2015 Fee Study: Investors Are Driving Expense Ratios Down

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Executive Summary

- Investors are paying less for fund management, largely as a matter of choice.
- The asset-weighted expense ratio across all funds was 0.64% in 2014, down from 0.65% in 2013 and 0.76% five years ago.
- Investors are choosing low-cost funds. Over the past decade, 95% of all flows have gone into funds in the lowest-cost quintile. Passive funds have benefited disproportionately.
- Investors continue to move away from load-based share classes while typically lower-cost share classes, such as Institutional shares, have gained favor.
- Firms sponsoring lineups with lower asset-weighted expense ratios—most notably Vanguard—have gained market share during the past five years.
- Over the past five years, 63% of the fund share classes and exchange-traded products in our universe reduced their expense ratio, but only about 24% of them saw their fee fall by more than 10%.
- Meanwhile, 21% of the share classes we examined ratcheted up their takes.
- Estimated industry fee revenue is at an all-time high, reaching $88 billion in 2014, up from $50 billion 10 years ago.
- During that 10-year period, industry assets under management increased 143% while the asset-weighted expense ratio declined 27% and industry fee revenue grew by approximately 78%.
- Thus, the industry—rather than fund shareholders—has benefitted most from the increase in asset under management.

Expense Ratios Are Falling

Investors are paying less for fund management. The asset-weighted expense ratio across all funds (including mutual funds and exchange-traded products, or ETPs, but excluding money market funds and funds of funds) was 0.64% in 2014, down from 0.65% in 2013 and 0.76% five years ago.

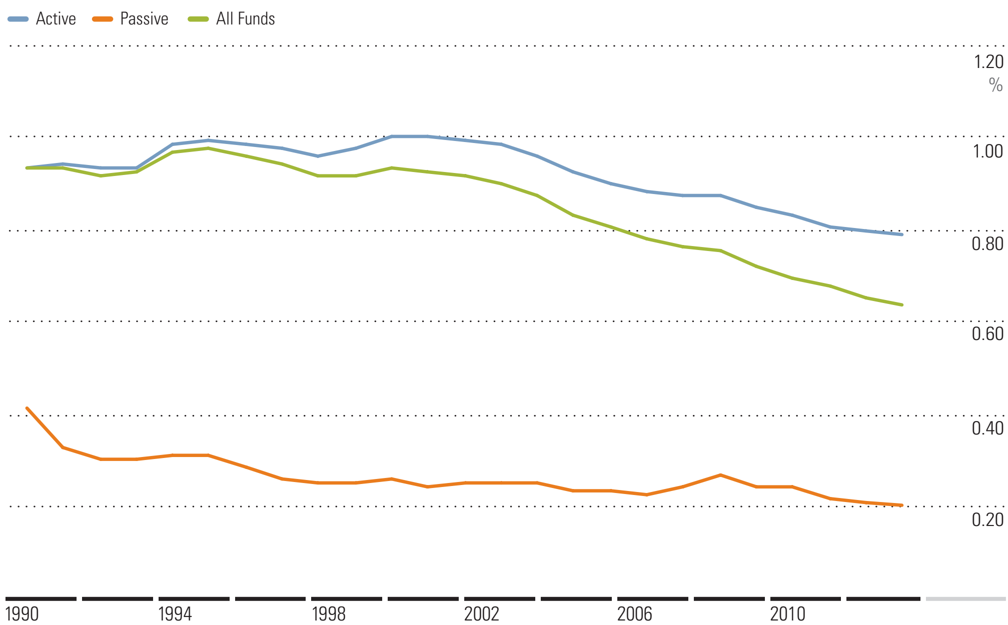
The trend is being driven more by investors seeking low-cost funds than it is by fund companies cutting fees. Fund investors are increasingly buying passive funds and investing in lower-cost actively managed funds. Asset growth has also spurred fee reductions triggered by built-in breakpoints.

However, much of the increased economies of scale are going to the fund industry rather than investors. Assets under management have risen faster than fees have fallen.

A Look at the Numbers: Asset-Weighted vs. Equal-Weighted

We emphasize the asset-weighted expense ratio rather than a straight average as it is more representative of the actual costs borne by investors than a straight average. Equal-weighted averages tend to be skewed by a few outliers—high-cost funds that attract few assets, in this case. The equal-weighted average expense ratio for all funds in 2014 was 1.19%, but funds with an expense ratio above that level held just 9% of total assets at the end of 2014. Some 91% of investors' assets were invested in funds with an expense ratio less than or equal to 1.19%. Thus, the equal-weighted average expense ratio is a bit of a straw man. The asset-weighted expense ratio, which best reflects investors' collective experience, was 0.64% in 2014.

Exhibit 1 Asset-Weighted Expense Ratios



Source: Morningstar, Inc.

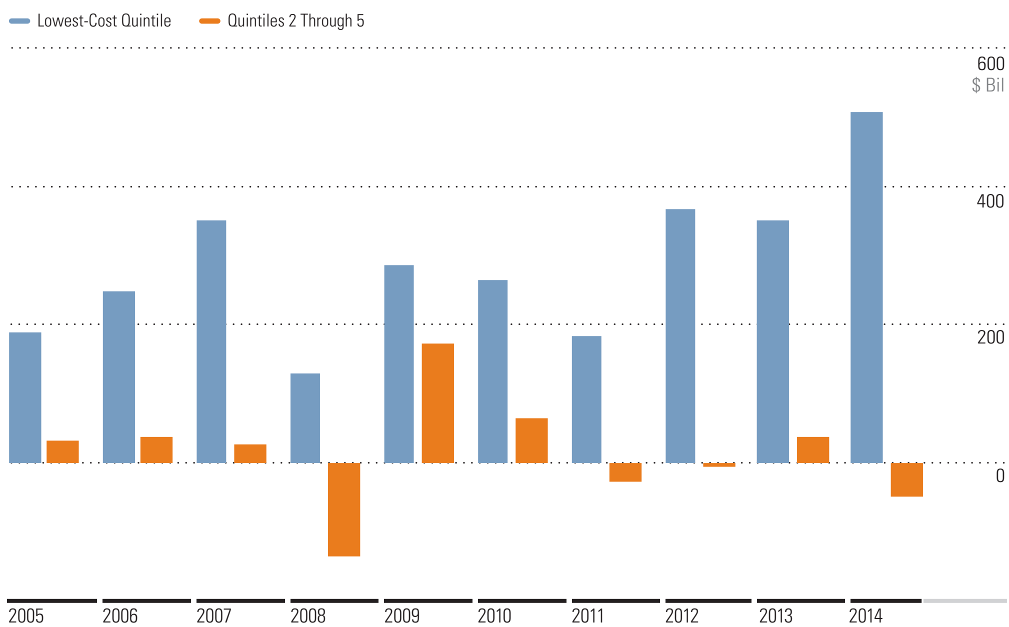
Investors Are Choosing Low-Cost Funds

During the past decade, low-cost funds have been attracting far more inflows than their more-expensive peers. This has helped to reduce the industry's average asset-weighted expense ratio over time. Mutual funds and ETPs with expense ratios ranking in the least-expensive quintile of all funds attracted an aggregate $3.03 trillion of estimated net inflows during the past 10 years, compared with just $160 billion for funds in the remaining four quintiles. That is to say that 95% of all flows have gone into funds in the lowest-cost quintile. Passive funds (mutual funds and ETPs) have been prominent recipients of the capital flowing into low-cost funds. Compared with funds falling in cost quintiles 2 through 5, funds in the lowest-cost quintile are more likely to be index funds.

The asset-weighted expense ratio for passive funds was just 0.20% in 2014, compared with 0.79% for active funds. Estimated net inflows to passive funds in 2014 totaled $392 billion, topping the $66 billion of flows into active funds. During the past 10 years, passive funds have collected $1.90 trillion in net new investor capital compared with $1.13 trillion for active funds. The difference is even starker among U.S. equity funds. Passive funds focused on U.S. stocks have attracted $671 billion of inflows during the past 10 years, compared with outflows of $731 billion for active U.S. equity funds.

Passive funds now account for 28% of the total assets in the universe we've examined, up from 13% in 2004. But this preference for lower-cost fare isn't limited to the realm of passive funds. Even within active funds, the lowest-cost quintile received $1.07 trillion of the $1.13 trillion of estimated net new flows during the past decade.

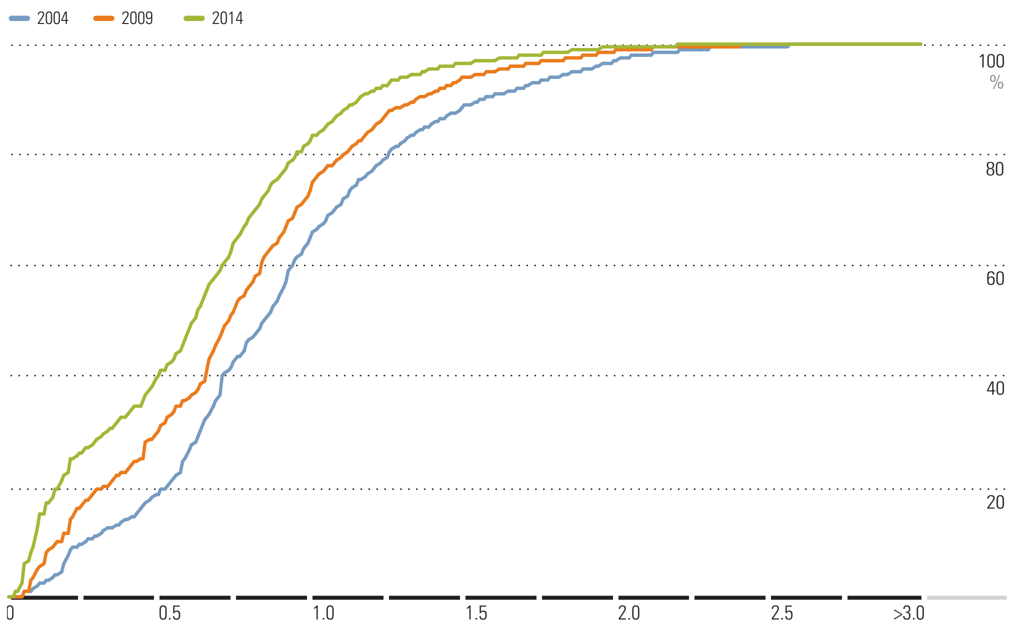
Exhibit 2 Estimated Net Flows by Expense Ratio Quintile $ Billion



Source: Morningstar, Inc.

Exhibit 3 below shows the aggregate effect of this trend over the course of the past decade. In 2004, about 20% of investors' assets were invested in funds with expense ratios less than or equal to 0.50%. By 2014, 41% of investors' assets were invested in funds with expense ratios at or below this threshold. Investors are expressing a clear preference for low-cost funds.

Exhibit 3 Distribution of Fund Assets by Expense Ratio



Source: Morningstar, Inc.

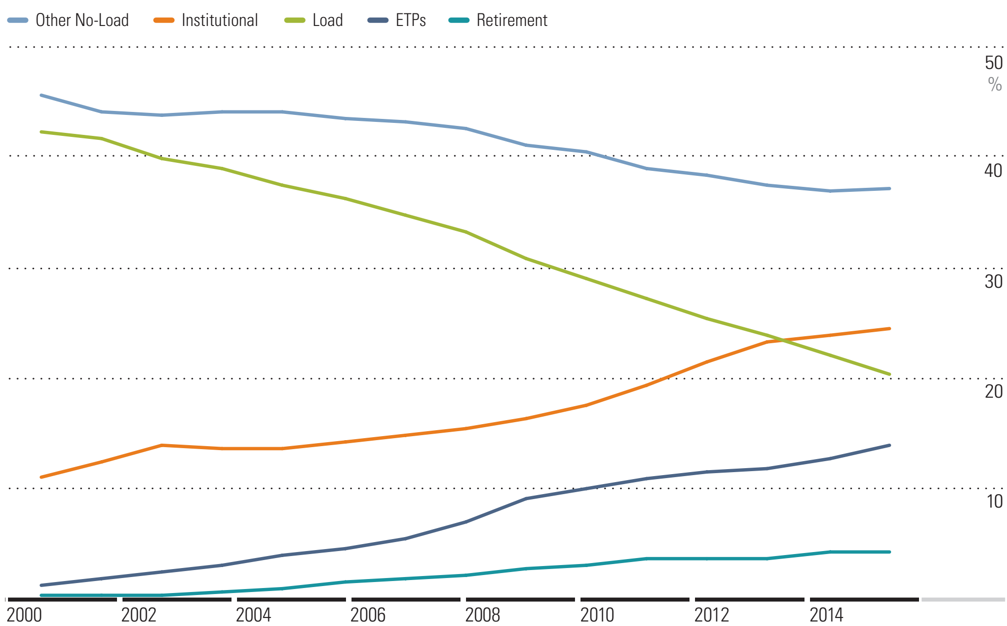
Share-Class Warfare

In addition to migrating en masse to lower-cost funds, investors also are flocking toward lower-cost share classes. Investors continue to move away from load-based share classes while typically lower-cost share classes, such as Institutional shares, have gained favor.

This trend has been driven by a number of factors. For instance, advisors are increasingly using wrap or omnibus accounts that bundle individual accounts in a manner that creates scale and gives them access to Institutional share classes. Also, fee-based advisors are bypassing load shares and opting to use exchange-traded funds or other no-load options on behalf of their clients. Advisors using no-load funds for their clients typically change for their services outside the fund's expense ratio. Those additional fees are outside the scope of this study, which focuses only on fund expense ratios. And finally, defined-contribution plans now make up a larger share of fund assets, driving investor dollars toward Institutional and Retirement share classes.

In the exhibit below, we grouped fund shares into five categories: Other No-load, Institutional, Load, ETPs, and Retirement. Load shares, which have by far the highest asset-weighted expense ratio, have experienced a steep decline in market share in recent years. Load shares charged an asset-weighted expense ratio of 1.02% in 2014 and held 20% of assets as of year-end, down from 37% in 2004. During the past 10 years, load shares saw outflows of $0.5 trillion. This compares with inflows of $3.5 trillion into all other mutual fund share classes and ETPs. The asset-weighted expense ratio for all of these no-load share classes was just 0.54% in 2014.

Exhibit 4 Market Share of Fund Assets by Share Class Type



Source: Morningstar, Inc.

Category Group

Asset-weighted expense ratios fell across each of the category groups we examined over the past five years. However, those groups that tend to levy above-average fees such as international equity, sector equity, and alternative increased their share of assets over that span. Funds that invest primarily in U.S. equities saw their asset-weighted expense ratios fall to 0.58% from 0.74% while their share of assets increased to 43% from 41%. It is no coincidence that the three category groups that experienced the largest increase in the percentage of assets invested in passive funds were also those that saw the largest declines in their asset-weighted expense ratios. It is also striking—though not surprising—to see that funds in the alternative category are by far the most expensive, charging (on an asset-weighted basis) more than twice the toll levied on the average investor dollar.

Exhibit 5 Asset-Weighted Expense Ratio, Market Share of Total Assets and Passive Share by Category Group

	Asset Weighted Expense Ratio (%)			Market Share of Total Assets (%)			Passive Share (%)		
	2009	2014	Change	2009	2014	Change	2009	2014	Change
U.S. Equity	0.74	0.58	–0.17	40.6	43.2	2.7	25.7	36.9	11.2
Sector Equity	0.82	0.66	–0.15	3.9	5.2	1.3	34.1	45.7	11.6
International Equity	0.94	0.77	–0.17	17.2	16.0	–1.2	20.8	27.7	6.9
Allocation	0.84	0.77	–0.07	8.6	8.7	0.1	2.5	3.9	1.4
Alternative	1.24	1.31	0.07	1.2	1.4	0.2	45.9	22.5	–23.4
Taxable Bond	0.60	0.56	–0.04	21.2	20.9	–0.3	14.8	20.8	6.1
Municipal Bond	0.65	0.56	–0.09	6.1	4.2	–1.9	1.3	2.4	1.1
All Funds	0.76	0.64	–0.12	100	100	—	20.2	28.2	7.9

Source: Morningstar, Inc

Expense Ratio Trends by Firm

On average, firms sponsoring lineups with lower asset-weighted expense ratios gained market share during the past five years. JPMorgan bucked this trend, experiencing a large increase in market share despite the fact that its funds' fees are not among the industry's lowest. Vanguard had the largest increase in market share among the top 10 fund families over the past five years. The firm also has the lowest asset-weighted expense ratio among this group. Vanguard has widened its audience in recent years. In particular it has appealed to the growing field of fee-based financial advisors who might not have had an incentive to use Vanguard's funds under a pay-for-distribution model.

Exhibit 6 Asset-Weighted Expense Ratio and Market Share of Assets by Provider

	Asset Weighted Expense Ratio (%)			Market Share of Total Assets (%)		
Provider	**2009**	**2014**	**Change**	**2009**	**2014**	**Change**
Vanguard	0.20	0.14	–0.06	15.0	19.2	4.1
Fidelity Investments	0.76	0.59	–0.17	9.6	9.0	–0.5
American Funds	0.82	0.71	–0.10	11.8	8.4	–3.3
BlackRock/iShares	0.54	0.46	–0.09	6.2	7.0	0.8
Franklin Templeton Investments	0.95	0.87	–0.08	3.7	3.2	–0.5
T. Rowe Price	0.79	0.72	–0.07	2.8	3.3	0.5
SPDR State Street Global Advisors	0.21	0.17	–0.04	2.6	3.1	0.5
PIMCO	0.66	0.68	0.03	4.2	2.8	–1.4
JPMorgan	0.89	0.78	–0.11	1.2	1.9	0.7
Dimensional Fund Advisors	0.41	0.36	–0.05	1.3	1.7	0.4

Source: Morningstar, Inc

(Some) Fees Are Falling (Though Not by Much)

As we've outlined above, the fact that expense ratios, on average, are trending lower is not a sign of a more generous approach to pricing by the industry. Nearly half of all funds have established management fee breakpoints in their prospectuses, whereby expense ratios are automatically reduced at pre-specified asset thresholds that are designed to pass economies of scale to fundholders. As the current bull market has grown long in the horns, many funds have crossed these thresholds because of some combination of asset-price appreciation and net new flows.

The asset-weighted expense ratio for all funds fell to 0.64% in 2014 from 0.76% in 2009, a decline of 15%. However, during this span, just 63% of the fund share classes and ETPs that existed in both 2009 and 2014 reduced their expense ratio, but and only about 24% of them saw their fee fall by more than 10%. Meanwhile, 21% of the share classes we examined ratcheted up their take.

Exhibit 7 Distribution of Share Classes by Expense Ratio Change

Percentage Change in Annual Report Expense Ratio between 2009 and 2014	Percentage of Share Classes That Existed in both 2009 and 2014
Decreased by more than 10%	24%
Decreased by up to 10%	39%
No Change	16%
Increased by up to 10%	14%
Increased by more than 10%	7%

Source: Morningstar, Inc

Fees by Type

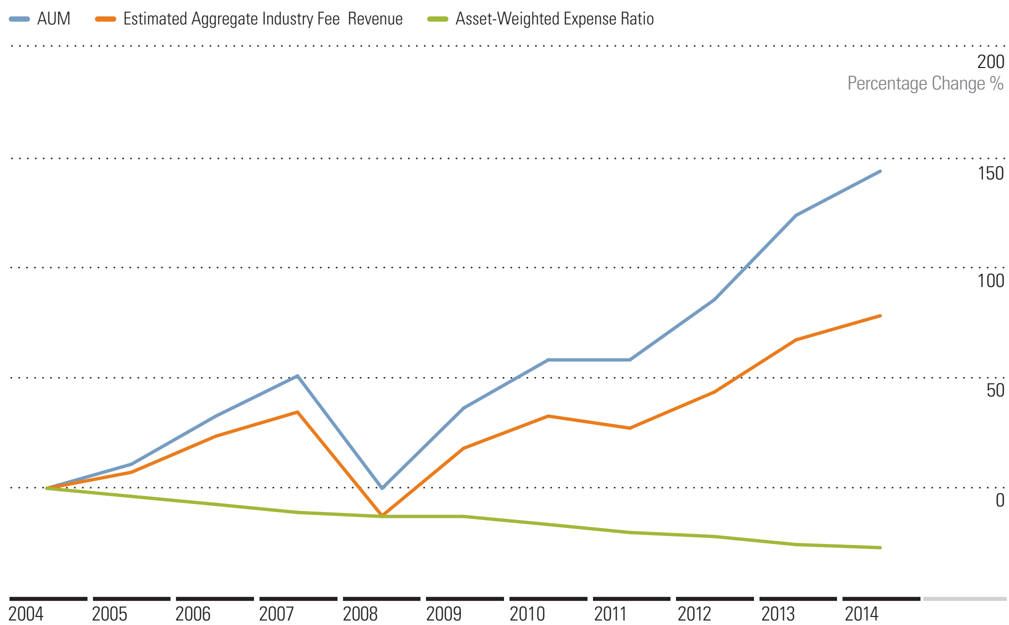
While the annual report net expense ratio includes all explicit fees incurred by a fund, these fees can be disaggregated and itemized according to their various sources, such as the advisor (management) fees, administration fees, distribution fees, and so on. Not all firms break out these expenses nor are they listed in a transparent and consistent way to help investment decision-makers.

Funds that held 84% of all assets as of the end of 2009 listed an advisor fee in both 2009 and 2014. The asset-weighted advisor fee for these funds was 0.45% compared with an asset-weighted net expense ratio of 0.79%. By 2014, the asset-weighted advisor fee had dropped by only 1 basis point to 0.44% while the asset-weighted net expense ratio dropped to 0.67%. So the decline in the asset-weighted net expense ratio we detail above was not so much driven by lower advisor fees as it was by lower fees covering other items such as distribution and administration.

Record Revenues

While the asset-weighted expense ratio has fallen, strong market appreciation and moderate inflows have pushed industry assets to record levels. We can proxy industry fee revenue by multiplying the asset-weighted expense ratio by total assets under management. By this measure, industry fee revenue is at an all-time high, reaching $88 billion, up from $50 billion 10 years ago. During that period, industry assets under management have increased 143% while the asset weighted expense ratio has declined 27%, and industry fee revenue has grown by approximately 78%. Thus, a much larger share of the benefits of the increase in assets under management has stayed with the industry rather than being returned to fund shareholders.

Exhibit 8 Estimated Fund Industry Fee Revenue



Source: Morningstar, Inc.

Investors Are Driving Change

The good news for investors is that expense ratios are falling. However, investors deserve most of the credit for seeking low-cost funds because individual funds' expense ratios and the advisor (management) component in particular have not moved much.

A Note on Data and Methodology

Unless otherwise noted, our universe includes all U.S. mutual funds and exchange-traded products, excluding money market funds and funds of funds. All funds, including obsolete funds, are included to the extent that Morningstar has the annual report net expense ratio and asset data. In all cases, our data source is Morningstar, Inc. as of 3/12/2015.

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