STRATEGIC
INSIGHT

A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders’ Total Costs in the U.S. Mutual Fund Industry

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Introduction and Strategic Insight Background

In the summer of 2012, Strategic Insight was commissioned by the Investment Funds Institute of Canada (IFIC) to provide a study of the U.S. mutual fund industry that in particular offers a perspective on mutual fund shareholders' costs. IFIC requested a Toronto-based research firm, Investor Economics, to similarly study Canadian mutual funds. To provide a view of the U.S. mutual fund marketplace that is most comparable to the experience of Canada, Strategic Insight's report focuses for the most part on investors who purchase funds with the assistance of a financial advisor.

Strategic Insight (SI) was founded more than 25 years ago in New York City as a research firm specializing in the mutual fund industry. In 1986, the year of SI's founding, the U.S. mutual fund industry had just crossed the $500 billion mark in assets under management (AUM) and was part of a $1 trillion global mutual fund industry. Today, mutual funds (including ETFs) oversee over $25 trillion in AUM around the world, including about $14 trillion in the U.S. Strategic Insight observes the evolution of the global mutual fund industry and provides research services in New York, Boston, London, Hong Kong, and Melbourne.

Strategic Insight's observations in this report are based on a number of sources, including SI's proprietary database (Strategic Insight Simfund) which tracks the mutual fund industry and incorporates data based on mutual funds' filings with the SEC, as well as data provided by Lipper, Morningstar, and SI's own research. Also used for this study is data and findings published by the Washington D.C. based Investment Company Institute, the national association of U.S. investment companies.

This report includes commentary based on Strategic Insight's past studies, SI's proprietary surveys of U.S. fund managers, data sourced from other research firms, and our firm's cumulative knowledge of the mutual fund marketplace acquired over the more than two decades since its founding. A number of previously published Strategic Insight studies also address the topic of mutual fund shareholder costs in the U.S. and globally and have in the past been shared with the fund management industry, industry observers, and regulators. The studies referenced below are available upon request to SI:

- *Mutual Fund Fees: Facts, Trends, Economies of Scale, and Market Forces*, 2004 (at the advice of the ICI, this study was shared with the U.S. Senate Banking Committee)
- *Rule 12b-1: Looking Back, Looking Forward, in the Context of a $12 Trillion Mutual Fund Industry*, 2007 (following SI's Director of Research participation at the S.E.C. June 2007 Public Hearing on the future of Rule 12b-1, this report was published and posted in the public comment page of the U.S. SEC)
- *Fund Fees in Europe*, 2011 (commissioned by the European Fund and Asset Management Association - EFAMA), this report was shared with the EFAMA member firms and with the public.)

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I. Executive Summary

- Mutual funds are widely accepted in the U.S. Their ownership is encouraged by the marketplace and enabled through regulatory initiatives. More than 80% of wealthy households in the U.S. invest in mutual funds.

- The $14 trillion U.S. fund industry has benefitted over the past three decades from the emergence of funds as the primary savings vehicle for retirement income, as well as from innovation in investment products, development of share class pricing alternatives aligned with evolving market demands, and transparency of fee information. In combination with these factors, the open architecture culture in the U.S. for fund selection and portfolio construction has also contributed to the fund industry's ability to serve the expanding and diverse needs of a wide range of individual and institutional investors across a wide range of distribution channels.

- The U.S. mutual fund industry is dominated by retirement savings, and has benefited from a number of U.S. government initiatives since the 1970s encouraging such investments. U.S. mutual fund investments dedicated for retirement savings within tax-advantaged accounts exceeds $5.5 trillion. About two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in such accounts, and during both bull and bear markets new stock fund investments are dominated by retirement savings. In addition to these tax-advantaged retirement account structures, a significant portion of U.S. mutual fund investments in taxable accounts are also intended for long-term savings and retirement income. Indeed, according to the Investment Company Institute, the majority of U.S. fund investors (62%) have been introduced to mutual funds through their corporate retirement Defined Contribution plan. Overall, 94% of U.S. mutual fund investors use funds to "save for retirement" (whether in taxable or tax-advantaged accounts).

- About one-quarter of all stock and bond mutual fund assets under management in the U.S. are held in Defined Contribution (DC) retirement plans. Outside of DC plans, about four in five individual investors in mutual funds have made the choice to be helped by a financial advisor (FA) for the management of all or the majority of their mutual fund investments.

- For investors choosing to be assisted by a FA, the methods through which funds are sold and FAs are compensated have dramatically changed over the years. During the 1980s-1990s, most funds were sold one-fund-at-a-time and FA compensation was primarily paid at point-of-sale. Today, most funds are purchased wrapped within an asset allocation portfolio, and compensation to the FA is mainly structured as a fee-for-advice paid year after year.

- For mutual funds purchased in recent years, fees-for-advice (comprising the great majority of U.S. financial advisor compensation for mutual fund new sales and oversight lately) are generally paid by the investor directly to the financial intermediary. These fees are in addition (and external) to the fees of the underlying mutual funds used within such a portfolio of investments. Such annual charges typically range from 1.00-1.50% of asset invested, with fees on account sizes typical of a middle-income mutual fund shareholder higher than those of high-net-worth investors.

- The fees-for-advice described above are added to the mutual fund fees embedded in such funds' Total Expense Ratios (TERs). Industrywide, TERs for actively managed stock and bond funds sold in the U.S. and typically used by financial advisors average around 0.85%. An investment portfolio made of multiple funds with above-average allocation to smaller cap, international, or non-traditional investments will have higher underlying fund costs; while a portfolio with higher than average allocation to bond funds or large cap U.S. stock funds may have slightly lower underlying fund costs.

- In sum, for a U.S. investor choosing actively-managed mutual funds selected and managed with the help of a financial advisor, total costs for fund selection, management, and oversight are roughly 2.00% of the portfolio holdings each year. (Generally, under one-third of this total cost is retained by the fund manager for investment management – with the balance captured by the fund's distributor and the financial advisor serving the investor, or used to cover operational and legal expenses.) This total shareholder cost level is not dissimilar to what is observed for European-sold mutual funds.

- The transition from point-of-sale compensation to fees-for-advice compensation over the past two decades in the U.S. was not driven by regulation. In Strategic Insight's view, a key reason for such transition has been the desire of fund distributors to establish a more stable revenue base for their financial advisors. The fees-for-advice model provided this more stable base, as compared to the revenue generated by "transactions" – which can decline dramatically during periods of financial uncertainty.

- Overall, some of our observations from the market-driven evolution of fund distribution within the large, mature, and well-regulated U.S. mutual fund marketplace raise a number of considerations for market observers in other countries:

- Shareholders total costs: What is the cost impact of the transition to a fee-for-advice structure and the resultant unbundling of the fees for financial advice and portfolio construction and monitoring from mutual fund management fees? Naturally the move away from point-of-sales commissions to fee-for-advice reduces instances of ill-timed and unnecessary transactions just for the purpose of generating commissions for advisors. It is our view, though, that such inappropriate activity by financial advisors is much less common than is argued by some observers (for evidence: mutual fund redemption activity in U.S. commission-based platforms is significantly *lower* than in fee-for-advice platforms. Broker-dealers at times acknowledge that their own generated revenues in commission-based platforms are dramatically lower than in fee-for-advice platforms, and thus such broker-dealers are consistently trying to shift their clients' invested assets to fee-based relationships.)

Overall, Strategic Insight believes that for many "buy-and-hold" inclined U.S. mutual fund investors, total shareholder costs over the lifetime of an investment have increased as a result of the transition to a fee-for-advice model. Many investors no longer have the benefit of paying commissions just once (or taking advantage of discounts of such commissions available to U.S. fund investors based on aggregate investments held within one distributor or across funds of the same investment manager). Note also that in the U.S. there are tax-advantages associated with paying for shareholder costs through fees embedded within the fund, and it is tax-inefficient to pay for such fees in an unbundled way. In total, the unbundling of fees has resulted in an increase in the total shareholder costs for many mutual fund investors – with such increases amplified due to tax considerations at times.

- <u>Shareholder investment results</u>: The shift to an asset allocation-based portfolio of funds, wrapped with a fee-for-advice, undoubtedly created more balanced and prudent investment strategies. This transition toward more a more structured asset allocation culture also eliminated some instances of opportunistic, market-driven, and thus ill-timed transactions due to selling "one-fund-at-a-time." Yet, one theme of concern is the higher-than-average asset velocity which Strategic Insight observes within fee-for-advice account structures. This more frequent activity at times may be reducing potential investment gains for some investors. Mutual funds held within commission-based platforms show asset turnover (i.e. redeeming one fund and using the proceeds to purchase another fund) in line with industry averages in recent years. In contrast, fee-for-advice platforms experience higher asset turnover. In particular, discretionary fee-based accounts (where financial advisors hold full discretion over their clients assets and can change and rebalance the portfolio of funds at-will and without the prior approval of the investor) show at times significantly higher average turnover of assets. This higher asset turnover typical within fee-for-advice accounts raises concerns about investment results, as compared to lower turnover "buy-and-hold" strategies. (Does such higher frequency rebalancing add to, or subtract from, investment results? We note that a number of academic studies have concluded that higher asset velocity correlates with lower relative investment results, as compared to lower asset velocity balanced investing.)

- <u>Diversify of investment strategies from many investment managers</u>: Higher asset velocity in fee-for-advice accounts results in shorter investor holding periods of fund investments. This, in turn, translates into lower fee revenues collected by the investment manager. With investment managers' costs of raising new assets in the

U.S. rising lately, such shorter projected holding periods (and thus lower projected investment management fees over the life of an investment) are placing increasing pressure on investment manager profitability. Over time, a continuation of these trends (higher distribution costs, lower fee revenues) may result in a smaller number of investment management firms – and thus a narrower scope of investment strategies – participating in the marketplace.

- Transparency of cost information: Investors and other marketplace participants can easily compare total shareholder costs when such costs are bundled within the typical U.S. reported Total Expense Ratio (and similarly, Canadian mutual funds' Management Expense Rations (MERs)). These expense ratios are consistently reported by each fund and captured by numerous companies tracking the mutual fund industry – thus making them easily benchmarked as a result. It is Strategic Insight's view that when total shareholder costs are unbundled – with fees-for-advice ratios reported by each distribution company separately, and to each investor individually – the transparency of total shareholder cost is reduced. In addition, the ability to compare total shareholder costs across different distribution organizations is lessened. With reduced transparency and industry-wide comparability, the asymmetric nature of the relationship between a financial advisor and their investment client becomes more one-sided. This is due to the reality that the trusted advisor drives both the investment choices and the fee-for-advice price equilibrium.

- Small investors' access: are costs and access to fee-for-advice platforms limiting opportunities for lower wealth investors to receive advice? With unbundled fees-for-advice typically rising as investor account sizes decrease (due to the lack of economies of scale in servicing such smaller accounts), many middle-income mutual fund investors are faced with the reality of significantly higher ongoing costs for financial advice – or even the complete lack of an advice option – within the continued transition to a fee-for-advice culture in the U.S.

Ultimately, the desire for professional financial advice in an increasingly uncertain global financial market continues to gain in emphasis among U.S. fund shareholders and many investors globally. Given the growing demand for such guidance (and the acceptance of its cost) the $14 trillion U.S. mutual fund marketplace exemplifies how naturally occurring marketplace forces and other factors can serve as powerful conduits in creating an effective environment for both investment managers and investors. The evolution of investment strategies, advisory services and pricing mechanisms for the compensation to financial advisors across many distribution channels, costs efficiencies due to scale, regulatory guidance, and transparency of key cost comparison variables all combine to enable access to advice across varying investor wealth and sophistication levels in the U.S.

II. History, Structure, and Evolution of the U.S. Mutual Fund Industry: A Perspective

U.S. Investment Companies: Assets Under Management ($ Trillion)							
	12/85	**12/90**	**12/95**	**12/00**	**12/05**	**12/10**	**6/12**
Open- and Closed-End Funds							
Equity and Balanced	0.1	0.3	1.3	3.7	4.9	5.7	5.6
Bond	0.1	0.3	0.7	0.9	1.4	2.5	2.8
Money Market	0.2	0.5	0.8	1.8	2.0	2.7	2.4
Total Open- and Closed-End	***0.5***	***1.2***	***2.8***	***6.4***	***8.3***	***10.9***	***10.8***
Other							
VA Underlying Funds	<0.1	0.1	0.3	0.9	1.1	1.4	1.4
Exchange Traded Products	--	--	0.0	0.1	0.3	1.0	1.2
Total	**0.5**	**1.2**	**3.1**	**7.3**	**9.7**	**13.3**	**13.4**

Source: Strategic Insight Simfund

Regulatory Initiatives and Marketplace Developments Facilitate and Promote Wide Acceptance of Mutual Funds as an Investment Vehicle

The acceptance of the mutual fund vehicle for savings and investments, income and capital accumulation, and retirement security is reflected in the over $1 trillion net invested into bond and stock U.S. mutual funds since 2008's extraordinary crisis.

The evolution of U.S. mutual funds since the 1970s benefitted from a confluence of regulatory initiatives enabling tax advantaged retirement savings, new investment areas, and technological innovations. The industry's growth has also been spurred by a favorable financial environment for bond, stock, and cash-equivalent mutual funds for most of the past four decades. Mutual funds offer an important foundation to retirement savings in America. More than $5.5 trillion are invested in mutual funds held in tax-advantaged retirement accounts (including individual retirement accounts (IRAs), Defined Contribution (DC) plans, and mutual funds underlying variable annuities). About two-thirds of the total assets in all equity and balanced mutual funds are held in such accounts, and during both bull and bear markets new stock fund investments are dominated by retirement savings. Indeed, the majority of U.S. fund investors (62%) have been introduced to mutual funds through their corporate retirement Defined Contribution plan. And 94% of U.S. mutual fund investors, according to the ICI, use funds to "save for retirement."

A few highlights of regulatory initiatives and other pricing innovations enabling fund growth:

- **1974** Individual Retirement Accounts (IRAs) for workers not covered by employer retirement plans are introduced (today mutual fund IRA accounts exceed $2 trillion)

- **1978** 401(k) retirement plans are introduced (about $2.5 trillion are held through mutual funds in Defined Contribution plans in the U.S.)
- **1980** The SEC adopts Rule 12b-1, allowing funds to pay for distribution (in a tax-advantaged way). Over the next three decades, 12b-1 fees became a dominant source of fees paid for distribution and advice. The role of 12b-1 fees in advisor compensation has, however, greatly diminished lately, as a result of a movement towards an externalized-fee-for-advice culture. Fees for advice are now largely charged and paid outside the mutual fund expense ratio, as increasingly funds with no embedded 12b-1 fees are sold
- **1988** Merrill Lynch launches the first multi-share-class funds ("A" with point-of-sale commissions, or "load," are charged to the investor and are paid to the financial advisor (FA), and "B," where the point-compensation to the FA is recovered through 12b-1 fee charges over the following 6-8 years. Very quickly, the new "B"-priced funds outsold front-load classes by more than 10:1 ratio
- **1989** The first mutual fund wrap program (charging a fee for advice paid externally by the investor, not through the fund's expense ratio) is introduced. Today, fee-based wrap programs account for over 70% of fund sales within the leading distributors in the U.S. serving investors seeking financial advice
- **1992** Schwab debuts OneSource, the first no-transaction-fee mutual fund "supermarket" (a "market" offering a wide range of investment options from a large number of fund managers, aggregated and reported by the platform administrator). Such platforms soon became the dominant place for fund purchases by self-directed investors. In addition, such "supermarkets" are used heavily by independent Registered Investment Advisors (RIAs) who manage over $1 trillion for individual investors. Schwab, Fidelity's National Financial, and TD Ameritrade are the dominant administrators for the fast growing distribution segment of independent RIAs
- **1993** The SPDR S&P 500, the first successful ETF, is launched. Today, overall assets managed by U.S.-registered Exchange Traded Funds exceed $1 trillion (and globally have eclipsed $1.5 trillion)
- **1994** The first Target-Date funds are launched. AUMs in such funds now exceed $400 billion, almost all in retirement plans, and such funds are increasingly the dominant default option choice in Defined Contribution (DC) plans
- **1997** The Taxpayer Relief Act of 1997 creates the Roth IRA (enabling investing without deductions, and tax-free accumulation into retirement years; today Roth IRA AUMs are near $200 billion)
- **2006** The Pension Protection Act (PPA) bolsters the role played by 401(k) and other DC plans in providing retirement security, and also sparks the growth of target-date funds.

A. U.S. Mutual Funds' Widespread Role in U.S. Wealth Accumulation

According to the U.S. Investment Company Institute (ICI), as of year-end 2011, mutual funds invested in the U.S. held:

- 29% of all U.S. corporate equity
- 26% of U.S. municipal securities
- 43% of all Commercial Papers
- 13% of all U.S. Government securities.

The acceptance of mutual funds is widespread in the U.S.

- Mutual funds are owned by 81% of wealthier households in the U.S. (those with over $100,000 of annual income).
- Among all households, 44% own mutual funds (about 52 million households).
- Most households that own mutual funds earn only a modest income: 62% of all households owning mutual funds earn less than $100,000 each year and 24% earn less than $50,000.
- Among fund-owning households, the median assets held in mutual funds were $120,000, making mutual funds among the most important financial assets for such families.
- It is not surprising that mutual funds are an investment vehicle adopted by "middle-income" investors (as well as by wealthier investors). These pooled investment vehicles have provided access to a wide range of strategies (e.g., U.S. fund investors benefit from more than 100 investment categories).
- Strict regulatory structure, oversight by funds' boards of directors, technological innovation, and a liquidity promise have all served to establish the leading role of mutual funds in the U.S. and elsewhere.
- Most fees charged in a mutual fund are allocated to investors based on their assets held within the fund. As such, some fixed per-account costs (e.g., transfer-agent fees) are actually higher than the amount paid by investors with very small accounts – thus such costs to the fund and their associated fees are in reality subsidized by larger shareholders. Overall, mutual funds are investments where higher-balance investors "subsidize" some of the costs of lower-balance investors (costs of investment management, transfer agency, or legal and operational that are pro-rated by assets held). Similarly, the "pooling" nature of mutual funds allows access to many difficult-to-invest-in sectors for shareholders with only $1,000 or $3,000 accounts.

B. Evolution of a Competitive Landscape: Increasing Asymmetric Power of the Largest Distributors Necessitates Investment Managers' Adaptations

Following the remarkable dislocation in the U.S. and global financial markets in 2008 and early 2009, demand for mutual funds has experienced dramatic changes in recent years. Among the key features of this evolving demand are:

- **Income and safety focus among U.S. fund investors**
- **Away from diversified U.S. stock funds**
- **Towards investments with low-correlation to main indices**
- **Global exposure**
- **Pre-packaged asset allocation**
- **Passive management, low fees.**

The dramatic rotation in investors' preferences in recent years, and even before the eruption of the 2008 financial crisis, has significantly influenced leadership among U.S. mutual fund managers. Note, for instance: of the 30 largest, thus dominant and most profitable U.S. mutual fund firms in the mid 2000s (based on December 2005 assets in actively managed stock and bond funds), close to half (or 40%) found it challenging to benefit from their scale and presence to achieve organic growth in the following six and a half years. Some such firms lost a quarter or more of their total fund assets over the six-plus year period, a time during which financial markets experienced boom, bust, and recovery. Naturally, other large fund firms thrived over the period – some among the top 30 (as of 12/05) had doubled their assets by mid 2012.

Clearly, a variety of market forces were at work in addition to evolving investment preferences: some of the leading fund managers benefitted from mutual fund assets previously held elsewhere or from transfers of money from other investments and savings. Yet, others managers suffered attrition. Asset mobility is a constant in the investment management business, as money is always in motion.

Additional reasons for the continuing asset losses (and inversely, for asset gains) of individual fund companies include relative fund performance amplified by transparency and accessible technology; brand awareness; and the near disappearance of closed architecture in the U.S. mutual fund industry (Target Date funds offered by the leading Defined Contribution Plan administrators being one of the exceptions). Naturally, how the excellent relative-performers on a mutual fund firm's lineup are aligned with the contemporary investment demand themes is also important.

Even funds attracting new money at a rapid pace due to their perceived performance excellence at times grow too fast and lose their relative past performance advantage, or reach capacity and close to new investors.

Overall, asset attrition is inherent to the investment management business. Each year, a stock or a bond fund tends to lose about 20-30% of its assets under management due to natural attrition, rotations from one investment strategy to another, performance and service reasons, and other factors (some exceptions exist). It is, therefore, critical for fund managers to continue to have access to distribution outlets in order to replace redeemed assets, as well as to give their portfolio managers opportunities to deploy new cash in recently discovered investment opportunities. Thus, to attract new investment flows, fund management firms must align the pricing of their funds, and their ability to finance the cost of distribution, to what is expected (and demanded) by the leading mutual fund distributors. As the leading distributors beginning in the 1990s transitioned their pricing model from point-of-sale compensation (financed with fund's embedded commissions and fees) to fees-for-service paid over time, fund companies similarly modified their offering of share classes suitable for fee-for-service relationships.

Two decades into such a transition, the great majority of today's U.S. fund sales via financial advisors are through low-fee fund share classes wrapped with an externalized annual fee (of over 1% each year) set and collected by the financial intermediary. (This topic is discussed at length in Chapter IV.)

Overall, the market and pricing power of the leading distributors in the U.S. is rising. The dominance of the top fund distributors has increased in the past few decades, as consolidations became a common theme among U.S. broker dealers. For example, the top 10 distributors in the U.S. (among them Bank of America's Merrill Lynch, Morgan Stanley Smith Barney, LPL, Schwab and Fidelity) oversee in total more than $10 trillion of assets, including maybe half of more of all intermediary-distributed mutual funds.

Continuing access to new investors and their financial assets – and to financial advisors among broker dealer distributors or Registered Investment Advisors (RIAs) – is essential to virtually every fund firm. Even those U.S. firms focusing historically on connecting with self-directed investors today strive to partner with financial advisors. (For example: Schwab has been the leading "supermarket" for funds sold to do-it-yourself investors. Yet during 2Q'2012, Schwab's RIA custody unit attracted $10 billion in net inflows while its individual investor business gained just $3 billion. Similarly, more than half of 2Q'2012's net flows at TD Ameritrade were from RIAs, as reported in Investment News.)

Given this reality, aligning fund firm's initiatives to the preferences in place among its broker dealer distributors (e.g., share class alternatives, FA education, technology, and profit sharing) are paramount. As discussed later in this report, the ways in which costs of fund distribution and access to FAs are evolving have determined the manner in which such costs are charged to fund investors.

A final note: Growth in the U.S. mutual fund industry is experienced by small and large fund firms. That said, a small number of highly visible firms benefit from a very high share of incremental inflows (the top three inflow-gathering firms in 1H'12 benefitted from net flows equal to one-half of the total net flows during 1H'12 into all stock and bond funds). Such success stems at times from the ability to offer lower fees due to scale (e.g., Vanguard has nearly $2 trillion in managed assets today); as well as efficient investment management in some market segments (witness the success of PIMCO's bond funds in recent years); and efficient distribution (such as achieved by JP Morgan Asset Management) – which in many cases mirror the benefits of scale in the U.S. mutual fund industry.

III. U.S. Fund Distribution

Over the past few decades, the U.S. mutual fund industry has evolved and matured. The range of investment strategies has increased, and fund distribution expanded greatly. Key marketplace trends such as the importance of retirement investing, the emergence of fund "supermarkets", and the dominance achieved by advice-driven distribution have had significant impacts on the mutual fund industry in the U.S.

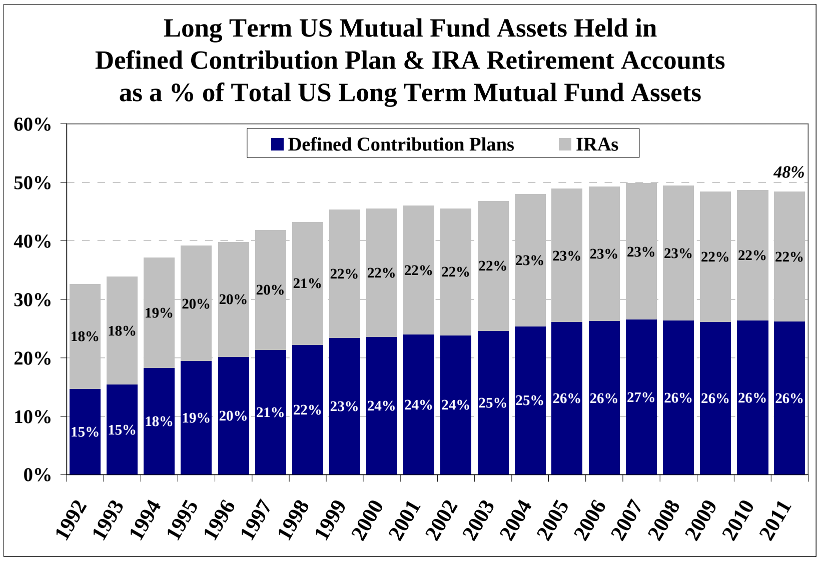
A. Role of Retirement Investing in the U.S. Fund Industry

While many important similarities exist between the Canadian and U.S. mutual fund marketplaces (including the prevalence of fund sales through financial advisors), there are also clearly important structural differences. One such difference is the configuration of retirement investing, which serves as one of the central pillars of the U.S. mutual fund industry. Presented below is a brief overview of the role that retirement accounts play within the U.S. fund market.

The growth of retirement investing in the U.S. was spurred by key legislation and national policies which created tax-advantaged savings accounts – including Individual Retirement Accounts (IRAs) and 401(k) Plans – that Americans can leverage for their long-term retirement investing. The Employee Retirement Income Security Act of 1974 (ERISA) was federal U.S. legislation that established minimum standards for employer retirement plans, as well as protections for retirement investors. Importantly for the U.S. mutual fund industry, the ERISA legislation also included the creation of IRAs. These accounts allowed individuals the opportunity to save for retirement on their own in tax deferred accounts made available through private financial institutions. Subsequently, The Revenue Act of 1978 created new Section 401(k) to the U.S. Internal Revenue Code. This paved the way for workers to utilize pre-tax salary deductions as a source of retirement plan contributions – leading to the widespread adoption of 401(k) retirement plans by U.S. employers. More broadly over time, this spurred the structural shift in retirement savings in the U.S. away from defined benefit plans (in which the employer assumes the investment risk) and toward defined contribution (DC) plans (in which the employee assumes the investment risk).

This evolution toward individuals, rather than their employers, assuming primary responsibility for managing the allocation and accumulation of their retirement savings created an opportunity for investors to leverage the diversified and cost-effective structure of the mutual fund vehicle to save toward their retirement goals. Mutual funds have since comprised a substantive portion of the retirement investment marketplace. As of the end of 2011, the U.S. retirement market in total held $17.9 trillion of assets and mutual funds accounted for nearly $5 trillion, or 26%, of such holdings according to the ICI.

Retirement savings accounts made up 48% of total long-term (stock and bond) U.S. mutual fund assets as of the end of 2011. The two tax-advantaged retirement account types through which mutual funds are held most prominently are employer-sponsored Defined Contribution (DC) Plans and IRAs (the latter are often comprised of retirement assets "rolled-over" from previous DC plan balances and now managed under the guidance of a financial advisor). The graph below charts long term mutual fund assets held within each of DC plan and IRA accounts, respectively, as a proportion of total long term fund assets in the U.S. Since 1992, overall fund assets in retirement accounts have increased their share of total long term fund assets by 15%.



Source: Investment Company Institute (ICI)

The structure of the U.S. retirement system has enabled mutual funds to serve as the primary vehicle used by millions of Americans to prudently save for retirement. At the same time, the steady inflow of regular employee salary deductions into retirement accounts – along with the low redemption rate and high asset stability benefits associated with many retirement investors' long-term investment horizons – have served to establish a solid foundation of scale and stability for the U.S. mutual fund industry. While DC plans and IRAs both provide U.S. investors with tax-advantaged means of saving for retirement, these account structures also carry important differences.

The structure of the Defined Contribution market in the U.S. – from the perspective of pricing options, access to advice, fund selection and total shareholder costs – is unique from other avenues of the U.S. marketplace. Because of these dynamics, a direct comparison of such DC plan participants' total shareholder costs (which in many cases would exclude payment for advice) to those of Canadian advisor-sold mutual funds would be largely out of context. Given DC plans' influence on the U.S. fund industry, however, some foundational information regarding their structure and pricing is important.

Many participants within employer-sponsored DC plans are acting without the services of a financial advisor, although such professional advice is often available as a plan option to participants if they choose to utilize it. In addition, investors' choice of fund offerings is limited to the specific funds available within each respective DC plan (often, particularly for smaller plans, encompassing mainly proprietary offerings from the financial services firm providing administrative and recordkeeping services to the plan). Given this combination of factors, "embedded advice" funds (mainly in the form of fund-of-funds which manage and rebalance ongoing allocations between stocks, bonds and other investments) are a significant and growing piece of investor demand within DC plans. In particular, Target Date funds – which provide ongoing asset allocation management and risk controls over the life of the fund based on an anticipated retirement date – have grown to $376 billion as of the end of 2011 (up from just $12 billion in 2001), with $270 billion of this total held within Defined Contribution Plans according to the ICI.

Given this environment within DC plans, pricing options and the determinants of overall shareholder costs can differ significantly from accounts held outside of such plans via a financial advisor relationship. The asset-based fee-for-advice compensation model has become the dominant means of accessing mutual funds via a financial advisor (as discussed in greater detail in subsequent sections of this report). Within DC plans, however, a majority of shareholders' total costs come via underlying fund expenses across a variety of share class pricing options.

One key factor influencing investor costs within DC plans is the size of the overall plan. As captured in the table below, large plans with over $100 million in assets account for more than two-thirds of total DC plan assets within the U.S. and more than one-half of DC plan participants. In particular, mega-sized plans of over $1 billion (representing many large S&P 500 U.S. corporations) make up the largest segment of plan assets (40%) and also plan participants (27%).

Total Defined Contribution Assets by Plan Asset Size

	Assets ($B)	Share of Total Assets	Share of Plans	Share of Participants
<$1MM	$132	3%	70%	8%
$1MM-$5MM	$334	7%	21%	11%
$5MM-$10MM	$192	4%	4%	6%
$10MM-$49MM	$523	12%	3%	14%
$50MM-$99MM	$286	6%	1%	7%
$100MM-$249MM	$465	10%	0.4%	11%
$250MM-$499MM	$398	9%	0.2%	8%
$500MM-$1 Billion	$407	9%	0.1%	7%
>$1 Billion	$1,794	40%	0.1%	27%
Total 2011 DC Assets	**$4,531**			

Source: PLANSPONSOR 2011 Recordkeeper Survey / ICI's "The U.S. Retirement Market, Fourth Quarter 2011" / SI Analysis
Assets reflect year-end 2011 ICI statistics; Plan data reflects PLANSPONSOR year-end 2010 data based on 83 million participants across 653,000 plans

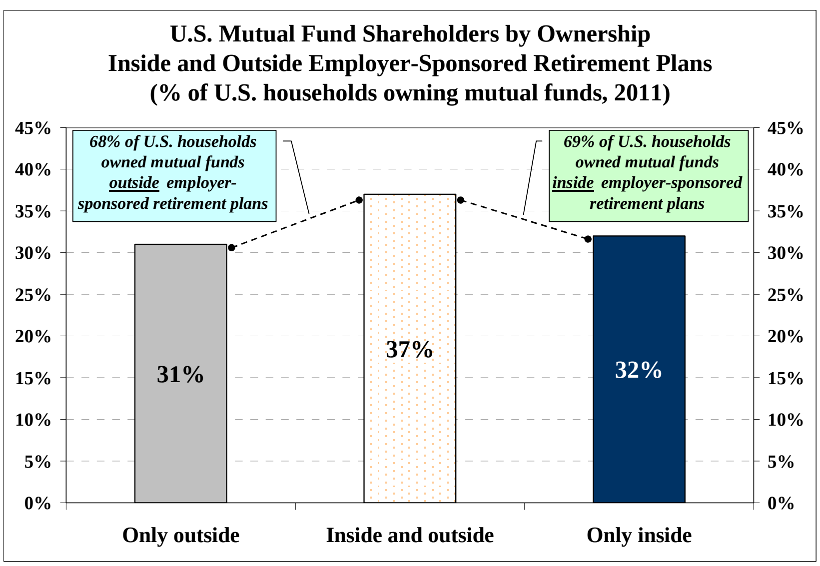
Against this backdrop within the DC plan marketplace, the table below charts examples of typical share class pricing options utilized within DC plans of different sizes ("micro" to "mega"). As captured below, the embedded service fees component of fund expenses (largely via 12b-1 fees) constitutes the largest cost variable across retirement-focused share classes and is mainly based on DC plan size.

Typical Share Class Characteristics by Defined Contribution Plan Size										
	Embedded Service Fees		Total Assets							
			2009		2010		2011		June 2012	
Share Class (Example)	via 12b-1 Fee	DC Plan Size	$Billions	Share %	$Billions	Share %	$Billions	Share %	$Billions	Share %
R1	1.00	Micro/Small	3	1%	4	1%	5	1%	5	1%
R2	0.75	Small	17	6%	18	5%	17	4%	17	4%
R3, R, Rtrm, N, P	0.50	Mid	83	29%	98	26%	92	23%	98	21%
R4	0.25	Mid/Large	50	18%	59	15%	50	12%	50	11%
R5, R6 W, K, I	0.00	Large/Mega	132	46%	203	53%	239	59%	291	63%
			285		*383*		*402*		*461*	

Source: Strategic Insight

The level of 12b-1 fees included within share classes typically utilized in DC plans tends to carry an inverse relationship to plan size – with larger plans benefitting from their overall scale to necessitate lower (often zero) embedded service fees, but smaller plans often warranting share classes with up to 1% in ongoing 12b-1 fees in order to help offset plan administration and other costs. Given the makeup of the DC plan marketplace, these pricing dynamics equate to significantly lower overall shareholder costs for a majority of DC plan assets and participants, as compared to the externalized fee-for-advice model utilized most prevalently for investors accessing funds through the professional guidance of a financial advisor.

While DC plans encompass just over one-half of U.S. fund assets held within retirement accounts and are clearly a key avenue of investment for many Americans, a majority of U.S. investors hold mutual fund assets both inside and outside of such plans. The graph below charts the percentage of U.S. households which own mutual funds both inside and outside of employer-sponsored retirement plans, as tracked by the ICI. While a robust 69% of U.S. households own mutual funds within an employer-sponsored retirement plan, only 32% of households own funds *exclusively* within such structures.



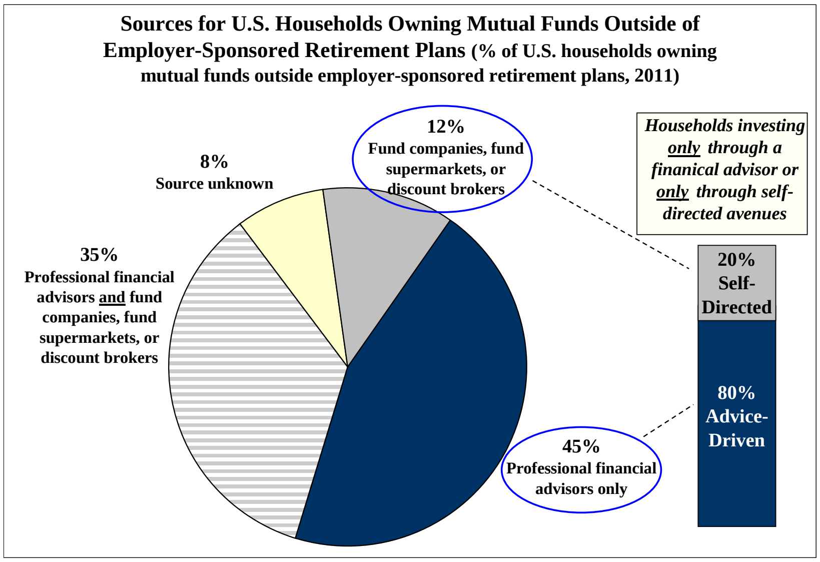
Source: Investment Company Institute (ICI)

Outside of employer-sponsored retirement plans, IRAs constitute a large proportion of the remaining fund ownership of U.S. households (as captured previously in this section, fund assets held in IRAs accounted for 22% of total U.S. long-term fund assets as of the end of 2011 and slightly under one-half of the total fund assets held within retirement accounts). Based on ICI research, 73% of the households captured in the graph above which owned funds outside of employer-sponsored retirement plans held funds within IRAs. Most IRAs are not employer-sponsored vehicles, but offer individuals the opportunity to save for retirement on their own within tax-advantaged accounts offered through private financial institutions (excluding certain IRAs – SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs – which are structured as employer-sponsored plans for small businesses).

These IRA accounts – often comprised of assets rolled-over from previous DC plan investments – are frequently held under the guidance of a financial intermediary. This offers IRA investors the benefits of professional financial advice and an open-architecture range of mutual funds to choose from. As such, this substantive portion of U.S. retirement assets often take on significantly different (and higher) shareholder cost characteristics than most assets held within DC plans. As retirement assets move into the intermediary-sold space via the IRA vehicle, shareholder cost begins to more closely mirror the dynamics of the fee-for-advice compensation structure most common among U.S. financial advisors. The evolution toward this fee-based environment in the U.S. and its implications around total shareholder cost are discussed in more detail in the following sections. (Note: the U.S. Department of Labor established new rules in late 2011 which accelerated the transition to a fee-for-service model among financial advisors guiding investors holding retirement accounts – both IRA and DC investments – see a link at http://www.dol.gov/ebsa/newsroom/factsheet/fsinvestmentadvicefinal.html.)

B. Advice-Driven vs. Self-Directed Distribution

One of the most important secular trends influencing U.S. fund distribution over the past 25 years has been investors' increasing reliance on financial advisors to manage their investments. The graph below, based on ICI research, focuses on the avenues outside of employer-sponsored retirement plans through which U.S. investors purchase mutual funds (the statistics below would be inclusive of fund purchases within most IRA retirement accounts).



Source: Investment Company Institute (ICI) / Strategic Insight analysis

While only 12% of U.S. households are exclusively "do-it-yourselfers" with regard to their fund purchases outside of retirement plans, overlap clearly exists between the same investors utilizing advice-driven and self-directed avenues for different portions of their fund holdings. A focus on those households purchasing funds only via a financial advisor or only via self-directed means reveals that roughly 80% of such investors within one of these two buckets purchased funds through a financial advisor in 2011. Or, analyzed another way, 45% of investors purchase funds exclusively through financial advisors and 35% purchase a portion of their fund holdings through an advisor – equaling to 80% of investors utilizing a financial advisor in some capacity.

The dominant role which professional advice plays in the U.S. investment marketplace has had a profound impact on the country's mutual fund industry. As fund distribution has expanded, the range of intermediary-sold distribution channels and types of financial advisors through which mutual funds are sold has also increased – from full service brokerages to independent financial planners and more. This growth has significantly influenced U.S. fund firms' sales and marketing efforts, while also impacting important aspects of mutual fund pricing, financial advisor compensation and overall shareholder cost (as discussed in greater detail in subsequent chapters).

At the same time, the expansion of fund sales through third-parties has also facilitated the fundamental movement toward an open architecture culture in the U.S. – providing investors and advisors with choice across a wide range of mutual fund sponsors. This environment has contributed to spurring competitive forces within the U.S. fund industry which have steered important market-driven equilibriums around pricing, investment product innovation, and more.

While financial advisors have always played an important role as partners to the U.S. mutual fund industry, one significant impetus which accelerated both the trend away from investors purchasing mutual funds directly from fund companies as well as the foundational movement toward open architecture was Charles Schwab's development of the first fund supermarket in the early 1990s. Schwab's "OneSource" platform offered investors and advisors their first opportunity to choose from a menu of no-load mutual funds from several different fund families under a single account structure (whereas previously investors would be required to purchase no-load funds on an individual basis directly from each fund company).

In its early stages, this centralized platform offered "do-it-yourself" investors a superior means to accessing a range of mutual funds. As the U.S. marketplace has evolved toward today's dominant reliance on the professional advice of financial advisors, however, new business within fund supermarkets has come to be increasingly led by the fast-growing Registered Investment Advisor (RIA) community – which utilizes these platforms as a key avenue to access mutual funds as part of their client portfolio construction process. RIAs are independent, primarily fee-only advisors whose client base typically includes high-net-worth and ultra-high-net-worth investors. There were 28,714 RIAs operating in the U.S. as of the end of 2011, up nearly 40% from 20,851 in 2004 according to Boston-based research and consulting firm Cerulli Associates. These RIAs managed nearly $3 trillion in total assets as of the end of 2011 (with roughly $1 trillion held in mutual funds and an additional $250 billion in ETFs), up from approximately $1.6 trillion of total RIA-controlled assets in 2004.

Today, fund supermarkets offered by Schwab, Fidelity's National Financial Services, Pershing, TD Ameritrade and others are utilized extensively by RIAs. These advisors leverage such platforms for asset custodial services, as well as for outsourcing of administrative and back office functions such as recordkeeping, technology, compliance, and more. Roughly 7,000 independent RIAs are dependent on Schwab's platforms to access mutual funds and other investments, construct portions of their clients' investment portfolios and to custody their clients' assets. From an overall asset composition perspective, Schwab's RIA custody unit held $728 billion of total assets as of the end of June 2012, while its individual investor business accounted for $737 billion. Among these two units, however, the RIA business has clearly been the key driver of growth at Schwab – attracted $23 billion in net new assets during the first half of 2012, as compared to just $9 billion within the individual investor unit.

Over time, RIAs' influence within fund supermarkets has significantly facilitated the expansion of traditionally direct-sold funds within the financial advisor marketplace. At the same time, this access to the RIA community has allowed traditionally broker dealer-sold U.S. fund firms to reach RIAs by offering no-load share classes (often their institutional shares) via supermarket platforms. This combination of forces has spurred even greater expansion of mutual fund sales across widening ranges of the advisor community.

The growth and success of fund supermarkets in the U.S. stems from a combination of the factors discussed, but is led in many ways by the size, diversity and structure of the U.S. marketplace. These fundamental factors have helped to facilitate the establishment and sustainability of the large supermarkets' "magnet" theory – with the availability of a wide selection of investment options attracting a diverse range of investors and advisors to these platforms, and vice versa with the supermarkets' investor presence (particularly RIAs) drawing an ever-increasing number of asset managers to offer funds via these programs. This tremendous scale of assets and diversity of investors and advisors is in many ways unique to the U.S. as compared to Canada, making the fund supermarket concept (and more broadly, the wide range of distribution channels in the U.S.) a difficult proposition to successfully establish within the Canadian marketplace at this point in its evolution.

From a shareholder cost perspective, the substantive presence within fund supermarket platforms of RIAs, who typically charge 1% or more for their advice and guidance, encapsulates an important theme within the U.S. distribution marketplace. A majority of the funds sold via such platforms and in fee-based wrap programs are no-load share classes (some with small levels of embedded distribution fees – primarily via Rule 12b-1 fees of up to 0.25% – and others without any embedded distribution financing). But the use of such funds' Total Expense Ratios (TERs) as a proxy for total shareholder cost paid by their investors can at times be misleading. As more investors use advisors, and as advisors shift toward a fee-based compensation model, more fund shareholders are paying for advice via an externalized, asset-based overlay fee charged outside of – and in addition to – total fund expenses.

C. Focus on U.S. Intermediary-Sold Fund Distribution

Amid the longer-term secular trend of U.S. mutual fund investors increasingly relying on the professional guidance of financial advisors to help manage their assets, the intermediary-sold fund distribution landscape in the U.S. has also continued to evolve. This advisor-sold marketplace in total represents roughly $5.5 trillion of mutual fund assets in the U.S. across a range of diverse channels. Among the largest and most important advisor-sold channels for fund firms are National Broker Dealers, Independent / Regional Broker Dealers and RIAs.

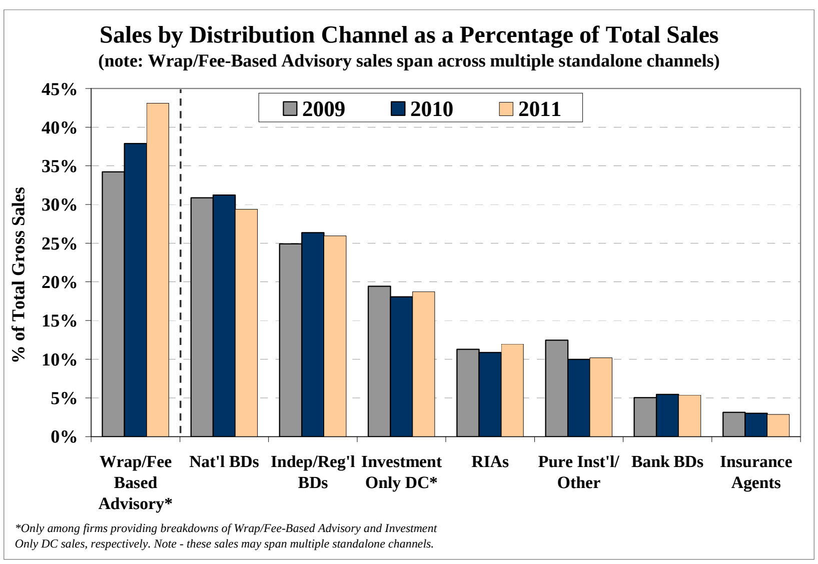
- The National Broker Dealer channel has experienced significant consolidation over the past several years and now encompasses four large firms – Merrill Lynch, Morgan Stanley, Wells Fargo and UBS. These firms, however, account for more than 50,000 financial advisors and represent a very substantive proportion of overall fund industry sales. From an asset perspective, the four National Broker Dealers account for in aggregate over $1 trillion in total mutual fund assets.
- Independent and Regional Broker Dealers also represent an important advisor-sold distribution avenue in the U.S. Many advisors affiliated with these firms operate as independent contractors (as opposed to National BD advisors who are employees of their firms). The Independent and Regional Broker Dealer marketplace is made up of a majority of small firms, but also encompasses several large and growing players such as LPL, Ameriprise, Edward Jones and others. Although much less concentrated than the National BD channel, Independent and Regional Broker Dealers in total account for about $1.2 trillion in total U.S. mutual fund assets.
- The RIA channel, as discussed previously, encompasses independent and largely fee-only advisors whose primary means of accessing mutual funds is via supermarket platforms such as Schwab, Fidelity, etc. While the RIA channel has been an emerging area of focus for many of the large, traditionally broker dealer sold fund firms in the U.S., much of the established mutual fund presence within

the RIA community has been concentrated largely among no load boutique and specialized fund managers. In total, RIAs hold roughly $1 trillion in U.S. fund assets.

Beyond these three distribution channels, advisor-controlled fund assets in the U.S. also reside within the wealth management units of private banks and trust companies, within bank broker dealer networks, and at insurance companies. For many U.S. fund firms, access to DC retirement plan investments is also a key focus of their new business strategy. The Investment Only DC channel accounts for fund sales via employer-sponsored DC plans by fund companies who do not maintain an affiliated DC plan recordkeeping unit. This channel is the most common avenue through which most fund firms distribute into DC plans.

Within the context of this distribution channel makeup, the following graph shifts perspective slightly to provide a more current depiction of important new sales trends within the intermediary-sold marketplace. In particular, the increasing importance of the fee-based compensation structure across widening ranges of advisors and investors has been one of the most important trends shaping the U.S. fund marketplace.

The graph below charts the proportion of gross long-term fund sales captured by various distribution channels in the U.S. over the last three calendar years for fund firms that distribute primarily through financial intermediaries. The results are based on an annual Strategic Insight survey of such fund managers. The 2011 survey results encompassed data from 45 fund managers and were reflective of over $900 billion in aggregate gross sales.



Source: Strategic Insight Fund Sales Survey

The U.S. financial services marketplace has experienced a fundamental shift over the past decade-plus toward an advice-based, asset allocation culture. With this shift has come the expansion of the fee-for-advice compensation structure among a growing number of financial advisors (largely at the expense of the point-of-sale commission-based compensation model). As captured in the preceding graph, the increasing dominance of fee-based advisory programs within the U.S. intermediary-sold fund landscape has only accelerated during the post-crisis period.

Sales via Wrap/Fee-Based Advisory platforms (which span across a number of the standalone channels captured above) accounted for 43% of total sales during 2011, up significantly from 34% in 2009. When excluding more institutionally-natured avenues such as Pure Institutional and the retirement plan-focused Investment-only DC channel from the total sales universe analyzed above, the data suggests that within the five remaining standalone channels (which are focused primarily on financial advisors serving individual investors), Wrap/Fee-Based Advisory programs captured roughly 60% of total fund sales in 2011 (up from 46% in 2009). In addition to fund sales within fee-based programs, many financial advisors use the "C" share class fund pricing structure (which carries 1% of annual trailer fees within the fund's expense ratio via 12b-1 fees) as a substitute for Wrap/Fee-Based Advisory programs. If such "C" share class sales are considered a form of ongoing fee-based payment for advice, as much as 70+% of all long-term fund purchases by individual investors made with the assistance of financial advisors in 2011 involved a fee-for-advice payment.

The fee-for-advice compensation model is increasingly prevalent across expanding segments of the largest U.S. distribution channels. Within the National Broker Dealer (or Wirehouse) channel, fee-based sales regularly make up at least of two-thirds of ongoing gross fund sales. In addition, a growing number of Independent and Regional Broker Dealers continue to see (and actively promote) accelerating transition of their advisors' business models from commission-based to fee-based structures.

In parallel with the increasing fee-based fund sales made by financial advisors within many large U.S. broker dealers, the rapid growth of the primarily fee-only independent RIA market also continues to serve as an important catalyst for the expanding fee-for-advice culture among U.S. advisors. The table below (also sourced from Strategic Insight's annual Fund Sales Survey) details annual sales growth rates for each U.S. distribution channel, based on the aggregated results from SI's survey group of mutual fund firms.

Sales by Distribution Channel
Annual Sales Growth (%)

	2007	2008	2009	2010	2011
Total Gross Sales	*19%*	*-9%*	*-5%*	*15%*	***8%***
Wrap / Fee Based Advisory	19%	17%	12%	27%	**26%**
RIAs	16%	22%	2%	5%	**16%**
Investment Only DC	29%	-7%	-10%	13%	**13%**
Independent / Regional BDs	16%	-15%	2%	23%	**7%**
Pure Institutional / Other	18%	-20%	-22%	10%	**7%**
Insurance Agents	17%	-22%	-33%	15%	**4%**
National BDs	22%	-13%	2%	17%	**2%**
Bank BDs	24%	-46%	-6%	5%	**-1%**

Source: Strategic Insight Fund Sales Survey

Mutual fund sales via Wrap/Fee-Based Advisory programs have clearly been a key driver of growth within the advisor-sold marketplace. The sales via such programs have grown at a faster pace than any standalone channel captured in the preceding table during each of the past three years (2009 through 2011). In addition, RIAs have registered as the fastest-growing standalone channel for fund firms in the SI survey group during three of the past four years (2008, 2009 and 2011). The growth of this fee-based advisor community continues to have significant impact on the fund sales of both large intermediary-sold U.S. fund managers (many of which are captured in the SI survey results), as well as many boutique and specialized fund firms (through supermarket platforms such as Schwab and via direct interaction with RIAs.)

D. Point-of-Sale Compensation Platforms vs. Fee-Based Platforms: The Reality of Investor Experience Is At Times Different from the Common Belief

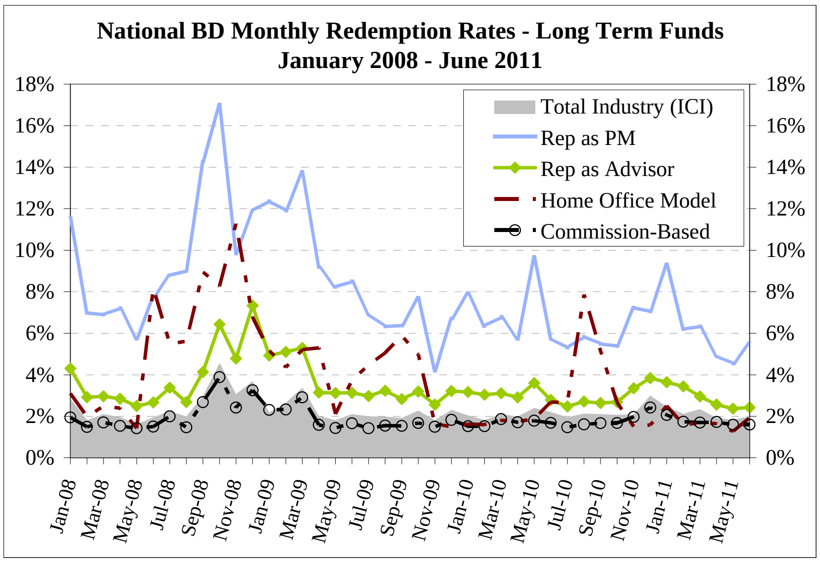
In addition to the impact which the dominant shift toward fee-based sales in the U.S. has had on the mutual fund industry, this evolution also continues to affect investor experience in many ways. One common theme often presented as a truism in the popular advocacy for transition from point-of-sale advisor compensation to fee-based compensation is the claim that when advisors are paid over time, they are not incentivized to imprudently "trade" their clients' investments in order to earn new commissions, and therefore the interests of the adviser and investor are better aligned. Another contention made with regard to fee-based compensation is that it increases transparency and reduces total shareholder costs in funds.

Similar arguments underlie a number of regulatory initiatives globally – such as in India and the "Retail Distribution Review" (RDR) in the U.K. While investor experience within some less-evolved mutual fund markets may be very different from that in the U.S., the observations made below may be helpful in international regulatory deliberations around the preferred model of compensation for investor guidance.

In many cases, over the life of an investment, a one-time compensation for financial advice based on the initial invested dollar amount (i.e. point-of-sale load) is less expensive than continual annual fees that are charged based on ongoing current total assets invested (and increase in conjunction with any appreciation of assets year after year). This is especially true when the point-of-sale commissions charged are reduced because of the investor having significant total assets at the fund or fund firm in total. (In the U.S., investors are offered discounted front-end sales charge rates for larger purchases, and the sales load "breakpoints" are based on their total assets invested at a single fund company or within many single broker dealers.) Not surprisingly, broker dealers often observe that their revenues generated in fee-for-service accounts are significantly larger than in commission-based accounts. While aggregate lifetime fees paid in fee-for-service relationships are higher than in many transaction-based accounts, it is believed that the value offered to investors in such ongoing services justifies additional costs.

The asset-based charges levied within fee-based programs, at times an overlooked component of total shareholder cost for mutual fund investors, are disclosed to and paid by each individual investor, but are not easily compared across the industry. In comparison, mutual fund expenses are transparent, publicly disclosed, and easy to compare across the industry for similarly invested funds.

In addition to shareholder cost and transparency factors, investor experience within commission-based versus fee-based scenarios can also be impacted by other fundamental factors such as trading activity and asset velocity. The data presented in the graph below captures gross monthly redemption rates (redemptions as a percentage of assets) segmented across different mutual fund platform structures at U.S. National Broker Dealers (representing over 30,000 financial advisors) as well as across the U.S. fund industry as a whole (as tracked by the ICI). The Rep as PM, Rep as Advisor and Home Office Model universes included in the graph represent three different mutual fund wrap platform types through which financial advisors can structure their fee-based relationships with clients (more detailed descriptions of each are included below).



Source: Coates Analytics Distribution Management System / Strategic Insight Analysis

The redemption patterns charted above show that funds held within commission-based platforms are not, on average, traded (or "churned") often. In reality, such funds generally incur the lowest trading activity, while funds held in fee-based accounts experience structurally higher asset movement. These trends represent a critical, but often not well recognized, reality. The stability of assets within funds sold by advisors earning commission-based compensation mirrors the satisfaction of advisors and investors in such accounts. Beyond cost, the data also implies that – based on the truism that higher frequency of trading and market timing will on average result in poorer shareholder investment experience over time – long-term investment returns in many commission-based platforms may be better than those experienced at times in higher trading-frequency fee-based accounts. (While not in the scope of this paper, a body of academic research in the behavioral finance area found repeatedly that over-confidence by the more active stock "traders" leads to under-performance; see, for example, the published research of University of California Berkeley's Terrance Odean http://faculty.haas.berkeley.edu/odean/. Strategic Insight believes that similar experiences are likely among active traders of ETFs as well as, on average, by financial advisors reallocating their clients' portfolio holdings with above average frequency.)

A few additional key observations:

- Commission-based platforms show monthly redemption rates often below 2%, virtually mirroring the industry's overall trends (which are anchored by the low-trading activity within most retirement investments).

- "Rep as Advisor" platforms – which encompass non-discretionary fee-based programs where the advisor must gain the investor's approval for each incremental transaction – generally show monthly redemption rates that are consistently higher than commission-based platforms, and rise notably during periods of market uncertainty and increased downside volatility.

- "Rep as Portfolio Manager (PM)" platforms are discretionary fee-based accounts, in which the advisor can buy and sell securities on the investor's behalf without gaining prior investor approval. Advisors within such programs are also most likely to adopt and experiment with non-traditional investment strategies and other innovative funds, and are dramatically more inclined (on average) to modify their clients' positions. On average, the redemption rates within Rep as PM platforms are three- to four-times higher than in commission-based platforms.

  Notably, discretionary account management by financial advisors (both via Rep as PM programs at broker dealers, as well as within the expanding RIA community) has been the fastest-growing avenue of the U.S. intermediary-sold distribution marketplace over the past several years.

- Home Office Models are fee-based platforms where the decision to change and rebalance funds is centralized at an institutional-selection team within the broker dealer, and is not triggered by the advisor or the investor. On average, Home Office Model redemption rates are low and stable, with the exception of months with significant portfolio rebalancing.

These factors around asset movement characteristics within different investor-advisor relationship structures and the associated implications for shareholder cost and investment performance offer another important component of overall investor experience in the U.S. As the movement from point-of-sale to fee-based compensation continues to evolve at different paces within the U.S. and other markets around the world, its ramifications for shareholder experience must be recognized and considered.

E. Implications around Shareholder Cost

The continued expansion of the fee-for-advice relationship structure in the U.S. carries wide-ranging implications for asset managers, financial intermediaries and investors. One of the most important aspects of this trend involves the evolution of advisor compensation and, in turn, shareholders' overall cost of financial advice and mutual fund ownership. Investors in the U.S. are increasingly paying for advice via ongoing asset-based overlay fees which are externalized from the mutual fund expense ratio and paid directly to the financial intermediary. Given this dynamic, total shareholder cost for mutual fund investors in the U.S. has significantly migrated outside of the fund expense ratio – as discussed in detail within the next chapter.

IV. The Evolution of Financial Advisor Compensation for Mutual Fund Advice: Marketplace Impact, Regulatory Guidance, and Price Equilibrium

Over the past few decades, the acceptance and use of mutual funds in the U.S. has become widespread and encouraged at a societal level. With such broad acceptance, marketplace forces largely drove the evolution of pricing equilibrium for mutual fund management and financial adviser guidance – balancing fees charged to investors, fees earned by investment management firms, and compensation paid to financial advisors, fund distributors and administrators. The scale of the $13 trillion+ U.S. mutual fund industry, and the diversity of its investment managers (with over 100 firms managing over $10 billion in mutual fund assets today), have allowed for the development of innovation in products and technology, as well as expanded options in fund distribution. Naturally the smaller Canadian mutual fund marketplace is evolving differently.

As the fee-for-advice model has become a dominant theme for advisor-guided relationships in the U.S., the ways in which investors pay for advice and fund selection – and the mechanisms through which financial advisors are compensated for providing such advice – have also evolved. Such evolution has been driven in large part by the strong preference among broker-dealer fund distributors for the fee-for-advice model. In many ways, the concentrated (thus asymmetric) market power of the leading distribution firms in the U.S. has driven much of the pricing choices offered to investors.

A. The Evolution of Compensation for Financial Advisors: A Broker Dealer Viewpoint

The past two decades have witnessed dramatic changes in how financial advisors in the U.S. are compensated. Much of these changes have been anchored on the business model preferences of broker-dealers and other fund distributors – as they aimed to transition compensation to their advisors to be paid over time as a percentage of assets under management, instead of as one-time point-of-sale commissions triggered by trading activity.

Over time, broker dealers have learned that the volume of opportunistic trading can fall sharply following market dislocations (beyond just the weeks of turmoil), as investors' confidence shrinks and they default to "inaction". This naturally can lead to a collapse of trading-based commission revenues and related profits. Equally important in broker dealer planning since the early 1990s has been the realization that technology and the internet were certain to shrink the cost of trading dramatically (today many trading platforms charge less than $10 per trade – a fraction of the trading commissions 20 years ago – and some have eliminated commissions altogether for certain trades).

Overall, revenue collected in asset-based fee-for-service platforms tends to decline only modestly following a significant market rupture (unlike the potential dramatic decline of trading activity and resultant commission revenues). In addition, broker dealers have certain flexibility to manage their fee-for-service ratios and revenues. For example, effective ratios of fees-for-advice often rise following a down market – as shrinking portfolios are charged higher effective fees.

The diversity of features across different fee-based platform types also provides broker dealers with some pricing flexibility. Fees in advisor discretionary fee-based accounts (where the financial advisor has the client's permission to manage their investments without the need for client approval before each incremental buy or sell action) are at times higher than in non-discretionary accounts. In addition, unlike many other account structures, some discretionary platforms allow advisors to also earn a fee-for-service on the portion of client portfolios held in cash. In the wake of the 2008-2009 turmoil, investors are becoming even more dependent on the guidance of their financial advisors – with discretionary fee-based account management registering as the fastest growing segment of the U.S. fund distribution landscape over the past few years.

Overall – and possibly inherent in the nature of the asymmetric relationships that exist between financial advisors and their clients – fees-for-advice largely do not decline in times of increased financial uncertainty. In fact, it can be argued that the importance of advice, rebalancing, and support in "staying the course" is actually greater in more uncertain times.

These asymmetric relationships are important to recognize as drivers of the dramatic changes in financial advisor compensation over the past few decades. For much of the 1980s and 1990s, compensation to advisors selling mutual funds was paid primarily by investors being charged a point-of-sale commission or "load". In the past decade, however, such compensation has evolved to be almost always paid over time as an ongoing fee-for-advice.

B. Compensation for Financial Advisors: Mutual Fund Share Class Structure and Evolution

For roughly 20 years, U.S. mutual funds have been offered in a range of share class pricing options – affording investors and advisors a variety of choices in structuring the cost of fund ownership (although each individual fund may not offer every potential share class). U.S. fund share classes can be broken into four basic groupings – Front Load ("As"), Back Load/Contingent Deferred Sales Charge (CDSC) ("Bs"), Level Load ("Cs"), and No-Load. The key characteristics of each of these pricing options are defined in the table below:

Share Class Type	Typical Naming Convention	Sales Charge Characteristics	Embedded Distribution & Marketing Fee (i.e. 12b-1 fee)	Total Assets ($Trillion) (as of May 2012)
No Load	Institutional, direct-sold, retirement, advisor class, etc.	No sales charge	25 basis points or less	**$5.9**
Front Load	"A"	Front-end sales load (typically ranging from zero to 5.75%, based on size of investments and rights-of-accumulation incentives)	Less than 50 basis points (typically 25 bps)	**$1.9**
Level Load	"C" & certain retirement-specific classes	These shares typically carry no sales load (though some may contain a front- or back-end load of 1% or less)	Greater than 50 basis points (typically 100 bps)	**$0.4**
Back Load/CDSC	"B"	No point-of-sale load, but a contingent deferred sales charge schedule exceeding 1% and extending past 1 year (typically starting at 4% and declining by 1% each year)	Greater than 50 basis points (typically 100 bps)	**$0.04**

Note: Total Asset figures include open-end stock and bond funds only (exclude money market funds, closed-end funds and ETFs)
Source: Strategic Insight Simfund MF / SI Analysis

As captured in the far-right column above, no-load shares account for the largest asset pool among U.S. share classes at $5.9 trillion as of May 2012. No-load shares encompass a range of investor types – including shareholders investing through fee-based financial advisory programs (as discussed in the previous chapter), as well as retirement plan savers, investors purchasing shares directly from fund companies, and institutional investors. These shares carry no sales loads and may contain an embedded small distribution and marketing fee in the form of 12b-1 fees of up to 0.25% (although investment flows have increasingly moved toward shares with zero 12b-1 fee, as discussed later in this chapter.) (Not included in the above table are the $1.1 trillion in ETF assets, about half of which are owned by individuals.)

Front Load "A" shares hold the second-largest asset base in the U.S. at $1.9 trillion (although such funds in aggregate have net redeemed over $250 billion since the end of 2006). A substantive portion of these "A" share assets include retail investors who purchased mutual funds through a financial advisor via a point-of-sale commission 10, 20, or even 30 years ago. (Note that in 2011, funds sold with a significant point-of-sale commission accounted for less than 10% of all fund sales through financial advisors, as sales migrated towards fee-for-service relationships.) The sales charge on "A" shares typically ranges up to 5.75% of an investor's deposit amount, but can be reduced or eliminated through rights-of-accumulation (ROA) discounts – which allow investors to pay a decreasing sales charge percentage as the size of their purchase increases (down to zero for investments over $1 million within most equity funds and at lower levels for many bond funds.) These ROA discounts are applicable not only within single funds but also across the accumulated total of an investor's purchases across a fund company's entire fund lineup. Sales loads on class "A" shares are also typically waived when purchased within a retirement plan or within fee-based advisory programs.

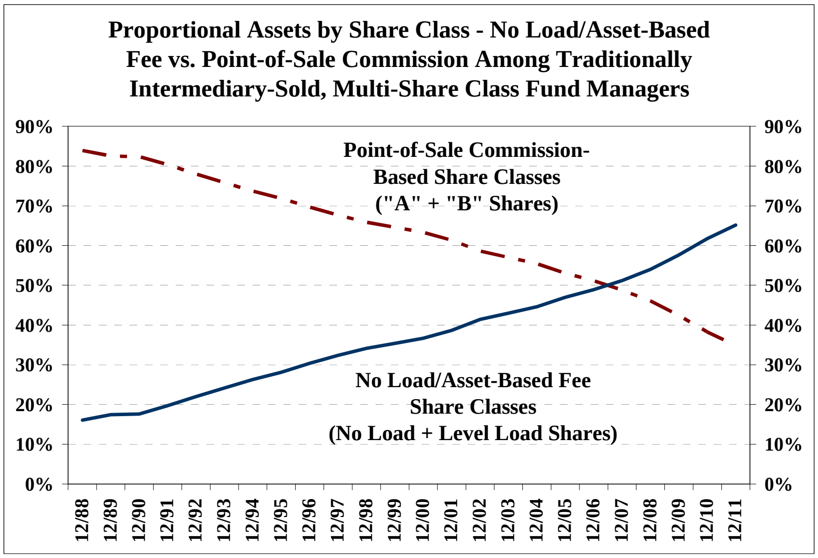
Level Load shares, accounting for $0.4 trillion, are made up primarily of class "C" shares – in which the cost of distribution is embedded within the mutual fund total expense ratio via the 12b-1 fee (normally 1%). These shares are typically utilized by investors and advisors to enable a fee-for-advice relationship within the structure of the fund expenses (often a cost-effective and tax-advantaged means of paying for advice – particularly for small investors), as an alternative to the externalized overlay pricing of fee-based advisory programs.

The Back Load/CDSC pricing structure of class "B" shares has moved increasingly toward extinction within the US marketplace – accounting for just $44 billion of total stock and bond fund assets (or less than 0.5% of total industry assets) and fewer than 0.5% of new sales annually. While as recently as the end of 2000, "B" shares made up over 10% of industry stock and bond fund assets, a combination of minimal new sales (with many fund families actually discontinuing new sales of "B" shares), naturally occurring redemptions and automatic conversions to "A" shares with lower 12b-1 fees continue to accelerate the pace of "B" shares' disappearance. The movement of financial intermediaries away from "B" shares in the U.S. has been triggered by a the overall transition to fee-based sales, as well as pricing disadvantages for many investors as compared to other share classes (such as for investors meeting ROA discounts within "A" shares, and many longer-term investors.)

C. Evolution of U.S. Share Class Demand: Transaction-Based vs. Fee-Based Fund Sales

The overarching movement toward the fee-for-advice compensation model across widening segments of the U.S. distribution landscape has had profound impact on mutual fund share class pricing (as well as overall shareholder cost). While share classes enabling point-of-sale commission (through either commissionable "A" shares or "B" shares) once served as the primary pricing structure through which financial advisors were compensated, such shares are diminishing in importance at an increasingly rapid pace.

The relationship over time between share classes carrying point-of-sale commission and share classes enabling a fee-based compensation arrangement provides a perspective on the evolution of U.S. share class demand, on the structure of shareholder cost, and on the overall distribution landscape. The graph below charts proportion of assets from 1988 through 2011 within share classes offering point-of-sale commissions versus those enabling a fee-based compensation structure. The data includes U.S. fund managers distributing primarily through financial advisors and offering a multi-share class pricing menu (i.e. some combination of "A", "B", "C" and Institutional/No Load shares). This comparison excludes traditionally direct-sold, no-load fund managers such as Vanguard and others in order to focus more specifically on scenarios in which investors and advisors have multiple pricing options within the same mutual fund (the inclusion of exclusively no-load fund managers would increase even more significantly the proportion of assets within No-Load / Asset-Based Fee shares).



Note: Includes open-end stock and bond funds only (exclude money market funds, closed-end funds and ETFs)
Source: Strategic Insight Simfund MF / SI Analysis

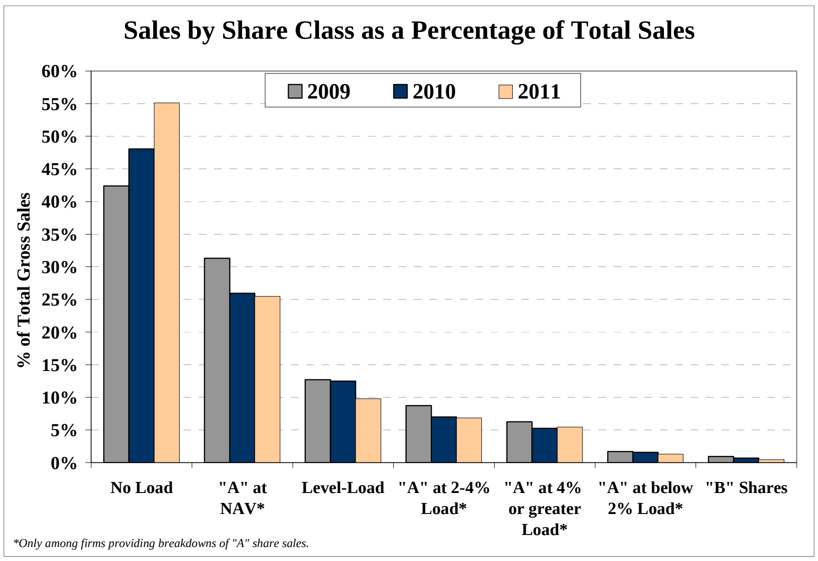
As the prevalence of fee-based programs has risen, No Load/Asset-Based Fee share classes have seen a steady increase in their share of total assets – rising from just 16% of the total assets captured above at the end of 1988 to 65% as of December 2011. In addition, large portions of "A" share sales over the past five to ten years have actually been made at net asset value (NAV), with the front-end sales load waived – mainly within fee-based programs or via retirement accounts. In 2011, SI survey data shows that 70% of "A" share gross sales were made at NAV. This would imply that the actual share of assets held in No Load/Asset-Based Fee scenarios is even greater than the proportions illustrated above.

From a shareholder cost perspective, the mechanisms of payment for professional financial advice have also shifted from primarily point-of-sale payment to ongoing asset-based fees. This movement to fee-based advisory programs has brought a number of benefits to investors – such as the ability to allocate assets across a more diversified range of "best-in-class" individual fund managers, more detailed portfolio monitoring and rebalancing processes, and more direct association between advisors' compensation structure and their success in successfully managing their clients' assets and retaining such accounts (i.e. based on ongoing assets under management, as opposed to transaction-based). From a pure cost perspective, however, payment of an ongoing, asset-adjusted annual fee may at times not be the most cost-effective means of accessing mutual funds for long-term investors.

Although sales of front load "A" shares have decreased significantly over the past decade within the U.S., the pricing structure of these shares does offer certain cost benefits over time for many investors. The payment of a one-time sales load based on initial investment size and amortized over the life of an investment can often encompass much lower total cost for long-term shareholders than the ongoing asset-based fees charged within fee-based advisory programs. Such cost benefits over time are increasingly greater for investors who meet Rights of Accumulation (ROA) front-load discount thresholds – up to those large investors who qualify for load-waived purchases of "A" shares at NAV.

D. The Accelerating Use of No Load Shares and the Increased Unbundling of Distribution Costs

Current demand trends for different share class pricing structures within the U.S. fund marketplace clearly illustrate the increasing dominance of the fee-for-advice compensation model. The graph below charts the proportion of gross sales captured by the different types of share classes (including a breakout of front load "A" share sales by actual load level). This data is based on the same annual Strategic Insight Fund Sales Survey on which the distribution channel analysis in the previous chapter was based. (The survey captures the results of 45 primarily intermediary-sold fund firms with a collective $900+ billion in long-term fund sales in 2011.)



Source: Strategic Insight Fund Sales Survey

Share classes most conducive for use within fee-based advisory programs – no-load shares and "A" shares sold at NAV (where the front-end sales charge is waived) – combined to account for 80% of total sales in 2011 among the SI peer group of 45 multi-share-class U.S. fund managers. At the same time, just 5% of total sales (or 1 in every 20 dollars sold) came via "A" shares with 4% or greater front load in 2011 – as the point-of-sale commission model for fund sales continues to decline among financial intermediaries in the U.S.

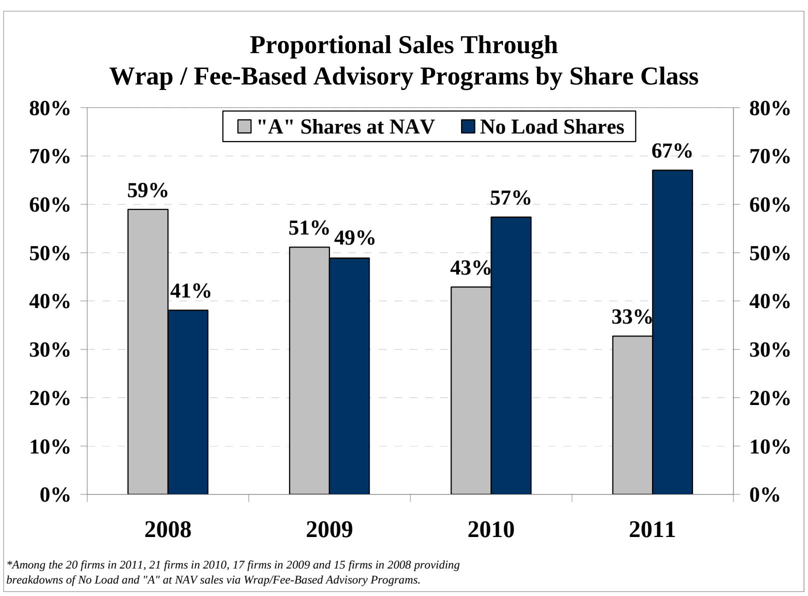
Level-load shares have been a steady source of demand among U.S. investors and advisors as an alternative to the externalized fee-based pricing model. During 2011, however, level-load shares saw their proportion of fund sales decline amid continued push among broker-dealers towards their fee-of-service platforms, as well as possibly the unresolved regulatory debate around Rule 12b-1 (some "C" share-reliant financial advisors have begun to proactively transition business to fee-based advisory programs, in anticipation of potential regulation-induced disruptions to their business, such as those stemming from possible new rules effecting Fiduciary Standards, Rule 12b-2 reform, new point-of-sales disclosure, or other concerns).

For many investors, such a transition to the externalized pricing model often equates to an increase in overall shareholder cost over the life of their investments (both in the form of higher annual fees for advice, as well as at times the loss of tax benefits associated with deducting internalized fund fees from a fund's taxable distributions to shareholders). In addition, as financial advisors transition more of their business to fee-based structures, some smaller accounts may ultimately face decreased access to financial advice – due to a combination of higher ongoing fees to the smallest investors and diseconomies of scale for intermediaries in servicing smaller accounts.

E. Unbundling and Externalization of Distribution Costs

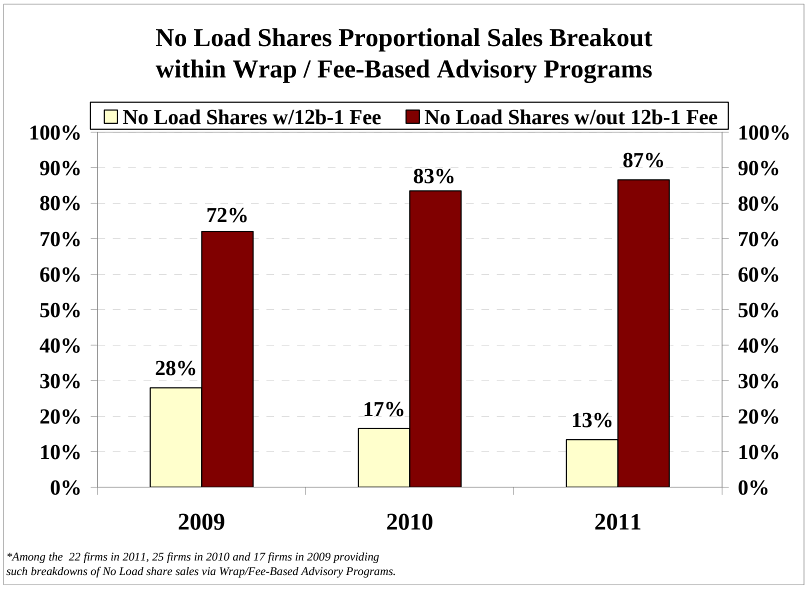
Against the backdrop of an overarching movement toward share classes enabling a fee-based compensation structure, the unbundling of distribution costs paid by investors has accelerated in recent years. Growth in the sales share of no-load share classes (which by SI definition are often with zero 12b-1 fees but can carry a 12b-1 fee of up to 0.25%) has accelerated most significantly over the past five years – increasing from 34% in 2007 to 55% in 2011. No-load shares with zero 12b-1 fees have been the key driver of growth over the past several years, as the cost of advice continues to increasingly migrate outside of mutual fund expenses and into the externalized overlay charges of fee-based programs.

The two graphs that follow immediately below take a closer look at this trend. The first shows the proportion of fee-based program fund sales that are made through "A" shares at NAV (which typically carry 0.25% of 12b-1 fees) as opposed to no-load shares. As can be seen in the chart, fund demand within fee-based programs has moved sharply away from "A" shares at NAV and toward no-load share classes.



Source: Strategic Insight Fund Sales Survey

The following chart shows that an increasingly dominant majority of the no-load sales in fee-based programs have come within share classes *without* any 12b-1 fee.



Source: Strategic Insight Fund Sales Survey

Naturally occurring market forces within the fastest-growing portions of the intermediary-sold space continue to push more of the U.S. mutual fund business toward fund providers' lowest-cost share class options. The increasing demand among many distributors and advisors for funds' lowest-cost share classes continues to shift an even greater proportion of total shareholder cost outside of the mutual fund expense ratio. Today, the primary cost of fund ownership for a growing number of mutual fund shareholders in the U.S. lies outside of the fund expense ratio and within distributors' externalized asset-based overlay fees. (In the context of the ongoing regulatory debate in the U.S. around embedded distribution costs via Rule 12b-1 fees, these trends point toward the diminished need for dramatic and costly overhaul of U.S. fund pricing.)

This continued structural shift nevertheless carries significant implications for both funds and investors. As a growing portion of the increasing fee-based demand within the U.S. distribution landscape continues to migrate toward share classes with very low, or zero, embedded distribution fees, overall fund expenses may trend down, but total shareholder costs may in many instances actually increase.

F. Externalized Overlay Fee Component of US Shareholder Cost

The total cost to mutual fund shareholders within fee-based advisory programs is comprised of two primary components – the expense ratios of the underlying funds (analyzed in more detail in the next chapter) and the asset-based fees-for-advice charged to investors outside of (and in addition to) underlying fund expenses. The asset-based charges levied within fee-based programs are generally difficult to benchmark (as compared to the detailed transparency of publicly disclosed mutual fund expenses) and are at times an overlooked component of total shareholder cost for mutual fund investors. As the fee-for-advice compensation structure has become embedded in the foundation of the U.S. intermediary-sold fund marketplace, however, these charges have come to comprise a significant proportion (typically more than half) of the total cost associated with mutual fund ownership for many U.S. investors.

As fee-based programs continue to expand in prevalence across a wider range of financial intermediaries in the U.S., they also continue to inevitably encompass a greater diversity of investor types and account sizes (beyond their legacy use by primarily wealthy investors). In the U.S., those fee-based advisory programs in which mutual funds play an important role can vary significantly in the services provided to investors (discretionary vs. non-discretionary account management, etc.), the composition of underlying investments (ranging from exclusively mutual funds, to combinations of funds and various other securities), and ultimately in their pricing.

Because of these factors, pinpointing a precise measurement of the "average" overlay fee paid by U.S. investors within fee-based advisory programs presents a difficult task. While many large investors may enjoy favorable pricing within fee-based programs, such structures are considerably more expensive for smaller investors. Given this diversity, it is important to understand measurements of both the fee paid on the "average dollar" (which will be weighted toward larger accounts and therefore lower given the breakpoints available within most advisory fee schedules) and the fee paid by the "average investor" (which takes into account the higher relative charges levied on many smaller investors).

The tables below capture the annual gross fee schedules for fee-based advisory programs within three prominent U.S. fund distribution firms, as disclosed within each firm's Form ADV filings with the US SEC. [Note – each of the distributors captured below offers a range of fee-based advisory program options. These fee schedules are applicable to only a portion of the mutual fund-centric fee-based advisory programs offered by each distributor. In addition, these stated fee schedules are at times negotiable.]

Gross Advisory Fee Schedules - Prominent US Distributor Samples

Distributor A (full service brokerage MF wrap program)		Distributor B (supermarket provider managed account program)		Distributor C (National Broker Dealer MF wrap programs)	
Client Account Size	**Annual Asset-Based Fee***	**Client Account Size**	**Annual Asset-Based Fee**	**Client Account Size**	**Annual Asset-Based Fee**
Less than $200,000	1.48%	Under $500,000	1.10%	First $500,000	1.50%
First $200,000	1.38%	$500,000 - $1,000,000	1.05%	Next $500,000	1.25%
Next $100,000	1.18%	$1,000,000 - $2,000,000	1.00%	Next $1,000,000	1.00%
Next $200,000	1.08%	$2,000,000 - $5,000,000	0.95%	Over $2,000,000	Negotiable
Next $500,000	0.88%	$5,000,000 - $10,000,000	0.90%		
Next $1,000,000	0.78%	Over $10,000,000	0.85%		
Next $1,000,000	0.63%				

**Additional discounted flat rates available for accounts over $3M*

Source: Form ADV filings

As captured in the fee schedules above, investors can face a range of potential overlay fees based on differences by firm and client account size. While $1 million-plus investors often pay fees of 1% of assets annually or at times less, smaller investors can face much higher ongoing charges (often exceeding the 1% embedded distribution costs via 12b-1 fees within level-load mutual fund shares.) For example, based on the parameters of the schedules above (and before any potential fee negotiation between an advisor and investor) an investor with an account size of $250,000 would pay an annual advisory fee of 1.34% at Distributor A, 1.10% at Distributor B and 1.50% at Distributor C.

While appreciating the diversity in types of fee-for-advice arrangements available to investors, the high level of competitive market forces within the U.S. also lead to certain pricing equilibriums. The table below, based on research from Boston-based research and consulting firm Cerulli Associates, charts the frequency of actual advisory fees charged by individual advisors to their clients across various account sizes.

In reading this table, the top row for example shows that only 1% of financial advisors charge less than 0.75% annually to clients with $100,000 accounts, while 65% of such advisors charge their $10 million dollar client accounts less than 0.75%.

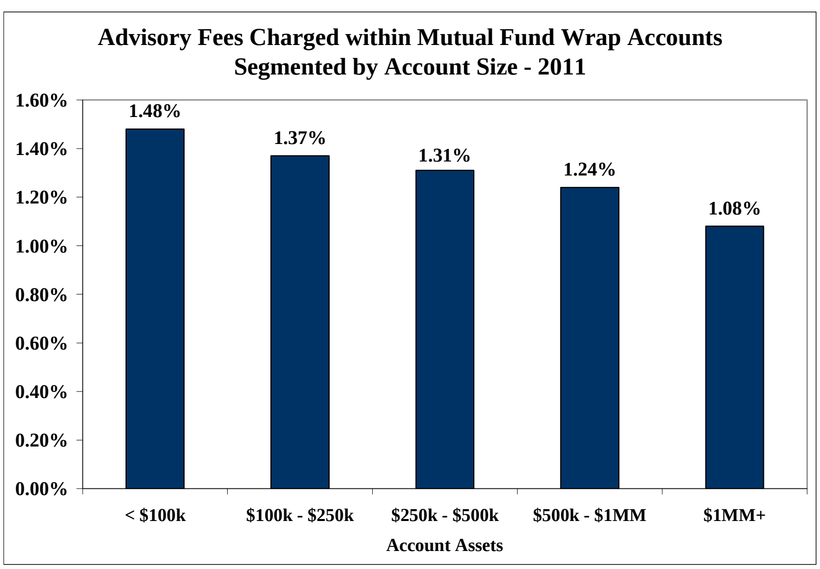
US Fee-Based Advisory Programs
Fequency of Advisory Fee Charged by Client Asset Size - 2011

Fee Range	$100K	$300K	$750K	$1.5m	$5m	$10m
Less than 0.75%	1%	1%	2%	7%	30%	65%
0.75% to 1.00%	6%	9%	22%	36%	45%	26%
1.00% to 1.25%	22%	35%	44%	36%	19%	6%
1.25% to 1.50%	39%	30%	16%	12%	3%	1%
1.50% to 1.75%	10%	12%	8%	6%	2%	1%
1.75% to 2.00%	10%	9%	6%	3%	1%	1%
2.00% to 2.50%	9%	3%	1%	0%	0%	0%
More than 2.50%	2%	0%	0%	0%	0%	0%

Sources: Cerulli Associates, in partnerships with the Financial Planning Association, the Investment Management Consultants Association, Advisor Perspectives, and Morningstar

As captured above, 70% of investors with account sizes of less than $100,000 are charged advisory fees higher than 1.25% and 31% are charged over 1.50%. This suggests that the externalized fees for an investment most typical of middle-income mutual fund investors would exceed 1.25%.

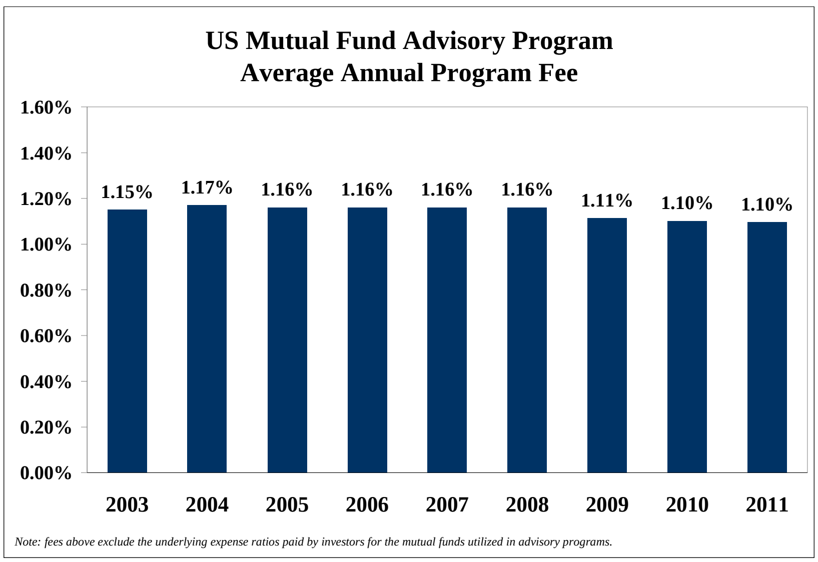
Similarly, the chart below – based on data and research from Toronto-based PriceMetrix – details the average overlay fee charged to investors of varying asset sizes across 11,000 mutual fund wrap accounts in the U.S.



Source: PriceMetrix, Inc. **Note: Advisory Fees expressed as RoA (Return on Assets)*

These fees for advice charged to small investors at times significantly exceed the embedded 1% ongoing 12b-1 fees typically charged within level-load mutual funds. Given these pricing realities and diseconomies of scale – spurred in large part by the fixed costs encountered by many distributors around various aspects of fee-based account maintenance – the fee-based account structure remains an expensive one relative to other options for many small investors.

In measuring the fee paid on the average dollar (as opposed to the average investor) within fee-based account structures in the U.S., the influence of larger investor accounts clearly plays a significant role – with a relatively lower number of accounts holding a very high proportion of actual dollars. The graph below, based on research from Cerulli Associates, charts the dollar-weighted-average annual program fee paid by U.S. investors in aggregate, incorporating all account-size breakpoints, within mutual fund-centric fee-based advisory programs (this data excludes underlying fund expenses and additional ticket charges that are levied in some programs, typically independent broker dealers).



Source: Cerulli Associates

The dollar-weighted-average annual overlay charge within fee-based U.S. mutual fund advisory programs during 2011 was estimated at 1.10%. This level has held relatively steady since declining in 2009 – likely due in part to advisors' post-crisis client retention efforts, as well as adjustments to account fees associated with investors' increased preference for bond funds over the past three years. (Many fixed income-centric portfolios often carry lower ongoing account fees than equity-centric models.)

The overlay fees charged to investors within fee-based advisory programs clearly comprise a substantive proportion of overall cost of ownership for many U.S. mutual fund shareholders. A holistic analysis of these externalized fees, however, also shows their variability across different shareholder types and sizes. This diversity in shareholder pricing within fee-based programs shines light on the actual cost-of-ownership realities faced by many investors in the U.S. At the same time, this analysis also illustrates the importance of maintaining a variety of pricing options within the marketplace to costeffectively serve both large and small investors (including both embedded and externalized methods of paying for advice).

G. Some Additional Observations on the Regulation of Fees Earned by Financial Advisors

Generally, over the past few decades U.S. regulators have avoided price-setting initiatives regarding compensation for mutual fund sales or for investment management of funds (and such regulation's potential for "unintended" consequences).

One such initiative was set two decades ago, in the early 1990s. The securities industry's self regulating body, NASD (renamed FINRA in recent years), issued a rule in July 1992 ("NASD Cap") mandating a ceiling to the total permissible charges in sales of mutual funds through financial advisors. (This rule considered point-of-sale commissions, contingent exit / redemption fees, and annual on-going compensations to advisors – or "asset-based sales charges" – maxing at 0.75%.)

Importantly, this "cap" was not set based on each single transaction (and tracing the cumulative costs associated with single transactions throughout the life of the investment). Instead, the NASD Cap was calculated on the accumulation of many transactions across all share classes of a single investment portfolio. As such, for example, for each $100 million of additional sales across all share classes, the cap was raised by about $6 million (minus any point-of-sale commissions paid just for these sales). This created, in effect, pool of "permissible" dollars being replenished with each additional transaction.

Over the years, as fewer funds were sold with point-of-sale commissions, redemption fees, or high embedded fees-for-service ("asset based fees") – and instead were increasingly sold without any load or embedded asset-based fees – the 1992 NASD Cap rule ceased to be a limiting factor for fees charged to shareholders.

More broadly, Strategic Insight suspects that very few individual funds have, at any time since the introduction of this cap, reached a point when the cap prevented them from charging fees that were embedded in the fund's structure. Thus, we believe that it was not regulatory guidance, but market forces driven by the preferences of broker dealer fund distributors, which have dictated the dramatic shifts in advisor compensation over the past two decades.

The NASD Cap took into consideration the sales practices used in the period when investors were paying for financial advice in one of three ways generally:

- "A" shares – point-of-sale commissions (most of which was passed along to the financial advisor). Generally, 5.75% was the most commonly used "load" level for small purchases, with the "load" declining for larger purchases or once the investors and their families accumulated larger aggregated investments with a single fund family or at the same broker-dealer (termed "rights of accumulation", commissions declined to minimal amounts or disappeared altogether for $500,000 or $1 million household ownerships.)

- "B" shares – annual 1.00% fees made up of "service fee" of 0.25% and an additional "asset-based fee" generally of 0.75% paid for a limited, pre-set number of years. "B" shares also have redemption fees triggered upon redemptions within a certain number of years post-purchase. Generally, the financial advisor was assigned a 4% commission at point-of-sale of "B"s (such payment was paid by the fund manager's distribution division and recouped over time).

- "C" shares – annual 1.00% fees made up of "service fees" of 0.25% and additional "asset-based fees" generally of 0.75% without a limit of time and without redemption fees (after the first year of ownership).

In the years since this 1992 rule, compensation for financial advisors has changed dramatically.

- 1980s and 1990s: 90%+ of compensation to FAs were paid at point-of-sales (led by the dominance of "A" and "B" share transactions)

- 2011: Virtually the opposite marketplace reality, as three-quarters or more of compensation to the financial advisors selling mutual funds now is paid annually over time. Very little open-end mutual fund sales are done today with a significant point-of-sale compensation paid to the financial advisor

- It is Strategic Insight's view that such dramatic transition over the past two decades was mostly driven by marketplace forces (not regulatory mandates) and significantly by the preference of broker dealer distributors to have the compensation for their financial advice paid over time, as opposed to at the point-of-sales.

Another example of regulators deliberative approach is their review of Rule 12b-1 and its role in enabling the delivery of financial advice. Rule 12b-1 was set about three decades ago in the 1980s, and has become a key mechanism allowing investors to pay for advice and its delivery through fees charged and embedded within funds' annual expenses (thus in a tax-advantaged way for U.S. investors owning a taxable, non-retirement account.)

In recent years, the SEC has focused on Rule 12b-1 with the view that this 1980s-originated rule needs to be modified (and possibly repealed). SI's Director of Research participated in the SEC's Public Hearing on Rule 12b-1 in June 2007, and SI research on that topic was submitted to the SEC subsequently (this report is available by request to SI). The SEC's recommendations around changes to the rule – as captured in its proposed Rule 12b-2 (released in 2010) – triggered a new wave of market participant input, advocating the need for further deliberations and assessment.

Today, five years after the SEC Rule 12b-1 hearings in Washington, marketplace forces continue to reduce, if not eliminate, many of the concerns expressed originally by the SEC. The use of Rule 12b-1 fees to finance new fund sales is rapidly disappearing, as documented in this report. Thus, in Strategic Insight's view, dramatic regulatory intervention is no longer needed around Rule 12b-1.

V. U.S. Mutual Fund Expenses

A. Total Expense Ratios and Investment Management Fee Trends

Over the years, investment management fees in the U.S. have modestly trended downward, as many funds grew in size thus enabling economies of scale which were shared with the investors in such funds. During the past decade, independent directors of U.S. mutual funds (who, among other responsibilities, oversee the fees charged by each fund to its shareholders) have increased their focus on mutual fund fees and how they compare to similarly invested mutual funds. Overall, many investment management companies have modified their funds' advisory fee structures through the introduction of contractual advisory fee "breakpoints" (reducing marginal fees slowly as the fund grows in assets), or through non-contractual fee waivers.

According to the ICI (measuring actively-managed and index funds across all investment strategies), over the past two decades, on an asset-weighted basis, average expenses paid by U.S. mutual fund investors within the embedded fund total expense ratio have fallen significantly. In 1990, investors on average paid 99 basis points (0.99%) of fund expenses for assets invested in equity funds. That ratio fell to 79 basis points in 2011. The decline in the average expense ratio of hybrid funds mimicked that of equity funds, while that of bond funds was more marked – declining 30%, from 88 basis points in 1990 to 62 basis points in 2011. The accelerating shift to no-load funds and no-load share classes (where 70% of assets reside today, nearly double the share of 1990), and the gains among index funds (which represent 12% of the stock and bond fund assets today, versus 1% in 1990), are among the factors influencing the decline of ICI-reported asset-weighted fee ratios. (The decline in the fee ratios would be greater if the $1.1 trillion of ETF assets, not accounted for in the ICI fee data above, were incorporated into this analysis – as ETFs are primarily offered as low-fee indexed strategies.)

The decline in the asset-weighted fee ratios is also impacted by the economies of scale enjoyed by many U.S. mutual funds. Funds holding assets in excess of $1 billion account for a majority of shareholders assets in the U.S. – with such mega funds control 88% of stock and bond fund assets (while funds over $5 billion control 60% of assets). Additionally, the influence of a few "mega" investment management companies (which manage nearly $2.5 trillion of active equity and bond funds) impacts composite asset-weighted fee ratios. The three largest U.S. managers of actively managed equity and bond funds are American Funds, Fidelity, and Vanguard. American Funds is responsible for nearly $1 trillion of such assets; the at-cost Vanguard charges fees equalling its costs as part of a co-operative business model for the nearly $600 billion it maintains of actively managed assets; and Fidelity actively manages about $800 billion of equity and bond funds in the U.S. (For comparisons: the largest mutual fund manager in Canada runs under $100 billion in actively managed equity and bond mutual funds).

The expectation of lower fund fees at times contrasts the reality that many funds are still too small to offer meaningful economies of scale (about half of all U.S. funds are less than $200 million). Also, the introduction of innovative investment strategies and the search for global "alpha" within more complex portfolios limit early opportunities to pass scale savings to investors. At the same time, the recent trends of rising distribution costs in the U.S. (financed increasingly by fund managers' profits) suggest that future reduction of total expenses ratios will be difficult even among funds reaching economies of scale.

While fees for actively-managed funds have trended modestly lower in the past decade, individual and institutional investors in the U.S. increasingly benefit from lower-fee index funds and indexed Exchange Traded Products (ETPs). The U.S. mutual fund market has witnessed a dramatic expansion of low-fee index strategies since the introduction of the first S&P 500 Index fund in 1976. Today, index-based mutual fund assets in the U.S. exceed $1.2 trillion and index-based ETP assets exceed $1.1 trillion (interest in index funds and ETPs has accelerated since 2008). Fee transparency guided by regulatory-mandated disclosure and aided by technology has played an important role in these trends.

For an increasing majority of U.S. investors, especially more affluent ones, a key additional consideration impacting costs stems from their use and dependency on the professional guidance of financial advisors (employed by national or regional broker-dealers, financial planning firms, or independent advisors who hold their clients' assets at Schwab, Fidelity's National Financial, and other "supermarkets"). As was detailed in prior chapters, U.S. mutual fund investors increasingly pay financial advisors an externalized fee-for-service which typically ranges from 1.0% to 1.5% of assets.

In addition to the 1.0-1.5% externalized fee-for-service charged to investors by financial advisors, our estimates suggest that fund shareholders pay between 70 – 80 basis points (or a bit more) in underlying total expenses for a well diversified, actively-managed investment portfolio comprised of stock and bond mutual funds. Clearly, introducing index mutual funds and/or exchange-traded funds into the portfolio would likely drive down underlying portfolio costs. At the same time, however, investors' growing engagement of "alternative" investment solutions – which typically carry higher costs – would have an inverse and increasing effect on aggregate underlying portfolio expenses.

B. Investor Access to Fund Documents and Transparency Requirements

Today, U.S.-domiciled mutual funds are among the most regulated and transparent financial products available to individual investors. While many sophisticated individuals and institutions invest directly in mutual funds, a wide range of extensive disclosure requirements are in place to assist and protect individual retail investors. U.S. mutual funds are required to publish and periodically update their selling documents ("prospectus"), strike a daily NAV, provide fee disclosure, and put in place board oversight. The mutual fund prospectus provides investors with a variety of key fund facts such as investment strategies and objectives, fees and expenses, and performance to name just a few.

Beyond the prospectus, investors and mutual fund data aggregators have access to a detailed array of information in other SEC-required documents such as the statement of additional information (SAI), and annual and semi-annual shareholder reports. The SAI includes detailed information on service provider contracts, investment policies, portfolio managers, controlling shareholders, and mutual fund officers and directors. Annual and semi-annual reports are published 60 days post mid- and full-year fiscal periods. These reports provide updated portfolio manager commentary, portfolio holdings, and key financial statements.

Beyond required regulatory documents, many mutual fund companies offer investors, prospective investors, and financial advisors an array of educational and promotional materials. These materials include portfolio manager commentary, thought-leadership whitepapers, and general market commentary. Typically, mutual fund investors can access all of the regulatory filings and other educational materials directly from mutual fund companies (in either print or electronic form), through financial advisors, from a variety of third-party industry participants (e.g. Morningstar), and from the SEC EDGAR regulatory filing database.

C. Structure Underlying the Total Expense Ratio

Strategic Insight's Simfund database allows us to segment total expense ratios into three buckets: (1) management fees (including fund administration), (2) distribution, sales, and marketing, and (3) other operating expenses which include, but are not limited to, transfer agency, custody, fund accounting, auditing, and legal services. The segmentation provides a transparent understanding of the components that make up a total expense ratio.

Management fees include both investment advisory services and fund administration. In the U.S., about 60% of mutual funds report both an investment advisory services fee and a fund administration fee, whereas the remaining 40% do not segment the two fees for financial reporting purposes. Investment advisory services are the dollar amounts paid by a mutual fund to the investment advisor for portfolio management and securities selection. Fund administration fees are the amounts paid by a mutual fund to the administrator for general oversight of the operations of a fund.

Distribution expenses primarily include 12b-1 distribution and service fees which are used to pay for sales-related expenses such as portions of financial advisor compensation and on-going sales support. According to an ICI survey, 63% of 12b-1 fees are used for compensating financial advisors for the sale of fund shares and related expenses, 32% are used for paying for expenses associated with administrative services provided to existing shareholders by third parties, and the remaining 5% are used for advertising and other sales-promotion activities. Note, as discussed earlier in this report, fund distributors are increasingly using share classes with little or no 12b-1 fees, as fees-for-service migrate completely outside the fund's embedded fee structure or stated total expense ratio.

Beyond collecting and passing the 12b-1 fees to their broker-dealer distributors, fund managers still assume the cost of marketing, as well as supporting and servicing distribution organizations. This cost is paid out of the managers' revenues and profits. Moreover, the rising costs of distribution support demanded today by many distributors mean that an even larger share of profits is used for marketing and related activity.

Other Operating expenses are the general business costs associated with supporting the operations of a mutual fund or costs mandated by regulations. Some of the most common expenses include transfer agency, custodian, audit, legal, fund accounting, and registration (disclosure of additional other operating expenses vary by fund family). Typically, the contracts underlying many of the service providers responsible for providing the above duties can be found in a fund's SAI. Within an annual report, the statement of operations also providers actual other operating expenses as paid out by a fund over the fiscal year.

The granularity of fund disclosure varies throughout the world, as governed by various regulatory regimes. In 2011, Strategic Insight analyzed European-domiciled mutual funds and compared them to U.S.-domiciled mutual funds. At times, the varying degrees of disclosure throughout the world make it difficult to compare, on an apple-to-apples basis, mutual fund fees and expenses. For instance and as highlighted above, U.S.-domiciled mutual funds face some of the most rigid reporting and regulatory requirements. U.S. investors have a significant amount of information at their fingertips. In the U.S., an investor can efficiently and quickly segment many of the fees and expenses that make up the total expense ratio.

In contrast, among European-domiciled mutual funds, the Annual Management Charges (an underlying component of Total Expense Ratio) include both management fees and payments made for fund distribution. Our research of European funds, based on non-public data provided by many of the leading fund managers in Europe, found that, after accounting for fees transferred to their distributors ("retrocessions"), retained management fees in Europe were not dissimilar to management fees in the U.S. Asset-weighted average net investment management fees in Europe were found to be only about three basis points greater than management fees in the U.S. (when excluding the three largest U.S. fund managers each managing $600 billion or more).

Asset-Weighted Average Embedded Fund Expenses in the U.S. vs. Europe (actively managed stock and bond funds)

	Management Fee			Distribution Expense			Other Operating Expenses		
Fund Type	All U.S[1]	U.S. ex-Mega[2]	Europe[3]	All U.S[1]	U.S. ex-Mega[2]	Europe[3]	All U.S[1]	U.S. ex-Mega[2]	Europe[3]
Stock	0.63	0.72	0.74	0.33	0.34	0.73	0.17	0.17	0.28
Bond	0.45	0.46	0.49	0.32	0.31	0.47	0.14	0.15	0.21

Footnotes:
[1]Actively (non-index or non-ETF) managed open-end U.S.-domiciled mutual funds as of fiscal year-end 2011 excluding: funds that operate an "at-cost" business model or employ an "all-inclusive/unified" management fee structure.
[2]Actively (non-index or non-ETF) managed open-end U.S.-domiciled mutual funds as of fiscal year-end 2011 excluding: funds that operate an "at-cost" business model or employ an "all-inclusive/unified" management fee structure. Additionally, the data excludes three "mega" fund managers that collectively manage over $2.5 trillion.
[3]Data represents Includes over EUR 1 trillion in EU-domiciled equity and bond mutual funds as of year-end 2010.

D. Historical Trends

When viewing the U.S. mutual fund industry as one large investor portfolio, the underlying allocation changes from year to year and thus the "average" fee paid by investors is affected as well. Overall, industry aggregate fee statistics have been driven lower over time due to the economies of scale created by the growth of the U.S. mutual fund business. Additionally, the changing distribution trends discussed previously – such as the shift away from load bearing share classes to lower load or no-load share classes – has reduced total expense ratios (on average) paid by investors for mutual funds. While aggregate industry fees have trended downward for the past two decades, it is important to note that such a decline was experienced unevenly across investment categories.

As the table below suggests, there is a degree of year-over-year variability in aggregate fee statistics. The collapse of global stock prices in 2008 has caused an increase in Total Expense Ratios, especially for stock funds. It resulted in a dramatic contraction of the "average account size" (often falling by half). Thus costs that are paid in fixed "dollars per account" (such as transfer agent fees) experienced a doubling of their fee ratios at times. Such a spike was most evidenced in stock funds with a high share of very small accounts. These falling asset levels also triggered some management fee breakpoints to work "in reverse", while fixed dollars operating fees were allocated across a smaller asset base.

The recovery of stock prices since March 2009 has reversed many, but not all, of these rising-cost influences. The data below charts asset-weighted net total expense ratios (excluding distribution costs) for actively managed funds from 2007 to 2011 (note the declining aggregate fee levels experienced in 2010 and 2011).

Asset-Weighted Average Net Total Expenses; excluding Distribution fees (actively managed stock and bond funds)					
Investment Category	**2007**	**2008**	**2009**	**2010**	**2011**
Large Cap U.S. Equity	0.67	0.69	0.74	0.73	0.71
Small Cap U.S. Equity	0.95	0.96	1.06	0.99	0.97
Large Cap International. Equity	0.87	0.87	0.89	0.89	0.86
Intermediate Term Bond	0.52	0.52	0.53	0.52	0.51

Source: Strategic Insight Simfund MF

In comparing 2007 pre-crisis fee ratio data above to that of 2011, Large Cap U.S. Equity and Small Cap U.S. Equity fund fees have risen somewhat, whereas Large Cap International Equity and Intermediate Term Bond fund fees have slightly decreased. In addition to the explanations above, the persistent net redemptions among diversified U.S. funds in recent years – and the only partial recovery of stock prices since 2008 – have resulted in significantly lower aggregate assets in Large Cap and Small Cap U.S. Equity funds today than in 2007 – reversing the benefits of economies of scale. Conversely, the Intermediate Term Bond investment category has grown over 50% over the past five years. The increased economies of scale have contributed to slightly lower fees.

An important contributor to the declining Total Expense Ratios for the average U.S. fund investor (as measured through asset-weighted fee ratios) is the increasing share of no-load funds or no-load share classes (who increasingly carry zero 12b-1 fees) – which have come to dominate the U.S. mutual fund industry. Today, three-quarters of all stock and bond fund assets are held in no-load share classes, as suggested below.

No Load Share Classes as Percentage of Total Assets[1]					
	1995	**2000**	**2005**	**2010**	**6/2012**
No-Load	50%	56%	62%	72%	75%
Other (Front, Back, Level)	50%	44%	38%	28%	25%

Source: Strategic Insight Simfund MF
Footnotes:
[1]Total Assets for stock and bond open-end funds including open-end ETFs

The table confirms many of the new sales themes previously addressed in this paper such as the acceleration away from traditional point-of-sale loaded shares to "cleaner" no-load share classes. Looking ahead, we expect this trend to persist as financial advisors continue to migrate their client assets towards fee-based wrap advisory relationships (at Strategic Insight's annual client conference held in June one national broker-dealer executive commented that over 80% of net flows at his firm are going to advisory accounts which use no-load funds, while another noted that his firm was moving 3-5% of mutual fund assets each year from brokerage to advisory platforms). Elsewhere, increased disclosure requirements within the defined contribution retirement investment space are also accelerating the sales of lower-load and no-load share classes.

VI. Reflections on the Evolution of Mutual Fund Shareholder Cost in the U.S.: Transparency, Unbundling, Competitive Forces, Price Equilibrium

Today, more than three decades into the modern era of the U.S. mutual fund industry, nearly half of all U.S. households (and over 80% of wealthy households) invest in mutual funds. The acceptance of the mutual fund vehicle for savings and investments, income and capital accumulation, and retirement security has been reflected in the $1 trillion-plus net invested into bond and stock U.S. mutual funds since 2008's extraordinary crisis.

A large share of U.S. mutual fund investments is held in Defined Contribution (DC) retirement plans. Beyond their DC investments, it is generally believed that four in five mutual fund investors in the U.S. are assisted by a financial advisor (FA).

Over the past two decades, the way financial advisors are compensated for their advice, guidance, and monitoring has dramatically changed. In the 1980s and 1990s, most funds were sold individually, and most compensation to FAs took the form of point-of-sales payment for each such transaction.

In contrast, most of today's U.S. fund sales that are guided by a financial advisor are anchored in an asset allocation approach – in which a number of funds with complementary investment strategies are packaged together, offering a balanced overall portfolio (stock and bonds, U.S. and international exposure, long-only and non-market-correlated strategies, etc.). In parallel with the dominance of a portfolio construction framework, the compensation preferences of increasingly powerful broker dealers and other fund distributors in the U.S. have shifted significantly toward ongoing payments for advice over time (as opposed to at point-of-sale).

These and other marketplace forces have combined to spur the dominance of fee-based investment programs in the U.S. – commonly referred to as "Mutual Fund Advisory" or "Mutual Fund Wrap" programs. For their evaluation of each investor's needs, fund selection, on-going monitoring, and periodic rebalancing, financial advisors are paid largely over time, not at point-of-sales.

Such compensation, paid directly by the investor (and not through the mutual fund expense ratio), is generally based on assets under management and typically ranges from 1.00% to 1.50% of AUM annually (with the higher annual fees charged for smaller size accounts). These fee ratios were discussed in Chapter IV. While the average fee ratio for all accounts within such mutual fund advisory programs is estimated at 1.10% of assets annually (see data from Cerulli Associates in Chapter IV), the fee ratio charged to a portfolio of less than $100,000 (typical of the mutual fund investor's middle-income and middle-wealth profile) can be significantly higher.

These annually-charged fees of 1%+ are levied on top of the total expense ratios (TERs) of the funds held within the asset allocation package. Industrywide, Strategic Insight calculates that the TERs of actively-managed stock and bond funds – similar to those typically held within an asset allocation mutual fund wrap portfolio – average around

0.70% or higher (based on an asset-weighted TER calculation of all actively managed stock and bond funds, excluding Rule 12b-1 distribution fees). The simple averages and median TERs of such funds are each over 0.90%.

In sum, the total cost of mutual fund ownership among the large proportion of U.S. investors investing through a fee-based advisory program of "wrapped" actively managed mutual funds is typically comprised of:

- Fees of the underlying funds – typically ranging from 0.70-0.90% of assets and inclusive of investment management and administration costs, transfer agent fees, legally-mandated fees, etc. Such fees are disclosed in quite a standardized manner in the funds' prospectus and other documents and are easily benchmarked to other funds. (Note that a portion of the fees collected by the investment managers may be passed along to the distributor.)

- Fees externalized to the funds' TERs – typically averaging 1.10% annually, but ranging from 1.25% to 1.5% for portfolios of less than $250,000. Such fees are set based on the overall size of each investor's overall portfolio (not on the holdings of each individual fund within it) and are disclosed in a customized way to each investor. While transparency on the "external-to-TER" fees is provided to the individual investor, a comparison of the externalized fees charged and services provided by the different broker dealers or individual advisors in the marketplace is not easily available.

In totality, U.S. mutual fund shareholders' total annual costs within fee-based advisory programs amount to roughly 2% of asset under management. Importantly, however, as alluded to above, this total can often be higher for smaller investors.

A wide range of competitive market forces around investor preferences, product innovation, regulatory initiatives, fund distribution shifts, and pricing evolution have been key factors driving the U.S. fund industry's maturation to a $14 trillion marketplace. While investors access mutual funds through a variety of avenues in the U.S. (within retirement plans, via the assistance of financial advisors, on their own), fund engagement through financial advisors has evolved into a primarily fee-for-advice relationship structure. As such, the total cost of mutual fund ownership for a growing number of U.S. investors has also evolved – with regard to structure, timing, level, and tax implications.

Ultimately, the desire for professional financial advice continues to gain in emphasis among U.S. fund shareholders and many investors globally. Given the growing demand for such guidance, the U.S. mutual fund marketplace exemplifies how evolution of pricing mechanisms can enable access to advice across varying investor wealth and sophistication levels.