2007	2008	2003	2004	2005	2006	2007	2008
Fees and expenses of which:	122	118	110	106	101	99	95	92	87	82	78	75	44	42	42	41	39	38
Load fees (annualized)	23	23	20	18	16	15	21	20	17	15	13	12	*	*	*	*	*	*
Total expense ratio	99	95	90	88	85	84	74	72	70	67	65	63	44	42	42	41	39	38

Note: Fees and expenses, one-time load fees, and total expense ratio are measured as asset-weighted averages. Figures exclude mutual funds available as investment choices in variable annuities and funds of funds.

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Potential Future Trends in Fund Expense Ratios

Recent press reports have suggested that fund expense ratios could begin to rise owing to the market downturn that began in the fall of 2007 and the attendant decline in the assets of stock mutual funds.[1] No such increase in fund expense ratios is evident in this paper, but experience from past market cycles indicates that a rising trend is possible. During the market downturn that lasted from early 2000 to early 2003, for example, average expense ratio of stock funds rose several basis points.

Why might declining assets lead to rising expense ratios? There are a number of reasons; two stand out:

- Some fund expenses are relatively fixed. Among other things, these include transfer agency fees (which tend to be charged as a fixed number of dollars per account), the cost of mailing fund literature, accounting and audit fees, and director fees. When fund assets fall, these fixed costs will rise as a percentage of assets, tending to boost a fund's expense ratio.
- Some fund complexes offer "breakpoints" in the management fee that they charge their funds. Such a fee structure reduces the fee rate as the fund's assets grow, sharing with investors the benefits of economies of scale. As asset levels fall, the fund may lose some of the benefit of those reduced rates, resulting in a higher expense ratio.[2]

Any potential increases in expense ratios as the result of these factors should be distinguished from increases in the contracted schedule of fund management fees. Any increase in the fee schedule would have to be approved by fund directors and shareholders.

If fund expense ratios are turning upward, the trend may be too recent to be captured in the data used in this study. The expense and other fee information used in this article are based on 2008 data, and thus do not reflect any fee changes occurring in 2009. Also, the fee data used in this article are based on funds' fiscal years, which may or may not align with the calendar year. For instance, the expense ratios of some funds included in the study cover the period February 2007 to January 2008, while others cover March 2007 to February 2008, and so forth. To the extent that a change in the trend of fund expense ratios began in late 2008, that change would not be fully reflected in this report.

1 See, for example, Sam Mamudi, "Battered Mutual-Fund Firms to Raise Fees on Shareholders," *Wall Street Journal*, March 22, 2009.

2 It is important not to confuse breakpoints in management fees (charged by the manager to the fund) with breakpoints in front-end loads. As noted earlier in this report, front loads are paid by the investor at the time of share purchase and are used primarily to compensate brokers for the advice and assistance they provide to investors at the time of purchase. Load breakpoints are typically based on the higher of an investor's assets held with a particular fund complex or an investor's cumulative purchases of funds in that complex. Thus, a drop in the stock market that leads to a decline in the investor's assets will not necessarily alter the investor's ability to make additional share purchases at a reduced load fee. For example, an investor who has invested $50,000 in a fund complex may still qualify for the load fee applicable for purchases of greater than $50,000 on his or her next fund purchase, even if the value of the initial share purchase has since fallen below $50,000.

Bond Funds

The average fees and expenses that shareholders paid for investing in bond funds fell 3 basis points in 2008 to 75 basis points. As with stock funds, the decline in fees and expenses that investors paid on bond funds reflected both lower load fee payments and lower average expense ratios (see Figure 3). In 2008, the average expense ratio on bond funds declined 2 basis points to 63 basis points.

Money Market Funds

The fees and expenses of money market funds averaged 38 basis points in 2008 (see Figure 1). From 1980 to 2008, money market fees and expenses have declined 17 basis points, a reduction of 31 percent.

Two factors have helped drive the reduction in money market fund fees in recent years. First, expense ratios have on average declined among both retail and institutional money market funds. For example, since 1998 the average expense ratio of retail money market funds dropped 7 basis points, while those for institutional money market funds have declined 5 basis points (Figure 5).

Second, institutional money market funds have gained market share since 1998, in part because businesses and other institutional investors have increasingly recognized the benefits that institutional money market funds offer in terms of scale economies, liquidity, diversification, and credit risk monitoring. The assets of money market funds nearly tripled from $1.4 trillion in 1998 to $3.8 trillion in 2008 (Figure 6).

Figure 4

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

Percentage of purchase amount

	Maximum front-end sales load	Average front-end sales load that investors actually incurred
1980	7.9	5.5
1985	7.2	5.4
1990	5.0	3.9
1995	4.7	2.5
2000	5.1	1.4
2001	5.1	1.2
2002	5.1	1.3
2003	5.2	1.3
2004	5.3	1.4
2005	5.3	1.3
2006	5.3	1.2
2007	5.3	1.2
2008	5.3	1.1

Note: 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. The average actually incurred is the maximum sales load times the ratio of total front-end sales loads collected by stock funds as a percentage of new sales of shares by such funds. Figures exclude mutual funds available as investment choices in variable annuities and funds of funds.

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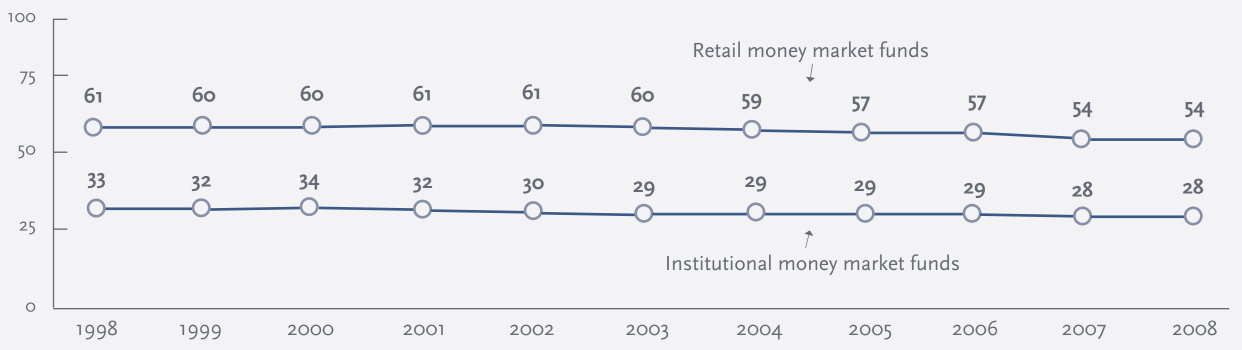
Figure 5

Expense Ratios of Institutional and Retail Money Market Funds

Basis points, 1998–2008



Note: Expense ratios are measured as an asset-weighted average; figures exclude mutual funds available as investment choices in variable annuities and funds of funds.

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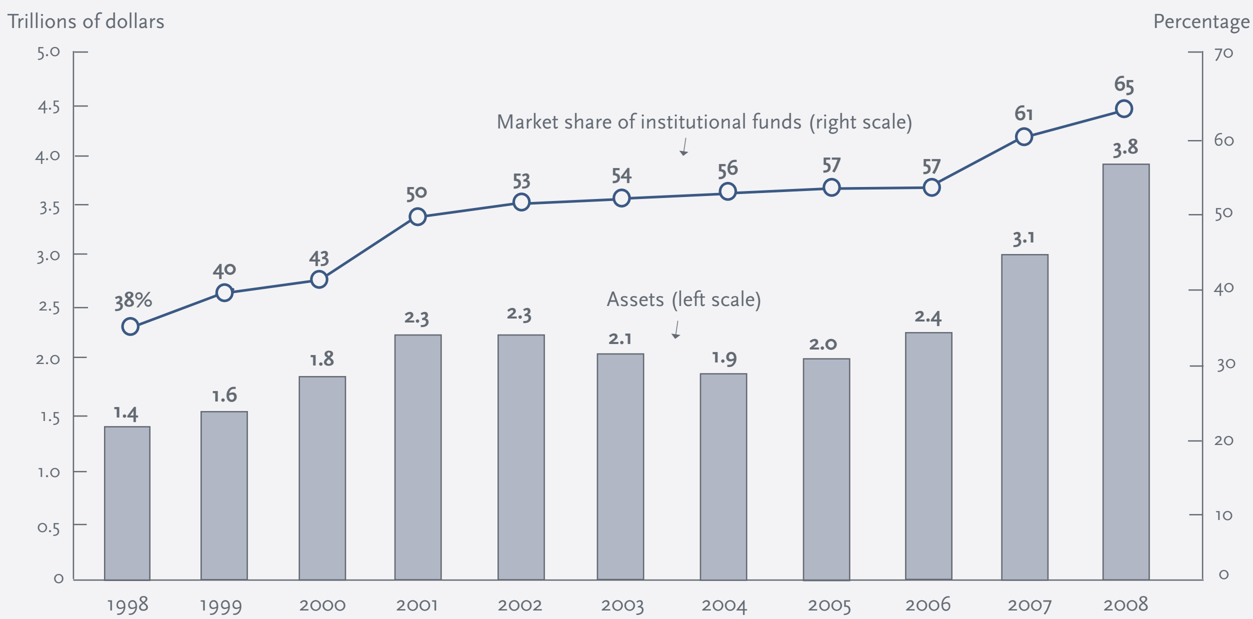
Over the same period, the share of money market fund assets held in institutional funds nearly doubled, rising from 38 percent in 1998 to 65 percent in 2008.

Because they serve a smaller number of investors with very large account balances, institutional money market funds tend to have lower expense ratios than retail money market funds. Any increase in the market share of institutional money market funds therefore lowers the asset-weighted average expense ratio of all money market funds.

Figure 6

Money Market Fund Assets and Market Share of Institutional Money Market Funds



Source: Investment Company Institute

Funds of Funds

Funds of funds are mutual funds that invest in other mutual funds.[5] The market for funds of funds has expanded considerably in recent years. By the end of 2008, there were 865 funds of funds with $490 billion in assets (Figure 7). Over 80 percent of the assets of funds of funds are in hybrid funds of funds, which are funds that invest in a mix of stock, bond, and hybrid mutual funds.

Figure 7

Funds of Funds Have Grown Rapidly in Recent Years

Number of funds of funds

					Memo	
	Total	Equity	Hybrid	Bond	Lifestyle[1]	Lifecycle[2]
1996	45	24	19	2	9	0
1997	94	41	48	5	30	3
1998	175	75	91	9	60	7
1999	212	83	115	14	78	8
2000	215	86	119	10	88	9
2001	213	85	123	5	86	15
2002	268	104	159	5	115	15
2003	301	112	184	5	115	26
2004	375	111	259	5	123	64
2005	475	129	334	12	160	91
2006	604	161	430	13	201	154
2007	723	178	533	12	222	222
2008	865	186	663	16	243	289

Total net assets of funds of funds, billlions of dollars

					Memo	
	Total	Equity	Hybrid	Bond	Lifestyle[1]	Lifecycle[2]
1996	$13.4	$4.6	$8.7	$0.1	$2.4	0.0
1997	21.5	7.6	13.8	0.1	5.9	0.3
1998	35.4	12.2	23.0	0.1	11.8	2.8
1999	48.3	18.7	29.5	0.2	17.0	5.4
2000	56.9	16.2	40.5	0.2	20.0	7.2
2001	63.4	15.8	47.3	0.3	21.5	10.7
2002	69.0	14.5	53.9	0.6	24.4	13.5
2003	123.1	28.6	93.6	0.9	43.0	23.7
2004	199.6	41.8	156.7	1.1	71.9	40.5
2005	306.0	58.6	246.8	0.7	116.1	66.0
2006	471.0	96.4	372.8	1.8	171.2	108.1
2007	639.8	122.9	513.8	3.1	220.2	175.0
2008	490.1	80.3	406.2	3.6	164.1	153.5

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

[1]A lifestyle mutual fund maintains a predetermined risk level and generally contains "conservative," "aggressive," or "moderate" in its name.

[2]A lifecycle mutual fund is a hybrid fund that typically rebalances to an increasingly conservative portfolio as the target date of the fund (mentioned in its name) approaches.

Source: Investment Company Institute

Much of the growth in funds of funds stems from investor interest in lifecycle and lifestyle funds. Lifestyle funds attempt to maintain predetermined asset allocations, while lifecycle funds (also known as target date funds) adjust their asset allocations over time in a pre-specified way. These features have made lifecycle and lifestyle funds especially attractive for individuals saving for retirement in 401(k) plans and IRAs. Lifecycle and lifestyle funds account for 62 percent of the total number and 65 percent of the total assets of funds of funds.

Given the growing use of funds of funds, ICI has begun tracking their expenses. From 2005 to 2008, the average expense ratio of funds of funds fell from 99 basis points to 92 basis points, a drop of 7 percent (Figure 8).[6] This development may reflect competition among an increasing number of funds of funds for investors' dollars. In addition, with the assets of funds of funds up 60 percent since 2005, scale economies may have played a role.

Figure 8

Total Expense Ratios of Funds of Funds

Basis points

	Asset-weighted average	Simple average	Median
2005	99	155	150
2006	97	145	139
2007	93	142	133
2008	92	138	129

Sources: Morningstar; Investment Company Institute calculations

Notes

[1] For more details, see Rea, John D., and Brian K. Reid. 1998. "Trends in the Ownership Cost of Equity Mutual Funds." *Investment Company Institute Perspective* 4, no. 3 (November). Available at http://www.ici.org/pdf/per04-03.pdf.

[2] Except where noted, fees and expenses reported in this publication 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 overstate the fees and expenses of funds in which investors hold few dollars.

[3] When an investor purchases shares of a mutual fund through a brokerage firm, the broker often registers the purchase with the mutual fund under the broker's name in a pooled ("omnibus") account, which is known as registering in "street name." Brokers do this for operational convenience and to help reduce costs.

[4] Institutional investors that invest for their own purposes (such as businesses and state and local governments) do account for a large portion of the assets invested in money market funds; for this reason, the expenses of retail and institutional money market funds are reported separately in this report.

[5] A very small number of funds of funds also invest in exchange-traded funds.

[6] An SEC rule addressing funds of funds, adopted in 2006, requires a fund of funds to report a total expense ratio in its prospectus fee table that accounts for both the expenses that it pays directly out of its assets (sometimes called "direct expenses"), as well as the expense ratios of the underlying funds in which it invests (often called "acquired fund fees" or "indirect expenses"). The expense ratios in Figure 8 include both the direct and indirect expenses of funds of funds.

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