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Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios

A Global Perspective—2019 Update

June 2019 update to the 2012 study by Strategic Insight for The Investment Funds Institute of Canada

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Introduction

This report has been commissioned by The Investment Funds Institute of Canada (IFIC) as an update to the data, analysis and information originally developed in 2012 as part of a study into the cost of ownership (CoO) of mutual funds in Canada and the United States.

This report focuses on updating the cost of mutual fund ownership metrics presented in the 2012 summary document, entitled *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: A Canada-United States Perspective*, and building on the updates and additional considerations published in September 2017.

This updated report should be read alongside the original, larger study, which provided an in-depth discussion of the methodology and industry context required to consider the development of the mutual funds CoO in Canada and the United States. While this report does not include a full update of the model, the methodology has been refreshed to account for recent developments in the CoO of mutual funds.

The updated information contained in this report has been developed by Strategic Insight personnel in Canada and the United States using data from both proprietary and public sources. Every effort has been made to ensure both accuracy and consistency to enable users of the report to develop a clear understanding of the developments that have occurred over the past two years.

Key Takeaways

Following the widespread and significant downward adjustments of mutual fund management fees between 2015 and 2017 (previously documented in the 2017 update of this report), fund pricing in Canada continued to trend down in the last two years, albeit at a slower pace than witnessed in previous years.

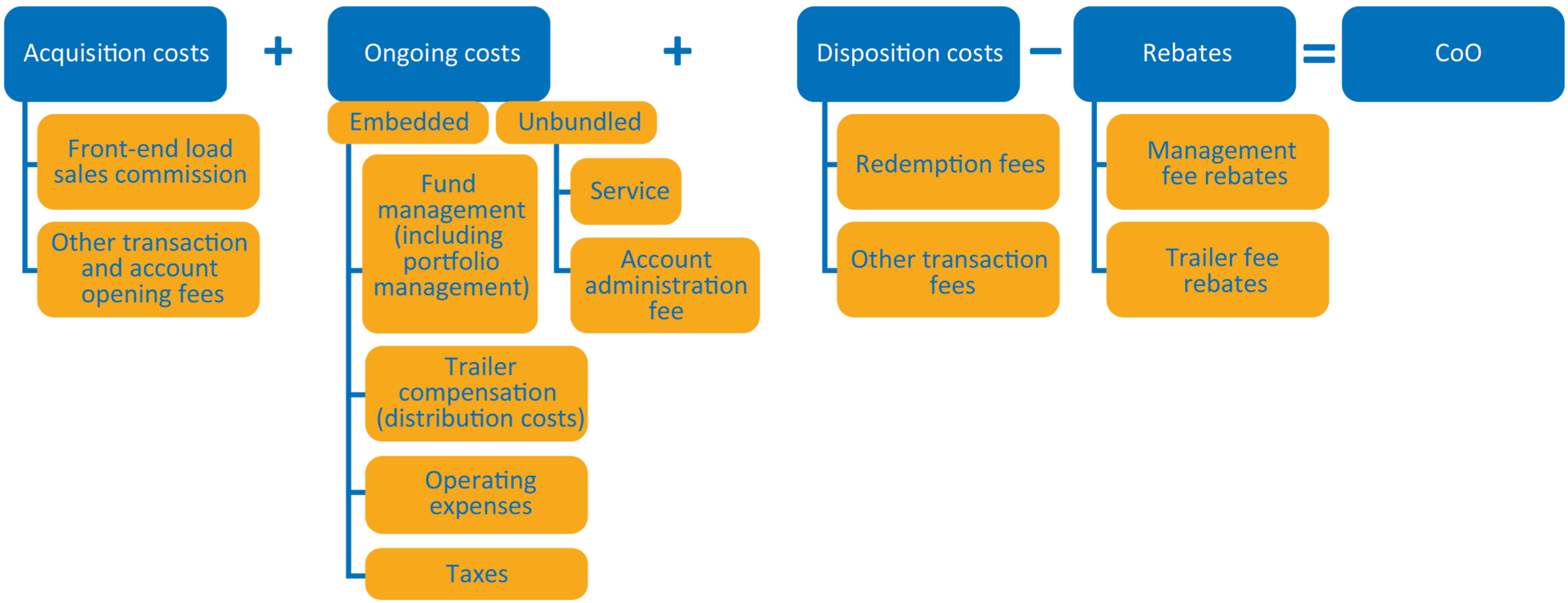
At 2.10%, the CoO of mutual funds in Canada declined by four basis points (or 0.04%) since the previous update of this report two years ago. Of the four basis points, three points were due to an asset-weighted decline in management fees, while one basis point was the result of a decline in asset-weighted taxes.

When excluding taxes, the CoO of mutual funds in Canada is at a level comparable to the average cost in other global markets such as the U.S, the U.K. and continental Europe.

The implementation of preferred pricing programs by 11 mutual fund companies in Canada has resulted in management fee discounts for unitholders that account for tens of billions of dollars. Preferred pricing programs can be executed with discounted share classes or via rebates of additional fund units. The former is accounted for in the management fee metrics presented in this report; the latter is not. It is estimated that preferred pricing programs implemented with rebates of fund units resulted in an additional two basis points of savings for unitholders.

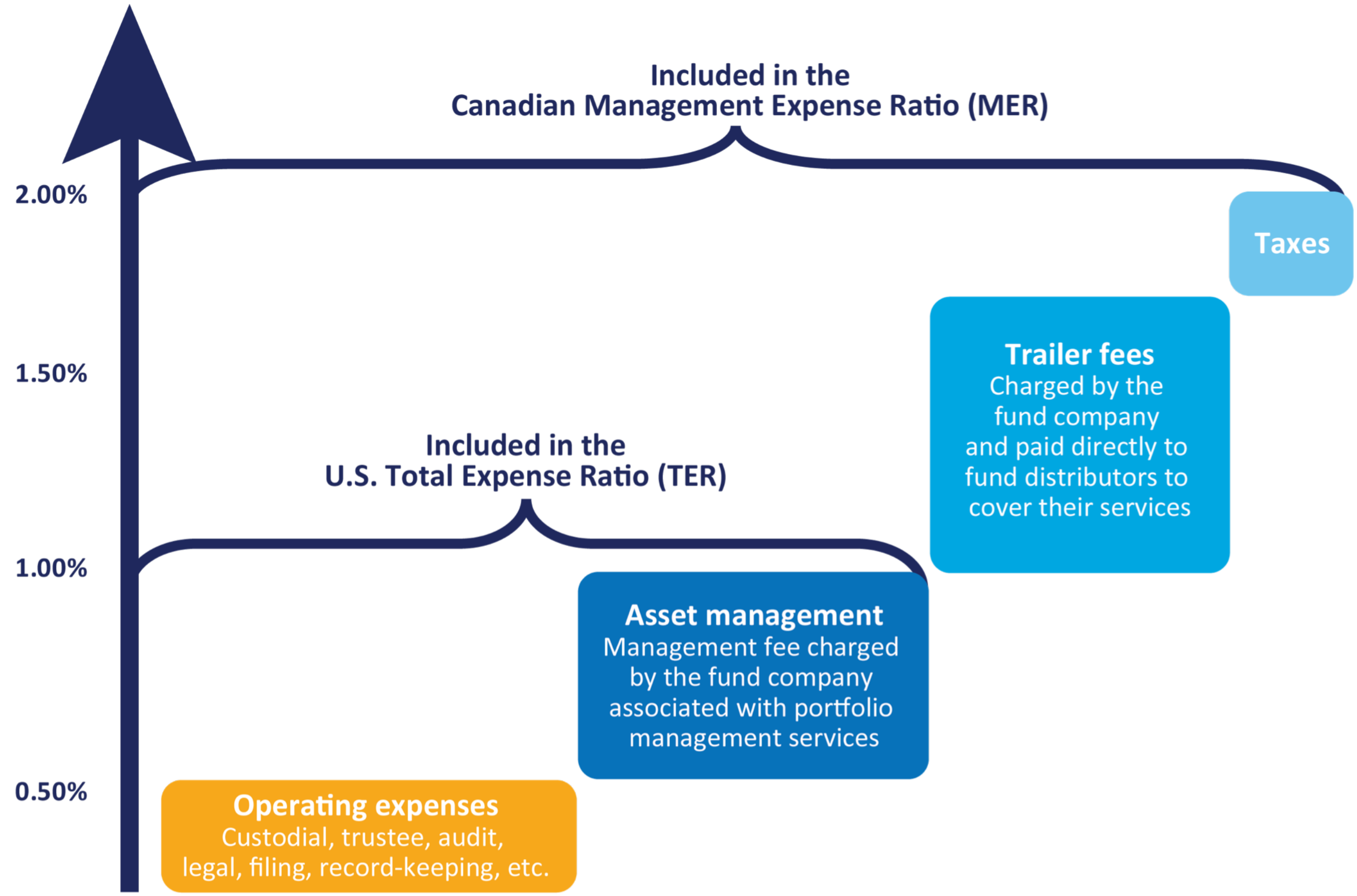
Cost of Mutual Fund Ownership: Analytical Framework

In analyzing theCoO, our methodology includes all measurable elements associated with the ownership of mutual funds. The holistic nature of the CoO concept stems from the inclusion of cost elements at each stage of the fund ownership cycle: at the time of purchase (acquisition costs); during the investment period (ongoing costs, which are both charged to the mutual fund and directly to the investor, minus any rebates); and at the time of redemption of fund units (disposition costs).



Key Elements of Canadian MERs (for Original Series of Fund Units) and TERs in the United States (for Series Used by Advisors Using Fee-based Platforms)

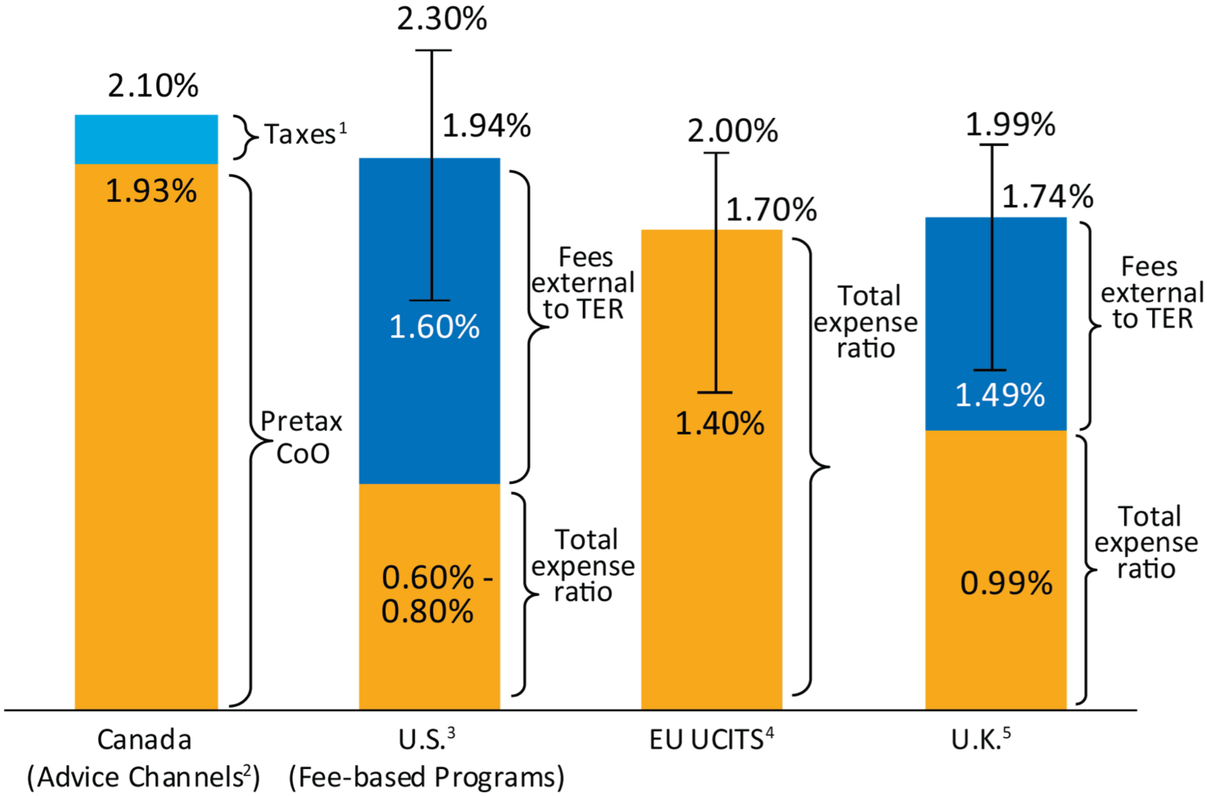
The use of the CoO framework enables industry participants and other observers to neutralize the impact of differences in the composition of total expense ratios (TERs) globally and Canadian fund management expense ratios (MERs). The figure below explores these differences by providing a side-by-side view of the main cost elements included in Canadian mutual fund MERs for the most prevalent fund series ("original series") and TERs in the United States for those funds used by advisors operating fee-for-advice business models.



Average Cost of Actively-managed Mutual Fund Ownership for Clients Using Advice Channels—Canada

Canada (All compensation models), United States and UK (unbundled, fee-based compensation), European UCITS (embedded compensation model)—2018

The figure below provides an update of the CoO of long-term mutual funds in advice channels in Canada and the United States, along with a comparator for the same metric in the U.K. and the European Union. As displayed in the chart, the average CoO in these jurisdictions is at a comparable level regardless of the fact that in some countries, advisory fees are overwhelmingly charged outside of the fund's management fees, while in other countries (most notably in Canada) advisory fees are mostly embedded in the fund's MER (for specific information about unbundled fee arrangements, see **Figure 8**).



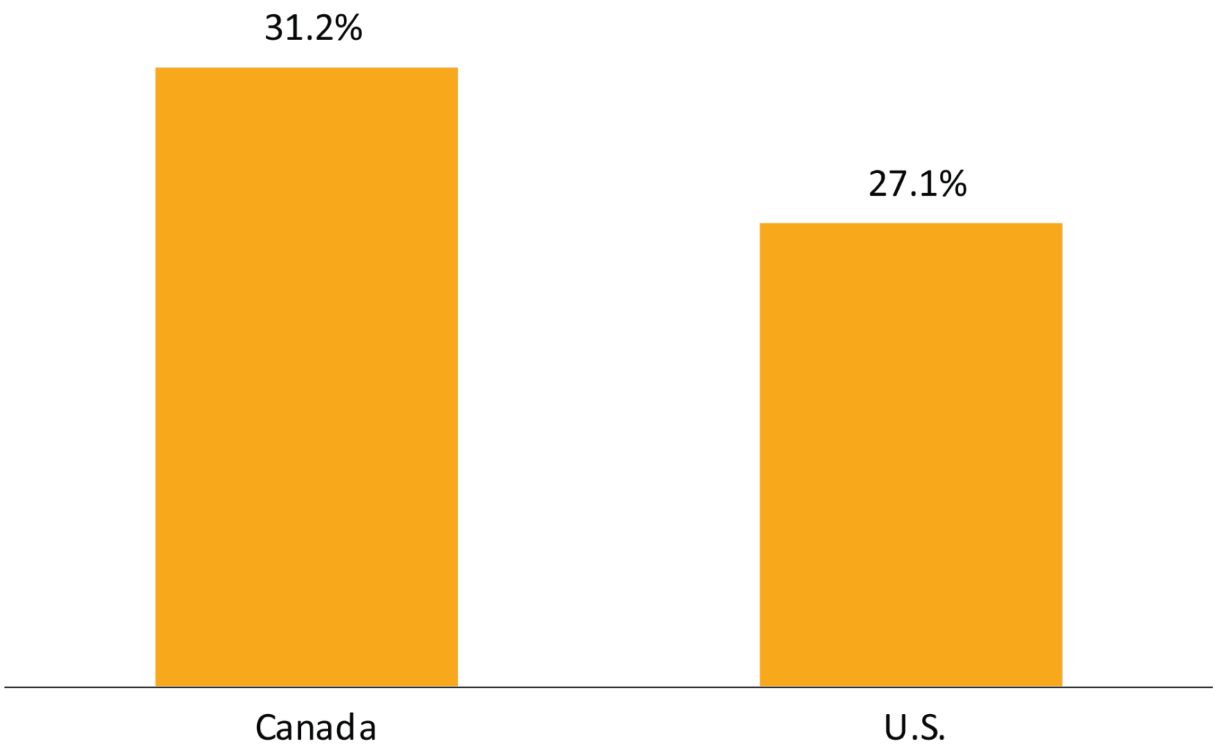
[1] Reflects an industry aggregate and is not specific to advice channels.
[2] For all account types.
[3] Ranges represent differences in distributor fees and asset classes for the top and bottom part of the bar, respectively.
[4] Source: ESMA Annual Statistical Report. Performance and costs of retail investment products in the EU 2019 (range represents the cost of different asset classes, data includes passive funds and self-directed distribution channels).
[5] Source: SIMFUND and FCA https://www.fca.org.uk/publication/data/underlying-data-bulletin-issue-13.xlsx range represents differences in distributor fees.

Long-term Mutual Funds as Percentage of Financial Wealth

As at December 2018

In both Canada and the United States, mutual funds represent a significant (and growing) share of financial wealth. Globally, funds are the preferred conduit for retail investors to access capital markets.

Mutual funds tend to be ubiquitous across jurisdictions, and are found in individual pension accounts, investment accounts of mass- and mid-market as well as high-net worth investors.



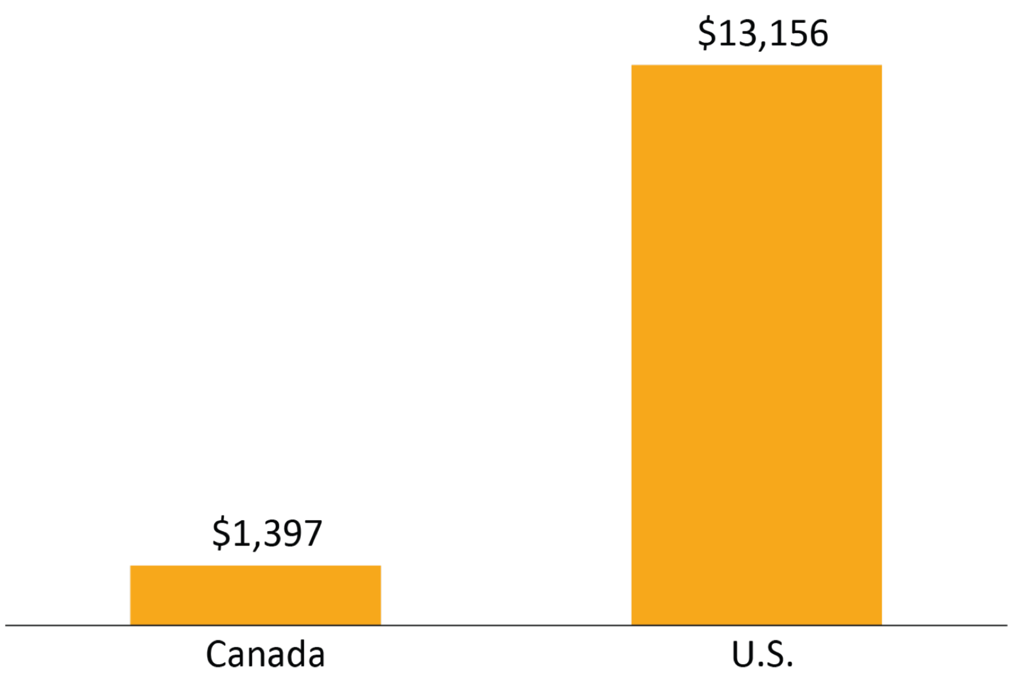
Source: Strategic Insight Research.

Long-term Mutual Fund Assets Under Management

Local currency in billions of dollars as at December 2018

The difference in the scale of the U.S. and Canadian mutual funds industry is shown below.

The mutual funds industry in the United States is more than 12 times larger than its Canadian counterpart. Mutual fund manufacturers and distributors in the United States can therefore take advantage of economies of scale in assets, client numbers, revenue and access to capital in order to pursue both innovation and pricing initiatives at a pace and scale not easily achieved by smaller jurisdictions, such as Canada.



Source: Strategic Insight Research.

Assets of 20 Largest Mutual Fund Complexes in Canada and the U.S.

Local currency in billions of dollars as at December 2018

This figure provides a company-level perspective of the differences in scale between the two markets.

	Canada	U.S.
Mutual fund assets	**$ 1,397,015**	**$ 13,155,589**
Assets of 20 largest fund managers	1,230,022	9,776,088
Share of mutual fund assets	88.0%	74.3%
Average Assets		
Largest 5 fund managers	128,928	1,415,998
Largest 10 fund managers	99,886	844,524
Largest 20 fund managers	61,501	488,804

	Canada	U.S.
Mutual fund assets	**$ 1,397,015**	**$ 13,155,589**
Assets of 20 largest funds	266,595	3,278,679
Share of mutual fund assets	19.1%	24.9%
Average Assets		
Largest 5 funds	27,592	314,348
Largest 10 funds	19,138	231,116
Largest 20 fund	13,330	163,934

Source: Strategic Insight Research.

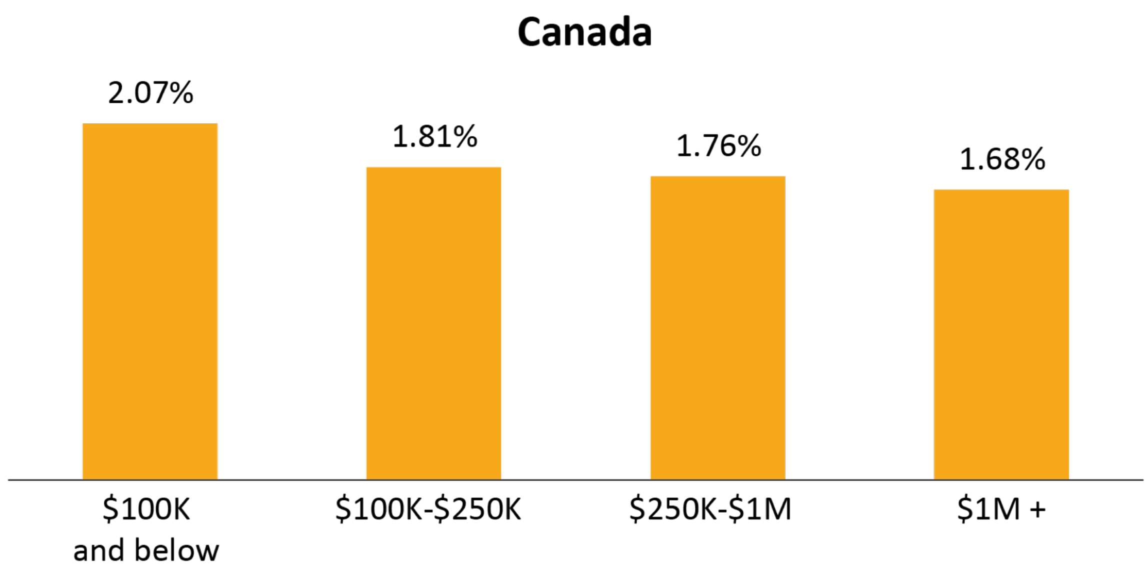
Cost of Ownership by Mutual Fund Balance Range—2018

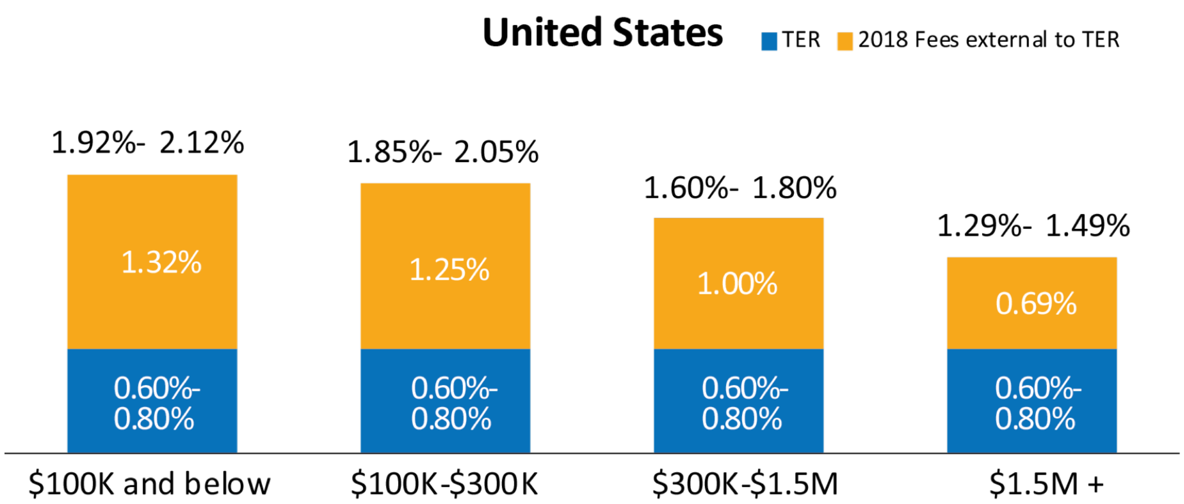
The charts on the following page use multi-series fund data and embedded and externally-charged advice fee data representing investment management and advice fee levels over a range of mutual fund balances to determine the cost of ownership for a specific mutual fund holding. As previously reported, the relative cost of mutual fund ownership declines as mutual fund balances increase, in both Canada and the United States. The figures on the following slide reflect the weighted cost of holding embedded and unbundled advice fee funds, the latter in fee-based accounts, in each balance tier.

Generally, in both countries, the weighted cost of ownership was marginally lower in 2018 than 2016. Pricing for very- and ultra-high net worth clients (balances >$5 million and >$10 million) will be lower than the >$1.5 million range presented as a more negotiated approach is adapted for both investment management cost and external advice costs in non-discretionary and discretionary fee-based accounts.

Factors influencing the differences between countries include the size of the high net worth (HNW) communities in the United States. and product mix in fee-based accounts—mutual fund adoption in United States fee-based remains much higher than in Canada. Canada mutual funds are at about 17% of assets held in the discretionary advisor managed programs, up from 13% three years ago, while in the United States, funds make-up more than three quarters of the assets in the rep-as-portfolio manager programs. Additionally, while F-series fund MERs have trended lower in Canada, the asset weight MER of the tiered high net worth series F class funds has actually edged up. This reflects the automated flow of F-series funds into the lower tiers of the F-HNW series which have been added in, under the upper tier pricing of F-HNW. This has not been the case in the United States because of the size of the upper reaches of the HNW market place and the adoption of funds.

Cost of Ownership by Mutual Fund Balance Range—2018 (cont'd)





Source: Strategic Insight Research.

Data sources: In compiling the data sets underpinning its analysis and research, Strategic Insight leverages both proprietary and third-party data sources. Specifically, Strategic Insight compiles the monthly mutual fund reporting in Investor Economics' *Insight Advisory Service* using monthly fund-level data provided by The Investment Funds Institute of Canada (IFIC), Morningstar Canada data, public filings, data submitted by mutual fund companies and gathered from a variety of public sources, including company websites. Individual segregated fund data is compiled by Strategic Insight from data submitted by Canadian life insurance companies. Exchange-traded fund (ETF) data is compiled by Strategic Insight from data submitted by ETF sponsors, sourced from Morningstar Canada data and other publicly available sources. Other data, including, but not limited to, fees, sales and asset distribution by province, load option and share classes, is compiled by Strategic Insight from public filings, Morningstar Canada data or data and information submitted by fund companies.

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