Executive Summary

Statement of A. Michael Lipper, CFA, Chairman of Lipper Analytical Services, Inc.

I am Mike Lipper and I am pleased to have the opportunity to appear for before the Sub-Committee today to discuss our analysis of mutual fund fees and expenses. Lipper Analytical Services, now a Reuters Company, is the principal provider of fund fees and expense data to the Board of Directors of investment companies.

Last year we released our Third White Paper in which we addressed the topic: **Are mutual fund fees reasonable?** In preparation for today's hearing, we have last week updated our study, which includes data for funds having their fiscal year end in 1997.

I will summarize briefly both points from the updated study, as well as additional observations. If you will, these are the 12 points which we know about mutual fund fees and expense.

TWELVE THINGS WE KNOW ABOUT MUTUAL FUND FEES AND EXPENSES

1. <u>Fund Performance Is Net of Expenses</u>.

Fund performance result is calculated after fund fees and expenses have already been deducted. We should not double count their historic importance.

2. <u>Future Levels of Fees Will Be Set By Future Conditions</u>.

Guessing the future level of fees and expenses is speculative and they will be set based on the environment particularly the cost of acquiring new clients.

3. <u>Fee Table Highlighted</u>

The Securities & Exchange Commission working with the industry has required the expense table to be prominent in each prospectus.

4. <u>The Press Is Watching</u>.

The press is extremely conscious of fund expenses and regularly writes about expenses. Leading publications, e.g. *The Wall Street Journal* show total expense ratios.

5. <u>Management Company Profit Margin Below Peak Levels</u>.

Even prior to this summer's market fluctuations, fund management company profit margins are not rising in spite of record asset levels.

6. The Boards Are Doing Their Jobs.

Each year, fund's board of directors review expenses along with performance. For the last few years these deliberations led to more instances of lower fees than higher fees. In 1997, 556 funds lowered their fees, 415 raised theirs. (See pages 12-14 of the updated Third White Paper.)

7. Mutual Fund Wrap Account Show Mutual Funds Are Not Overpriced.

In recent years one of the fastest growing contributors to fund sales are mutual fund wrap accounts which provide external advice on selection and monitoring of funds. The estimated $55 billion (more than 1% of the industry) in these accounts would not have been possible if consumers felt that mutual funds were over priced products.

8. Mutual Funds Share Economies of Scale With Investors.

Economies of scale can only be achieved by individual funds. When a fund grows significantly beyond the point needed to establish its viability, a fund can (depending on its investment objective) achieve economies in some aspects of its operations.

The best way to test whether economies are shared with investors is to examine older, established funds that have experienced significant growth. In 1986, the average fund managed about $328 million. Eleven years later, these same funds had grown to manage, on an average, about $1.5 billion. Because of competition and economies of scale, however, the median level of annual fees paid by shareholders dropped by about 1.5 percent. Again, emphasis must be placed on the fact that substantial, sustained growth at an individual fund is the key perquisite to achieving economies of scale.

9. The Business' Rapid Growth Is Due Largely To Hundreds Of New Fund Management Companies And Thousands of New Funds.

The business' growth has resulted mostly from new entrants to the marketplace. These funds increase the business' size, but the funds themselves do not achieve economies of scale unless they grow for a sustained period. (See Page 8)

Some have observed that because the "fund industry" has grown so fast, "industry averages should reflect economies of scale". But this observation relies on a badly flawed assumption. The assumption that because the business has grown rapidly, the average fund must have grown rapidly. The observation neglects the reality that most of the business' growth has come from new entrants to the marketplace.

In 1986, the fund business managed approximately $550 million in assets. By the end of 1997, that figure had grown to approximately 4.0 trillion. But look at where the growth really came from. In 1986, there were 1,505 mutual funds in existence. At the end 1996,

there were 11,877. The average mutual fund in 1997 (which managed $560 million) was really not that much larger than the average mutual fund in 1986 ($328 million). As these figures make clear, fund business growth came from the introduction of new entrants to the marketplace. Since 1986, hundreds of new fund companies and over 10,000 new mutual funds have been created; nearly eight times as many as existed a decade before.

10. Reports That Fund Fees Are Increasing Are Methodologically Flawed.

Most reports that indicate "average" mutual fund fee levels are increasing suffer from one or more serious methodological mistakes. If these mistakes had not been made, the results would show that the average fund fee levels have fallen rather than risen.

By Providing Just The Simple Average Of Fund Expense Rations, The Reports Fail To Adjust For The Higher Fees Typically Charged By New Mutual Funds Trying To Establish Themselves. (P. 12) There is little sense in giving the same weight to the expense ratio of a small fund with relatively few shareholders as is given to a huge fund with hundreds of thousands of shareholders. Yet, this is done routinely, even though the result is badly distorted from a public policy point of view.

When Comparing Present Averages To Those 5 Or 10 Years Ago, The Reports Fail To Account For The Impact Created By The Shift To Equity Funds. (P. 9) Most business participants recognize that stock mutual funds generally have higher expenses, and thus charge higher fees than bond mutual funds. And bond funds cost more to operate than money market funds. Because the business now consists of a higher percentage of stock funds than it did eleven years ago, the "average" business expense ratio will appear to have increased. The same phenomenon has occurred within the stock fund category itself. The number of international, global and small cap funds (all of which are more expensive to operate than a typical domestic stock fund invested in large companies) has become a higher proportion of the stock fund category. Comparisons of expense ratios of stock funds today to stock funds eleven years ago that neglect this distinction may be distorted.

The Reports Neglect To Account For The Impact Of Fee Levels Caused By The "Massive Shift" From Funds With Front-End Loads To Funds With Higher 12b-1 Fees. (P. 10-11) Sales commissions (or loads) paid by investors when they purchase fund shares are not included in expense ratios. But, 12b-1 fees – which most often are used as a replacement for a load – are included in the

ratio. The long-term trend toward substituting 12b-1 fees for loads also may create a substantial bias in comparisons from year to year. Unless the bias is accounted for, the comparison is again badly distorted.

11. <u>American Mutual funds cost much less than overseas funds</u>.

The Canadian fund average total expense ratio is almost double the U.S. average. The fees charged by the average American stock mutual fund are also lower than the average charged in 19 out of 21 European countries. For example, I have just returned from a meeting of the various fund associations in Europe. At this meeting in private discussions, I was told that a leading European fund group's management fee is running twice what the United States average does by asset class.

12. <u>The Present System Is Working</u>.

In a classical economic model, mutual fund fees and expenses are being set by the marketplace with a higher level of disclosure than any other United States investment products. Knowledgeable buyers and sellers are being brought together by competent advisers and representatives including their boards of directors. In summary the system is working.