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RESEARCH FUNDAMENTALS

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# Fees and Expenses of Mutual Funds, 2006

## Key Findings

- **Mutual fund fees and expenses fell to their lowest levels in more than a quarter century in 2006.** Stock fund investors on average paid 107 basis points in fees and expenses, a drop of 4 basis points from 2005. Fees and expenses on bond funds fell 5 basis points, while those on money market funds fell 2 basis points.
- **The drop in fees and expenses 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 since 1980.
- **The decline in fees and expenses in 2006 on stock funds in part reflected lower load fees paid by investors.** In 2006, the average maximum sales load on stock funds offered to investors was 5.28 percent, but the average sales loads investors actually paid was just 1.31 percent owing to load fee discounts on large purchases and fee waivers on purchases through 401(k) plans.
- **The decline in stock fund fees and expenses also reflected lower expense ratios.** The average expense ratio on stock funds fell 2 basis points in 2006. Over the past five years, the average expense ratio of stock funds has dropped 11 basis points as investors shifted their purchases toward lower-cost funds and as expense ratios fell on stock funds they already owned.

## Mutual Fund Fees and Expenses Continue Downward Trend in 2006

The average fees and expenses that investors paid on mutual funds fell in 2006 to their lowest levels in more than 25 years (Figure 1). Investors paid 107 basis points, on average, to invest in stock funds, a 4 basis-point decline from 2005. Average fees and expenses on bond funds dropped 5 basis points to 83 basis points, and those on money market funds dropped 2 basis points to 40 basis points (Figure 2).

The reduction in mutual fund fees and expenses in 2006 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 since 1980. The average fees and expenses of money market funds, which are lower than those of stock and bond funds, have fallen more than 25 percent since 1980.

*Sean Collins, ICI Senior Economist, prepared this report.*

## How ICI Measures Average Mutual Fund Fees and Expenses

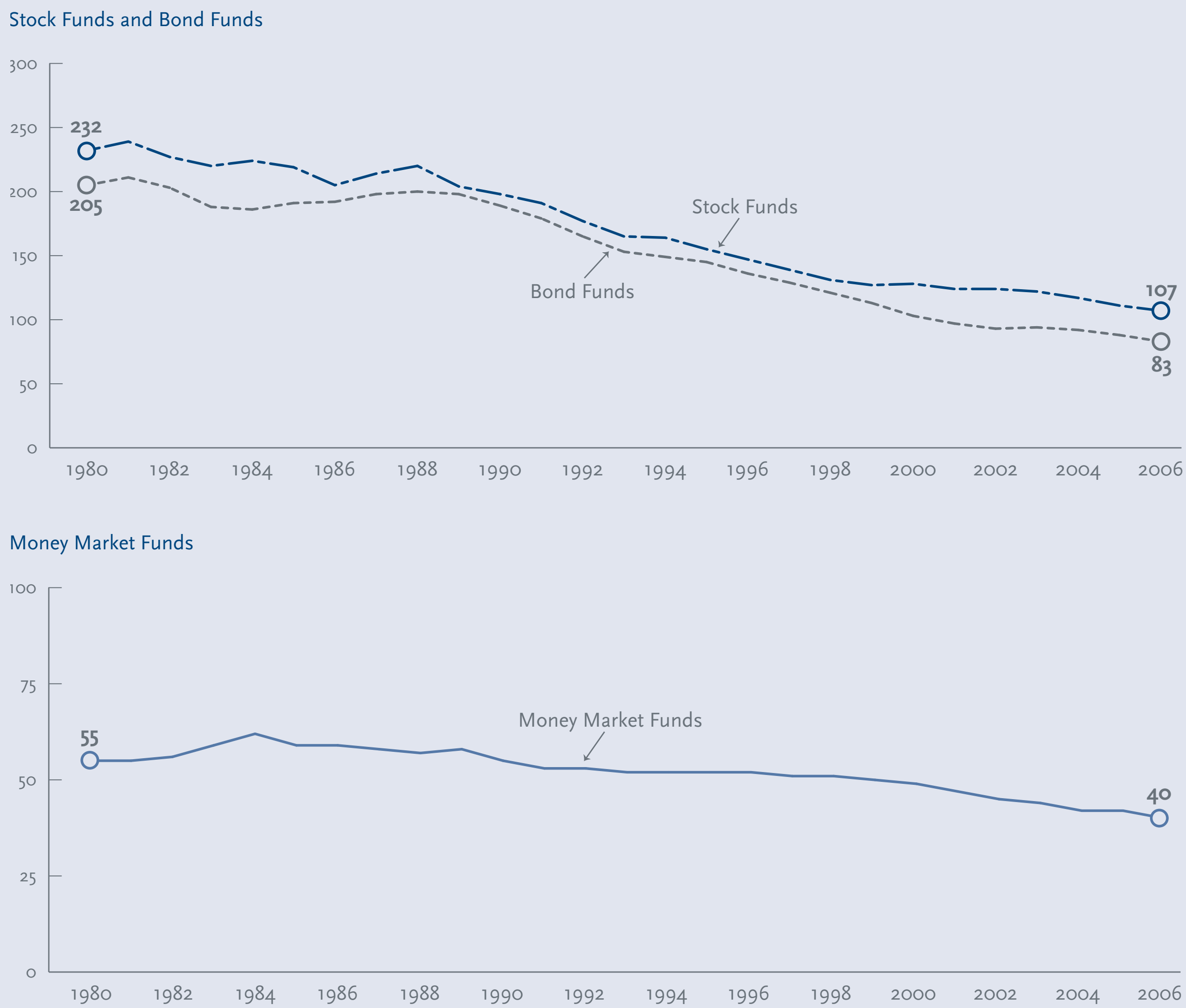
Mutual fund investors incur two primary kinds of fees and expenses when investing in mutual funds: sales loads and ongoing expenses. Sales loads are one-time fees that investors pay either at the time of purchase (front loads) or, in some cases, when shares are redeemed (back-end loads). Ongoing expenses are paid from fund assets and investors thus pay these expenses indirectly. Ongoing fund expenses cover portfolio management, fund administration, shareholder services, distribution charges known as 12b-1 fees, and other operating costs.

A variety of factors affect a mutual fund's fees and expenses, including its investment objective, its assets, the average account balance of its investors, fees that fund investors may pay out of pocket rather than indirectly through the fund, and whether the fund is a "load" or "no-load" fund. Load funds include fees and expenses to compensate brokers or other financial advisers who provide investors with financial planning, advice, and ongoing service. Load fund investors pay for 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

**Figure 1**

**Mutual Fund Fees and Expenses Continued to Decline in 2006**

*Basis points, 1980–2006*




*note: Fees and expenses incurred in money market funds are measured as an asset-weighted average.*

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have no front- or back-end load fees and have low or no 12b-1 fees. Because load funds include compensation to brokers and financial advisers, they typically have higher fees and expenses than no-load funds.

To understand trends in mutual fund fees and expenses, it is helpful to combine one-time sales loads and ongoing expenses into a single measure of fund ownership costs. ICI arrives at such a measure by adding a fund's annual expense ratio to an estimate of the annualized cost that investors pay for one-time sales loads.[1] This measure assigns more weight to those funds with the most assets in order to appropriately depict the fees and expenses paid by investors.[2]

## Stock Fund Fees and Expenses

The average fees and expenses paid by stock fund shareholders fell 4 basis points in 2006, following a 6-basis-point decline in 2005 (Figure 2). From 1980 to 2006, stock fund fees and expenses have declined by 125 basis points, a reduction of more than 50 percent.

Lower payments for load fees accounted for half (2 basis points) of the decline in stock fund fees and expenses in 2006. Lower investor outlays to pay loads, in turn, reflected a slight increase in sales of load funds with loads significantly discounted from their maximum rates. Discounts on load fees are common among load funds. Load funds typically offer significant discounts from maximum load fees for large purchases (often $50,000 or more), and discounts normally are greater for even larger purchases. In addition, load funds often waive sales loads on purchases made through 401(k) plans. In 2006, the average maximum sales load on stock funds was 5.28 percent, but the average sales load actually paid was 1.31 percent, down slightly from 1.35 percent in 2005.

In 2006, total fees and expenses paid on stock funds were also pushed down by a decline in the expense ratios of stock funds, which fell 2 basis points. This 2-basis-point drop owed to two factors: an increase in the popularity of low-cost funds and investors incurring lower expense ratios in the funds

**Figure 2**

**Fees and Expenses Dropped for Stock, Bond, and Money Market Funds in 2006**

*Basis points, 2001–2006*

| | Stock Funds | | | | | | Bond Funds | | | | | | Money Market Funds | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Fees and Expenses of which: | 124 | 124 | 122 | 117 | 111 | 107 | 97 | 93 | 94 | 92 | 88 | 83R | 47 | 45 | 43 | 42 | 42R | 40 |
| One-Time Load Fees (annualized) | 25 | 24 | 23 | 22 | 21 | 19 | 22 | 20 | 20 | 20 | 18 | 16 | – | – | – | – | – | – |
| Total Expense Ratio | 99 | 100 | 99 | 95 | 90 | 88R | 75 | 73 | 74 | 72 | 70 | 67 | 47 | 45 | 43 | 42 | 42R | 40 |

*R: revised*

*note: Fees and expenses, one-time load fees, and total expense ratios are measured as asset-weighted averages.*

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they already owned (Figure 3). Of these two factors, the fall in the expense ratios of individual funds that investors already owned was slightly more important this past year.[3]

The lower average expense ratio on stock funds implies considerable cost savings for fund investors. For example, the average expense ratio on stock funds fell, cumulatively, 7 basis points during 2005 and 2006. If this 7-basis-point decline persists, at current asset levels stock fund investors will save an estimated $4.6 billion per year in expenses.[4]

### *Low-Cost Stock Funds Hold Most Stock Fund Assets*

Investors gravitate toward low-cost funds. For example, in 2006 investors held 90 percent of their stock fund assets in funds whose expense ratios were less than the average expense ratio of all stock funds that investors could choose from in the marketplace (Figure 4).

Investors' preferences for low-cost mutual funds are reflected in their purchases of both actively managed and index mutual funds. For example, during the 10-year period from 1997 to 2006,

**Figure 3**

**Two Major Factors Contributed to the 2-Basis-Point Drop in the Average Expense Ratio of Stock Funds in 2006**

*Basis point drop due to each factor*

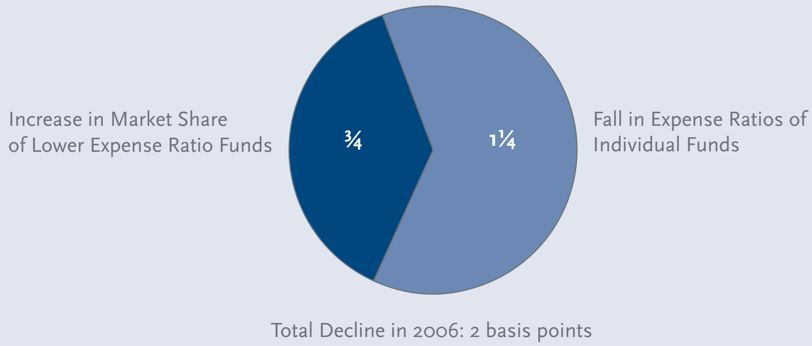


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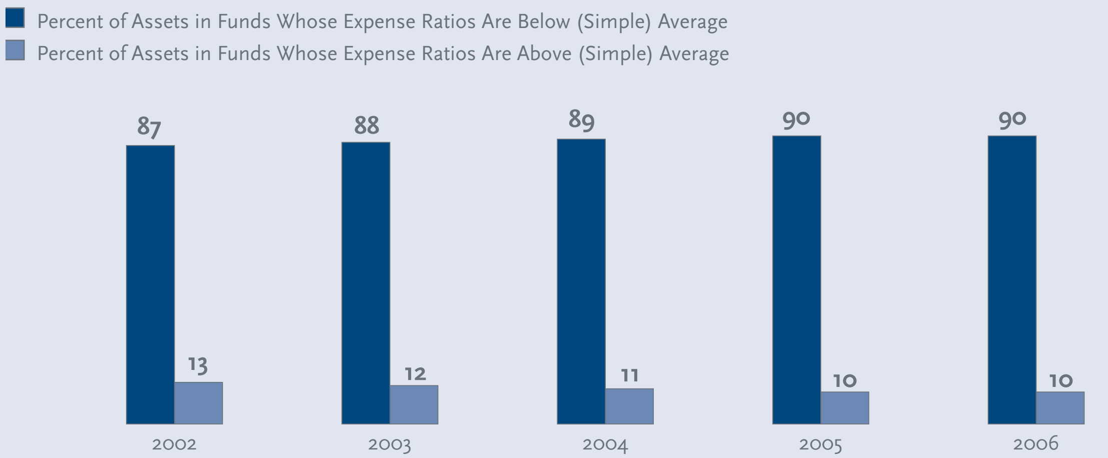
**Figure 4**

**Stock Funds with Below-Average* Expense Ratios Hold Nearly 90 Percent of Assets**

*Percent of total equity fund assets, 2002–2006*




**Average expense ratio is the simple average of the expense ratios of all share classes of all stock funds offered to investors in the mutual fund market.*

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90 percent of investors' new purchases of stock funds went to those funds whose expense ratios were below the average expense ratio of stock funds offered in the marketplace (Figure 5). Among actively managed funds, 87 percent of investors' new purchases went to those actively managed funds whose expense ratios were below the average expense ratio for such funds. Among stock index funds, 98 percent of the new cash went to those index funds with expense ratios below the average expense ratio of stock index funds available in the market.

### *The Influence of Funds of Funds on the Expense Ratios of Stock Funds*

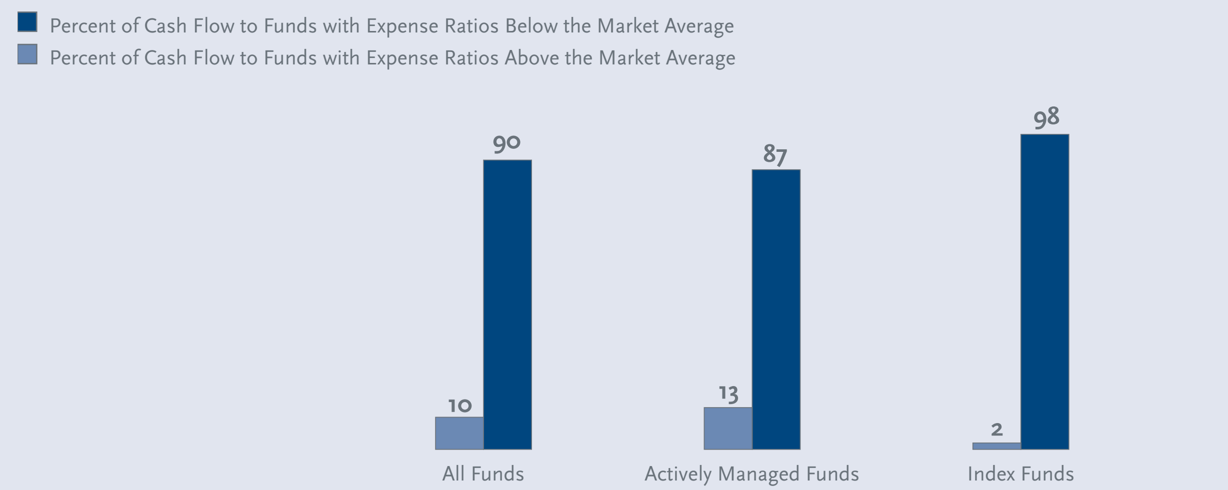
To date, ICI has not included funds of funds in its measures of the expenses of stock funds.[5] This treatment was appropriate because funds of funds represented a relatively limited portion of the mutual fund market. However, the market for funds of funds has expanded considerably in recent years, particularly with the growing popularity of lifecycle and lifestyle funds.[6] From 1996 to 2006, the assets of funds of funds jumped from just $13 billion to $471 billion and the number of funds of funds grew more than tenfold (Figure 6).

Given this rapid growth, it is appropriate to consider whether funds of funds could have a meaningful influence on the average expense ratio for stock funds. Of particular interest is the potential for funds of funds to boost the average expense ratio of stock funds. With "conventional" mutual funds (i.e., mutual funds that are not funds of funds) the inclusion of a previously excluded group of funds can either raise, lower, or leave unchanged the average expense ratio. In contrast, because of their special structure, the inclusion of funds of funds can only raise the asset-weighted average expense ratio.[7] Thus, excluding funds of funds could produce an average expense ratio that *understates* the expenses that shareholders actually incur for investing in stock funds.

**Figure 5**

**Stock Funds with Below-Market-Average* Expense Ratios Receive 90 Percent of New Cash**

*Percent, 1997–2006*




**Market-average expense ratio is the simple average of the expense ratios of all share classes of all stock funds offered to investors in the mutual fund market.*
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## Figure 6

### Number of Funds of Funds

*Year-end*

| Year | Total | Equity | Hybrid | Bond | Total | Lifestyle | Lifecycle | Other |
|---|---|---|---|---|---|---|---|---|
| 1996 | 45 | 24 | 19 | 2 | 45 | 9 | – | 36 |
| 1997 | 94 | 41 | 48 | 5 | 94 | 33 | – | 61 |
| 1998 | 175 | 75 | 91 | 9 | 175 | 63 | 4 | 108 |
| 1999 | 212 | 83 | 115 | 14 | 212 | 81 | 5 | 126 |
| 2000 | 215 | 86 | 119 | 10 | 215 | 91 | 6 | 118 |
| 2001 | 213 | 85 | 123 | 5 | 213 | 89 | 12 | 112 |
| 2002 | 268 | 104 | 159 | 5 | 268 | 118 | 12 | 138 |
| 2003 | 301 | 112 | 184 | 5 | 301 | 118 | 23 | 160 |
| 2004 | 375 | 111 | 259 | 5 | 375 | 126 | 61 | 188 |
| 2005 | 475 | 129 | 334 | 12 | 475 | 164 | 87 | 224 |
| 2006 | 604 | 161 | 430 | 13 | 604 | 205 | 150 | 249 |

### Assets of Funds of Funds

*Billions of dollars, year-end*

| Year | Total | Equity | Hybrid | Bond | Total | Lifestyle | Lifecycle | Other |
|---|---|---|---|---|---|---|---|---|
| 1996 | $13.4 | $4.6 | $8.7 | $0.1 | $13.4 | $2.4 | – | $11.0 |
| 1997 | 21.5 | 7.6 | 13.8 | 0.1 | 21.5 | 6.2 | – | 15.3 |
| 1998 | 35.4 | 12.2 | 23.0 | 0.1 | 35.4 | 12.1 | $2.5 | 20.8 |
| 1999 | 48.3 | 18.7 | 29.5 | 0.2 | 48.3 | 17.4 | 5.0 | 25.9 |
| 2000 | 56.9 | 16.2 | 40.5 | 0.2 | 56.9 | 20.6 | 6.6 | 29.7 |
| 2001 | 63.4 | 15.8 | 47.3 | 0.3 | 63.4 | 22.1 | 10.1 | 31.2 |
| 2002 | 69.0 | 14.5 | 53.9 | 0.6 | 69.0 | 24.9 | 13.0 | 31.1 |
| 2003 | 123.1 | 28.6 | 93.6 | 0.9 | 123.1 | 43.6 | 23.2 | 56.4 |
| 2004 | 199.6 | 41.8 | 156.7 | 1.1 | 199.6 | 72.5 | 39.8 | 87.2 |
| 2005 | 306.0 | 58.6 | 246.8 | 0.7 | 306.0 | 116.9 | 65.2 | 123.9 |
| 2006 | 471.0 | 96.4 | 372.8 | 1.8 | 471.0 | 172.0 | 107.2 | 191.8 |

*note: Components may not add to the total because of rounding.*
*source: Investment Company Institute*

In fact, the inclusion of funds of funds would have little effect on the expense ratio of stock funds. The level of the expense ratio of stock funds would be boosted by 1 basis point or less up until 2005 and by 2 basis points thereafter (Figure 7). The trend in the expense ratio of stock funds would likewise be little changed. For example, regardless of whether funds of funds are excluded or included, the average expense ratio of stock funds would have fallen by 2 basis points in 2006 and by more than 10 basis points over the past decade.

Nevertheless, if funds of funds continue to attract considerable investor interest, they could begin to add more to the average expense ratio of stock funds. Thus, future ICI updates on mutual fund fees and expenses will monitor the fees and expenses of funds of funds.

## Bond Fund Fees and Expenses

The average fees and expenses that shareholders paid for investing in bond funds fell 5 basis points in 2006, to 83 basis points.

As with stock funds, in 2006 the decline in fees and expenses that investors paid on bond funds owed to falls in both one-time load fees and fund average expense ratios (Figure 2). Payments for one-time load fees dropped by 2 basis points, to an average of

**Figure 7**

**Funds of Funds Would Contribute Little to Average Expense Ratio of Stock Funds**

*Basis points, 1996–2006*

| Year | Total Expense Ratio* | | |
|---|---|---|---|
| | "Conventional" Mutual Funds Only | "Conventional" Mutual Funds Plus Funds of Funds | Difference |
| 1996 | 102 | 102 | 0 |
| 1997 | 98 | 98 | 0 |
| 1998 | 96 | 96 | 0 |
| 1999 | 94 | 95 | 1 |
| 2000 | 98 | 99 | 1 |
| 2001 | 99 | 99 | 0 |
| 2002 | 100 | 101 | 1 |
| 2003 | 99 | 100 | 1 |
| 2004 | 95 | 96 | 1 |
| 2005 | 90 | 92 | 2 |
| 2006 | 88 | 90 | 2 |

**asset-weighted average*

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16 basis points, reflecting lower investor outlays for one-time load fees at load funds, as well as a small increase in the market share of no-load bond funds.

The remainder of the drop in the total fees and expenses paid on bond funds owed to a decline in the asset-weighted average expense ratio of bond funds. In 2006, the asset-weighted average expense ratio on bond funds declined by 3 basis points, to 67 basis points.[8] Since 2004, the average expense ratio that shareholders paid for investing in bond funds has fallen 5 basis points, a reduction that will save them an estimated $750 million annually going forward assuming the reduction persists.[9]

## Money Market Fund Fees and Expenses

The average fees and expenses paid by money market fund investors fell 2 basis points in 2006, to 40 basis points. From 1980 to 2006 money market fees and expenses have declined by 15 basis points, a 27 percent reduction.

This sizable reduction in money market fees and expenses is due in part to a dramatic increase in the share of money fund assets held in institutional money market funds. Institutional money funds, on average, have lower expense ratios than retail money market funds due to their larger average account size. The share of money fund assets held in institutional funds has, in fact, more than doubled since 1990, from just 20 percent in 1990 to 57 percent in 2006.

Two factors helped foster the increase in the market share of institutional money funds. First, businesses and other institutions have increasingly recognized the benefits that institutional money funds offer in terms of scale economies, liquidity, diversification, and monitoring of credit risk. Second, the market share of retail money funds has been pushed down since the late 1990s because brokerage firms have relied less on money market funds and more on bank money market deposit accounts as cash management vehicles for their retail clients.

## Notes

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

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

[3] The contribution analysis in Figure 3 is determined by first calculating the amount by which the asset-weighted average expense ratio of equity funds would have declined if the expense ratio of each and every equity fund had remained unchanged between 2005 and 2006. This contributed ¾ of a basis point (labeled in Figure 3 as "Increase in Market Share of Lower Expense Ratio Funds") to the 2-basis-point reduction in the asset-weighted average expense ratio of equity funds. By definition, the remaining 1¼ basis points must owe to changes in fund expense ratios between 2005 and 2006 (labeled in Figure 3 as "Fall in Expense Ratios of Individual Funds").

[4] The $4.6 billion estimated savings per year is based on stock fund assets of $6,564 billion as of year-end 2006 (i.e., $6,564 billion × 7 basis points). If stock fund assets or expense ratios differ, the annual savings could be either greater or lower than $4.6 billion.

[5] Funds of funds are mutual funds that invest in other mutual funds. A very small number of funds of funds also invest in exchange-traded funds. The great majority of funds of funds, and virtually all of the assets in funds of funds, are held in equity or hybrid mutual funds, both of which ICI classifies as "stock funds" for purposes of measuring mutual fund fees and expenses.

[6] Lifecycle funds are funds of funds that follow a predetermined reallocation of risk over time to a specified target date, and typically rebalance their portfolios to become more conservative and income-producing by the target date. Lifestyle funds are funds of funds that maintain a predetermined risk level and generally use words such as "conservative," "moderate," or "aggressive" in their names to indicate the fund's risk level.

[7] Because funds of funds invest in other mutual funds, they incur *indirect* and d*irect* expenses. Indirect expenses are those that they incur by virtue of their investments in underlying "conventional" mutual funds, which have expense ratios of their own. As "shareholders" in those underlying funds, funds of funds implicitly incur the expense ratios of the underlying funds through a reduction in the returns they receive, in precisely the same way that all other retail or institutional investors in conventional mutual funds do. Direct expenses constitute any other operating expenses that a fund of funds incurs, which may include advisory or administrative fees, 12b-1 fees, transfer agent fees, or other expenses. To properly and fully account for the expenses that shareholders incur for investing in funds of funds, only the direct expense of funds of funds must be counted (the indirect expenses of funds of funds have already been counted through the expense ratios of the conventional mutual funds in which the funds of funds have invested). In addition, the assets of funds of funds must be *excluded* from the asset-weighting of the expense ratios of individual stock funds. This is because the assets of funds of funds have already been captured through their investments in underlying conventional stock funds.

[8] To date, funds of funds have had essentially no influence on the asset-weighted average expense ratio of bond funds (far less than 1 basis point). For this reason, we do not report asset-weighted average expense ratios for bond funds adjusted for the influence of funds of funds.

[9] The $750 million estimated savings is based on bond fund assets of $1,495 billion as of year-end 2006 (i.e., $1,495 billion × 5 basis points).

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