Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios

A Canada—U.S. Perspective 2015 Update

May 2015 Update to the 2012 study by

Investor Economics and Strategic Insight

For

The Investment Funds Institute of Canada

iNVESTOR ECONOMiCS

Table of Contents

Introduction

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

This report focuses on updating the cost of mutual fund ownership metrics presented in the 2012 summary document, entitled *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: A Canada — U.S. Perspective*. That summary, and the larger report on which it was based, *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*,[1] proposed an analytical framework for comparisons of the total cost of ownership by mutual fund investors in the United States and Canada, and presented a high-level comparison of cost of ownership measures in both countries. The framework identified and highlighted the impact of structural differences between the U.S. and Canadian mutual fund industries, including scale, distribution channels, taxation and distributor compensation models.

The current updated report should be read alongside the original larger study, which provides a thorough account of the methodology and industry context required to consider the development of the mutual funds cost of ownership in Canada and the United States.

The updated information contained in this report has been developed by Investor Economics and Strategic Insight using data from both proprietary and public sources. Every effort has been made by both firms to ensure both accuracy and consistency to enable users of the report to develop a clear understanding of developments that have taken place in the past two years.

[1] Also see, A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry. Strategic Insight, November, 2012.

Key Takeaways

- In both Canada and the United States, mutual fund assets under management (AUM) increased by nearly 30% over the two-year period ended December 2014.

- The average total cost of ownership of mutual funds for clients using advice-based distribution channels in Canada was 2.2% at the end of 2014 (2.02% when the impact of taxes is excluded). The average cost of ownership for clients in the U.S., which does not levy taxes, was 2.0%.

- The cost of ownership in both countries has remained largely unchanged from 2012.

- There are differences between the two markets in the manner in which investors typically pay for the services they receive from fund manufacturers and advisors.

    - In Canada, the management expense ratio (MER) generally includes trailing commissions (ongoing fees paid to distributors) and applicable taxes. The embedded fee structure is used by mutual funds that currently account for approximately 85% of all fund assets in Canada.

    - In the United States, the total expense ratio (TER) does not include taxes, as the U.S. does not have an equivalent HST tax structure and due to the prevalence of the unbundled fee-based model, a majority of the fund series do not include trailing commissions. Approximately 80% of mutual fund gross sales across all advice channels outside of the employer group pension schemes are accounted for by fee-based accounts. In those accounts, ongoing fees are generally charged at the account level.

- In Canada, the relative importance of point-of-sale commissions (embedded or not) in the distributor compensation formula has been on the decline. In 2014, 91% of net flows are estimated to have been generated by no load funds or front-end load options with waived fees. If all mutual fund industry assets are taken into consideration, no load funds and front-end load options with waived point-of-sales commissions accounted for 77% of industry assets at the end of 2014, a share that has been growing over time (it was at 72% in 2010).
- The asset-weighted MER of long-terms funds in Canada declined from 2.08% at the end of 2011 to 2.03 % at the end of 2014.

Canadian and the U.S. Mutual Fund Industry Backdrop: 2012—2014

This update to the 2012 report has been undertaken against a backdrop of two years of mutual fund industry expansion in Canada. At the end of 2014, assets held in long-term mutual funds totalled $983 billion—approximately 31% of total household financial wealth—a total which was approximately $110 billion greater than that recorded at the end of 2012. The growth reflects a combination of the effect of positive capital markets and accelerating net flow activity, which attracted $66 billion into the universe of mutual funds in consideration over the two-year period.

Mutual fund assets in the United States also expanded over the two-year period, increasing from $13.1 trillion to $15.8 trillion. This growth can also be attributed to strong equity markets and record inflows of new money.

Over the two-year period, in Canada, we have observed a continued rise in the popularity of funds of funds and asset allocation solutions and, to a lesser extent, the greater use of multi-series share classes, continued in Canada.

The shift away from load options with point-of-sales (back-end load) commissions also continued over the period. If all mutual fund industry assets are taken into consideration, no load funds and front-end load options with waived point-of-sales commissions accounted for 77% of industry assets at the end of 2014, a share that has been growing over time (it was at 72% in 2010). From a net flow perspective, 91% of net flows in 2014 are estimated to have been generated by no load funds or front-end load options with waived point-of-sales commissions. With respect to funds being sold with deferred sales commissions (DSC), at the end of 2014, assets in such funds represented 17% of all fund assets, down from 30% in 2007.

In the United States, flow data for retail mutual funds indicated that in 2007, 71% of long-term flows were on a no load basis (no upfront commission or DSC).

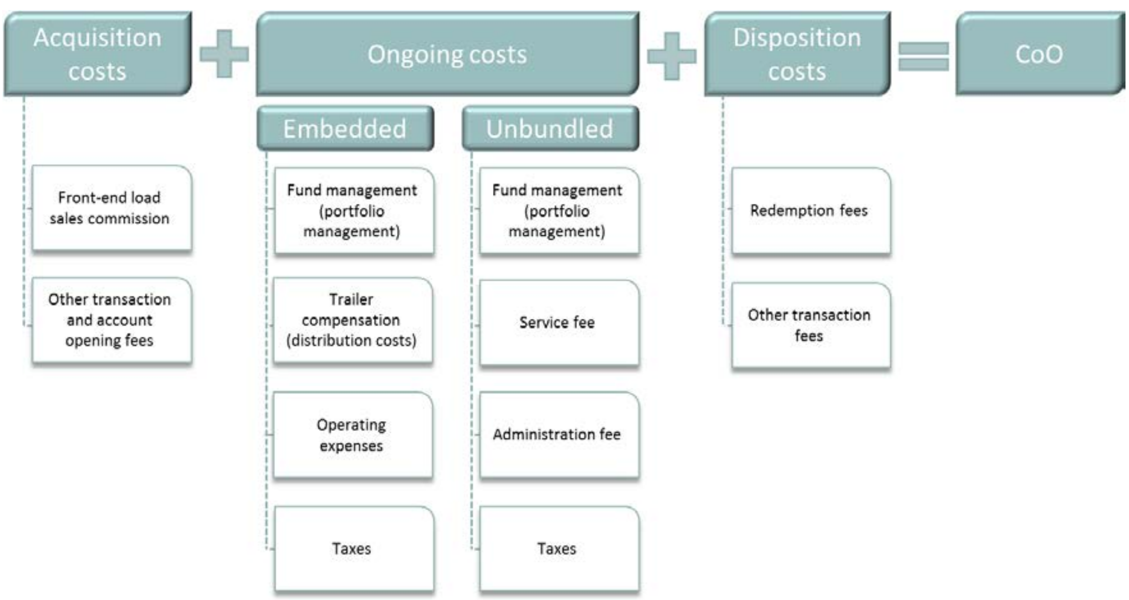
Also, in Canada a number of factors including the overall shift to lower-priced no load options, changes in asset mix and firms lowering management fees, exerted downward pressure on the cost of ownership of mutual funds. The asset-weighted MER of long-terms funds declined further from 2.08% at the end of 2011 to 2.03 % at the end of 2014.

Cost of Ownership as the Analytical Framework for Canada-U.S. Comparisons

In analyzing the cost of ownership in Canada and the United States, the original studies published by Investor Economics and Strategic Insight in 2012 adopted a comprehensive view of costs associated with owning mutual funds: the cost of ownership framework (see **Figure 1**). This view reflected investor costs included in the reported fund expense ratios—the total expense ratio (TER) in the U.S. and the management expense ratio (MER) in Canada—as well as, importantly, costs residing outside of the fund expense formulas.

The holistic nature of the cost of ownership concept stems from the inclusion of cost elements at each stage of the fund ownership cycle: at the time of purchase (acquisition costs); during the investment period (ongoing costs, both charged to the mutual fund and directly to the investor); and, at the time of redemption of fund units (disposition costs).

Figure 1: Cost of Ownership Framework (CoO)



The relative importance of the three variables depends on the distribution channel used to purchase the fund; the load option selected; the series of mutual fund units purchased by the investor; the amount invested, and the type of account (e.g. fee-based brokerage) in which the fund is being held.

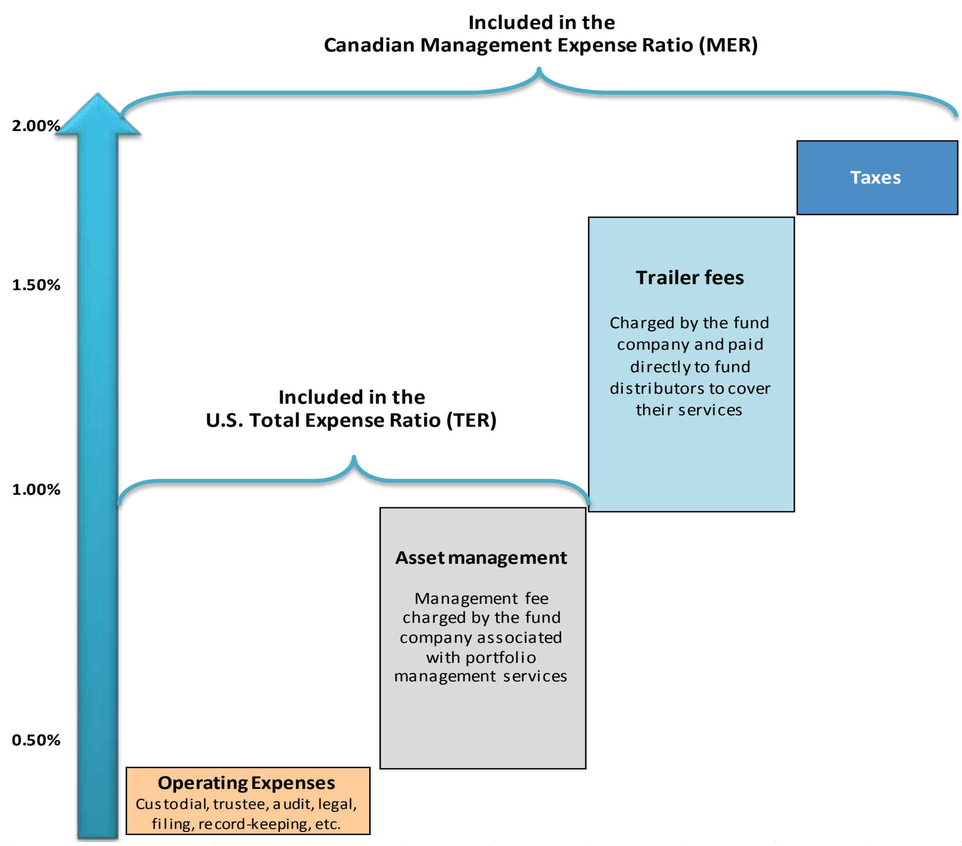
While the primary difference between mutual sales in Canada and the U.S. is that most sales in Canada are made with embedded distribution fees and in the U.S. most funds are sold within the unbundled fee structure, the various elements of the cost of ownership framework equally apply to both jurisdictions.

The original 2012 Investor Economics study suggested that the cost of ownership framework, which had been developed for the purpose of producing a U.S. versus Canada comparison, can also serve as an analytical platform for investor cost comparisons across other countries. As a validation of this point, we note that a similar framework has been recently adopted in the U.K. by The Financial Services Consumer Panel to illustrate the cost of ownership in the study *Investment Costs—More Than Meets the Eye*.

Key Elements of Canadian Management Expense Ratio (MER) and U.S. Total Expense Ratio (TER)

The use of the cost of ownership framework enables industry participants and other observers to neutralize the impact of differences in the composition of the U.S. fund TERs and the Canadian fund MERs. **Figure 2** explores these differences by providing a side-by-side view of the main cost elements included in the Canadian mutual fund MERs for the most prevalent fund series ("original series") and the U.S. fund TERs for those funds used by advisors operating fee-for-advice business models.

Figure 2: Key Elements of Canadian MERs (for Original Series of Fund Units) and U.S. TERs (for Series Used by Advisors Using Fee-based Platforms)



The chief difference resides in the inclusion—or exclusion—of the ongoing distributor (and advisor) fees from the reported fund expense ratio.

The practice of embedding such ongoing fees (referred to as trailing commissions or trailers) within the mutual fund management fees is the prevalent approach in Canada for the most popular series of fund units. This embedded fee structure is used by mutual funds that currently account for approximately 85% of all fund assets in Canada. The unbundled fee-based model has been growing rapidly but it is still relatively small when compared to the U.S.

In the United States, the majority of mutual fund sales are associated with unbundled fee-based accounts. Fees for service are generally charged at the account level on an asset-weighted basis. As such, these account management fees are not included in the TER metrics reported by mutual funds in the United States.

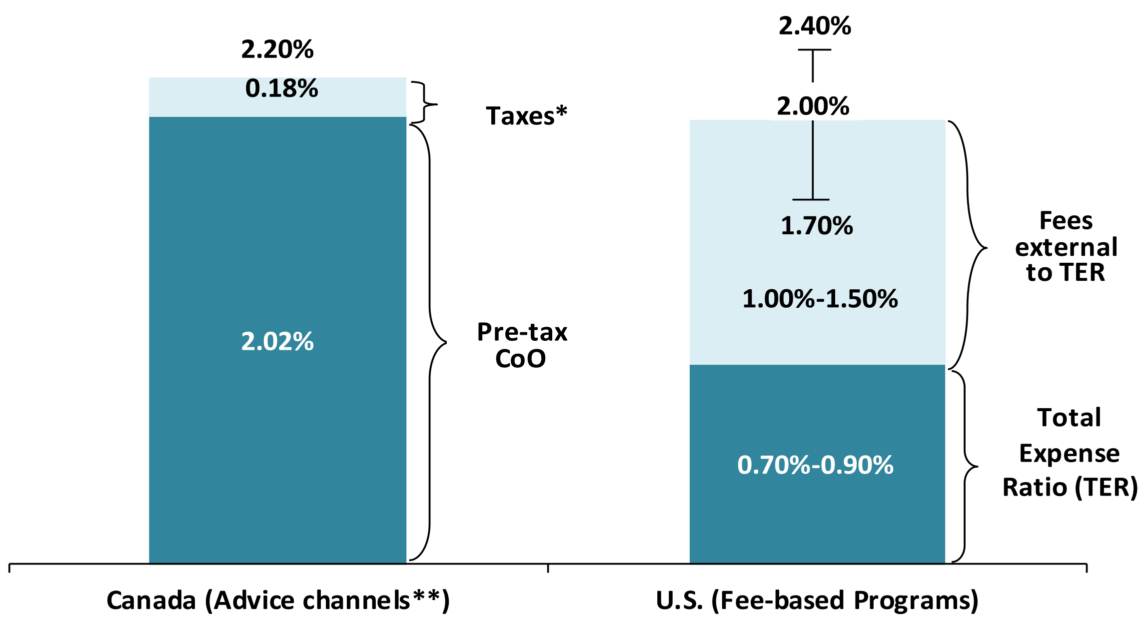
Another key difference between the two jurisdictions is that almost all elements in the Canadian MER attract value-added or sales taxes. By contrast, in the United States, no value-added taxes are levied on the key components of the TER.

Cross-country Comparison of Mutual Fund Investor Costs

Advice channels account for 80% of Canadian mutual fund asset holdings. Similarly, in the United States (excluding funds held through employer-sponsored retirement plans, which represent an estimated 26% of mutual fund assets) approximately 80% of investors rely on a financial advisor exclusively, or for a significant portion, of their investments (source: Strategic Insight).

Figure 3 updates the comparable cost of ownership for clients in advice channels in the U.S. and Canada. As was concluded in 2012, the cost of ownership of funds in advised relationships in Canada—both commission- and fee-based—is at a comparable level to the average cost of ownership incurred by a typical fee-based investor in the United States who has chosen to be guided by a financial advisor.

Figure 3: Cost of Mutual Fund Ownership for Clients Using Advice Channels—Canada (all compensation models) and the United States (unbundled, fee-based compensation)—2014



**Note: This reflects an industry aggregate and is not specific to advice channels*
***For all account types*
Source: Investor Economics and Strategic Insight.

As stated above, over the past two decades, advisor compensation in Canada and the United States has shifted away from a reliance on sales commissions paid at the time of purchase towards a greater importance of ongoing asset-based fees collected throughout the duration of the investment. Despite this similarity, there are structural differences in the approach taken in Canada and the U.S.

In Canada, ongoing fees for distribution and financial advice are generally "bundled" within a fund's management expense ratio alongside fees for investment management, administration and operations, all with the addition of the cost of applicable taxes. In the United States, the most common approach is the unbundled fee-for-advice model in which investors pay a negotiated ongoing fee directly to the distributor/advisor. These fees are charged in addition to the fees embedded in a fund's total expense ratio.

The depicted U.S. cost in **Figure 3** reflects the dominant fee-for-advice model, and includes a range for external (unbundled) fees. These fees can range from up to 1.5% of managed assets charged annually for smaller investments (i.e. below $100,000) down to approximately 1.0% for larger investments (i.e. over $1 million). For more detail and examples of fee schedules in fee-for-advice models in the U.S., please see page 33 of *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry*. External fees are charged to investors along with the underlying average fund TERs estimated at 0.85% (which does not include any distributor fees).

By adding these two cost components, *Strategic Insight* estimates the average cost of ownership for U.S. mutual fund relationships guided by a financial intermediary to be approximately 2%. This cost may range depending on the size of the relationship, family of funds, and the portfolio asset mix. For U.S. investors with accounts under $250,000, the cost of ownership may reach 2.25% or higher due to increased external fee levels.

The Canadian measure has been assembled as an asset-weighted average representing all types of accounts sold through advice-giving distribution channels. This average cost of ownership accounts for the impact of transactional charges and fund-embedded fees (MER) and unbundled fees levied at the account level.

Beyond these differences, the analysis suggests that the cost of ownership of funds in advised relationships in Canada—both commission- and fee-based—is at a comparable level to the average cost of ownership incurred by a typical fee-based investor in the United States who has chosen to be guided by a financial advisor.

This analysis, combined with the findings of the *Strategic Insight* research in 2012, also suggests that a move to unbundled fee-for-advice models has not resulted in a reduction of investor costs of mutual fund ownership.[2]

The overall cost of ownership of mutual funds in Canada and the United States remained unchanged from 2012. **Figure 3** indicates that the average cost of ownership is higher in Canada, with the majority of the difference reflecting taxes levied on

[2] For more on this topic, please refer to the original study by Strategic Insight, *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry, November 2012.*

embedded costs and other fees. If taxes are excluded, the Canadian cost of ownership is 2.02%, compared to a cost of 2.0% in the U.S. (For information on the methodology used to determine the tax component, please refer to page 59 of the *Investor Economics* 2012 study *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*).

The cost of ownership of funds in Canada presented in **Figure 3** includes only advice channels. However, the overall cost of ownership declines when funds that are purchased without advice, such as through discount brokerages or directly from fund manufacturers, are included. Once all distribution channels and available share classes are taken into account, the cost of ownership of funds in Canada declines by approximately 15 basis points, to 2.04%. No comparable data is available for the U.S. at this time. This benchmark represents a modest decline from 2.1% reported in our 2012 study.

Additional Considerations for U.S.-Canada Comparisons of Cost of Mutual Fund Ownership

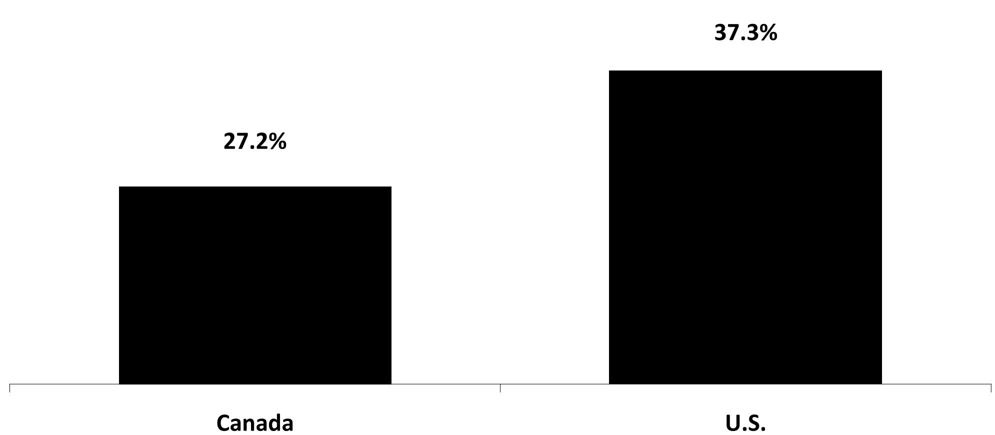
Beyond the difference in the prevalence of the unbundled fee-based advice-giving models between the U.S. and Canada, the original study highlighted a number of structural differences that should be taken into account when developing cross-border comparisons of the cost of mutual fund ownership. This section provides updates on selected issues. This section also features a newly-constructed analysis of the impact of the invested asset level on the cost of mutual fund ownership.

The Importance of Mutual Funds to Individual Savings: 2014 Update

In both countries, mutual funds represent a significant portion of household financial wealth (investible assets) and serve as the main gateway to capital markets for the household sector. This is particularly the case for households in the mass- and mid-market wealth segments.

As indicated in **Figure 4**, mutual funds in the United States account for a larger share of total personal investible assets than in Canada. This largely reflects the role that funds play in the United States as a key ingredient of defined contribution retirement platforms, such as and 401ks. Another notable difference is that mutual funds are more widely used in the United States in accounts maintained by affluent investors.

Figure 4: Mutual Funds as a Percentage of Household Financial Wealth[3]
As of December 2014



Source: Investment Company Institute, Investor Economics' Insight and Household Balance Sheet Report. Mutual funds exclude ETFs and closed-end mutual funds.

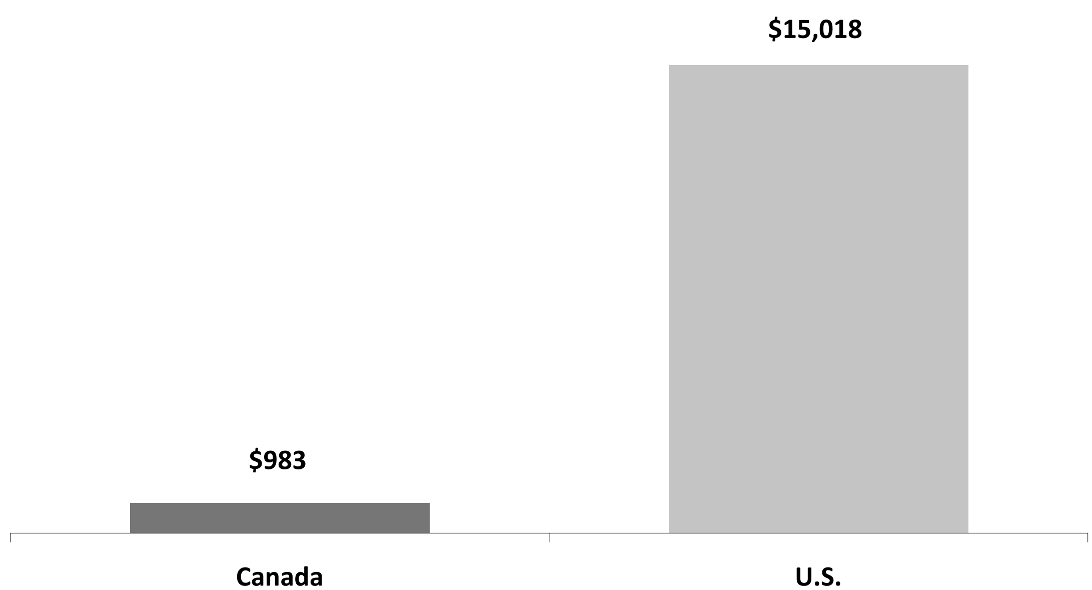
[3] Household financial wealth represents discretionary financial assets owned by retail investors, including deposits, investment funds and securities in brokerage and other accounts

Range of Investor Choices Reflects Market Forces and Scale: 2014 Update

The more mature and larger U.S. fund marketplace generally offers a broader array of options to investors, particularly in terms of delivery conduits; alternative pricing models that have evolved to reflect client and advisor demand; and, via investment mandates. For example, regulators in the United States have permitted a wider range of investment strategies (including liquid alternatives) to be offered by mutual fund manufacturers to retail investors.

The difference in the scale of the two industries is illustrated in **Figures 5** and **6** below. The mutual fund industry in the United States is more than 15 times larger than its Canadian counterpart. The gap between the total assets of the two industries underlines the ability of U.S. mutual fund manufacturers and distributors to take advantage of economies of scale in assets, client numbers, revenue and access to capital in order to pursue innovation and pricing initiatives at a pace and scale not easily achieved by smaller fund jurisdictions such as Canada.

Figure 5: Long-term Mutual Fund Assets under Management
In billions of dollars, December 2014



Source: Investment Company Institute, Investor Economics' SIMFUND Canada
Mutual funds exclude ETFs and closed-end mutual funds.

Although not measured directly in this study, scale is likely a factor that impacts pricing in both countries. The sheer scale of the U.S. mutual fund industry has enabled pioneering innovations in fund delivery, such as "fund supermarkets"[4], several of which administer over $100 billion. The cost of ownership of mutual funds in this channel is generally significantly lower than the average of 2% for advice distribution. This channel format is absent from the Canadian retail investment landscape.

Figure 6 provides another perspective on the differences in scale between mutual fund companies and individual funds in both markets.

At the end of 2014, there were three U.S. fund managers whose individual assets under management eclipsed the entire Canadian mutual fund industry. The second table explores the potential for economies of scale at the U.S. fund level, where spreading of certain costs across a larger asset base could have a meaningful impact on the cost-to-customer.

Figure 6: Assets of 20 Largest Mutual Fund Complexes and Mutual Funds in the U.S. and Canada*

December 2014 assets in millions of Canadian dollars

Top 20 Largest U.S. Managers		Top 20 Largest Canadian Managers	
Manager	**Assets**	**Manager**	**Assets**
Vanguard	$2,808,707	RBC Global Asset Management	$165,752
Fidelity	1,841,374	TD Asset Management	106,412
American Funds	1,375,304	Scotia Global Asset Management	81,600
JPMorgan Funds	602,246	CIBC Asset Management	78,082
T Rowe Price	549,057	Fidelity	77,676
Franklin Templeton	545,031	Investors Group	73,454
BlackRock	495,486	BMO Investments	53,784
PIMCO LLC	456,886	Mackenzie	48,273
Federated	323,915	Manulife Mutual Funds	32,875
Goldman Sachs	305,944	MD Financial	25,930
Dreyfus	294,222	Franklin Templeton	21,111
DimensionalFundAdv	289,511	Desjardins Investments	19,996
Wells Fargo	281,059	AGF Investments	18,659
Schwab	263,413	Sentry Investments	16,762
Invesco	259,460	National Bank	16,356
OppenheimerFunds	239,806	IA Clarington	15,239
Dodge & Cox	214,448	Beutel Goodman	13,683
MFS	202,888	Mawer	11,709
Columbia MgmtInvst	190,485	SEI Investments Canada	11,386
Legg Mason/Western	171,090	HSBC Global Asset Management	11,150

** CI Investments and Invesco Canada not included due to confidentiality restrictions*

[4] An investment firm or brokerage that offers investors a wide array of mutual funds from different fund families. Investors benefit by obtaining access to an extensive range of top performing funds, as well as by receiving a consolidated statement of all their mutual fund holdings.

Figure 6 *(continued)*: Assets of 20 Largest Mutual Fund Complexes and Mutual Funds in the U.S. and Canada*

December 2014 assets in millions of Canadian dollars

Top 20 Largest U.S. Funds

Fund	Manager	Assets
Vanguard Total Stock Mkt Index	Vanguard	$385,289
Vanguard IL Index	Vanguard	217,779
Vanguard 500 Index	Vanguard	198,473
PIMCO Total Return	PIMCO LLC	166,310
Growth Fund of America	American Funds	165,466
Vanguard Prime MM	Vanguard	153,935
Vanguard Total Intl Stk Idx	Vanguard	152,012
Europacific Growth	American Funds	140,219
JPMorgan Prime MM	JPMorgan Funds	137,147
Fidelity Cash Reserves	Fidelity	132,189
Vanguard Total Bond Mkt Index	Vanguard	128,343
Fidelity Contrafund	Fidelity	127,431
Income Fund of America	American Funds	112,331
Capital Income Builder	American Funds	112,131
Franklin Income Series	Franklin Templeton	107,350
Vanguard Total Bd Mkt II Idx	Vanguard	105,282
Vanguard Wellington	Vanguard	102,962
Capital World Growth & Income	American Funds	100,155
Fid Spartan 500 Index	Fidelity	98,700
American Balanced	American Funds	92,418

Top 20 Largest Canadian Funds

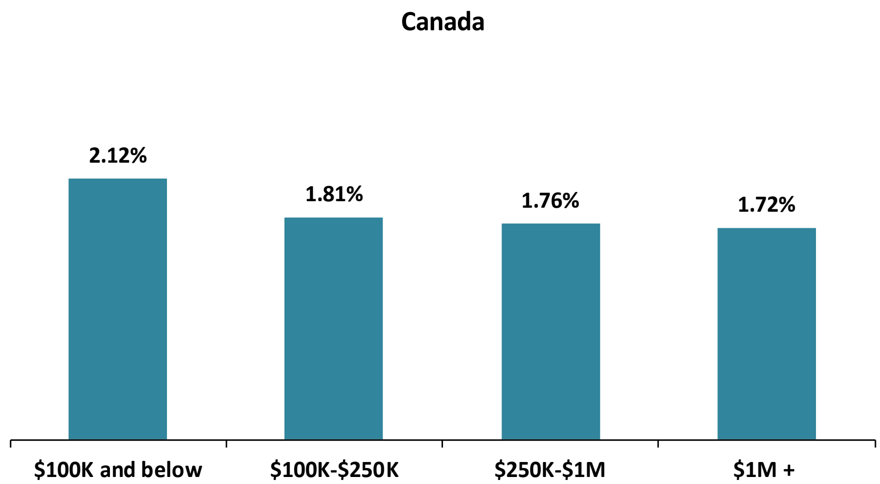
Fund	Manager	Assets
RBC Canadian Dividend Fund	RBC Global Asset Management	$18,022
Investors Dividend Fund	Investors Group	17,392
RBC Bond Fund	RBC Global Asset Management	12,837
Fidelity Monthly Income Fund	Fidelity	12,760
TD Canadian Bond Fund	TD Asset Management	10,756
Imperial Canadian Bond Pool	CIBC Asset Management	10,107
Manulife Monthly High Income Fund	Manulife Mutual Funds	9,538
RBC Monthly Income Fund	RBC Global Asset Management	9,459
TD Canadian Core Plus Bond Fund	TD Asset Management	9,116
TD Monthly Income Fund	TD Asset Management	8,693
Phillips, Hager & North Bond Fund	RBC Global Asset Management	8,618
Imperial Canadian Dividend Income Pool	CIBC Asset Management	8,169
Imperial Short-Term Bond Pool	CIBC Asset Management	8,160
Fidelity Canadian Asset Allocation Fund	Fidelity	7,216
Scotia Canadian Dividend Fund	Scotia Global Asset Management	7,211
RBC Balanced Fund	RBC Global Asset Management	6,881
TD Dividend Growth Fund	TD Asset Management	6,715
PIMCO Monthly Income Fund (Canada)	PIMCO Canada	6,546
Fidelity Canadian Balanced Fund	Fidelity	6,076
CIBC Monthly Income Fund	CIBC Asset Management	5,909

The Effect of Asset Levels on the Cost of Ownership

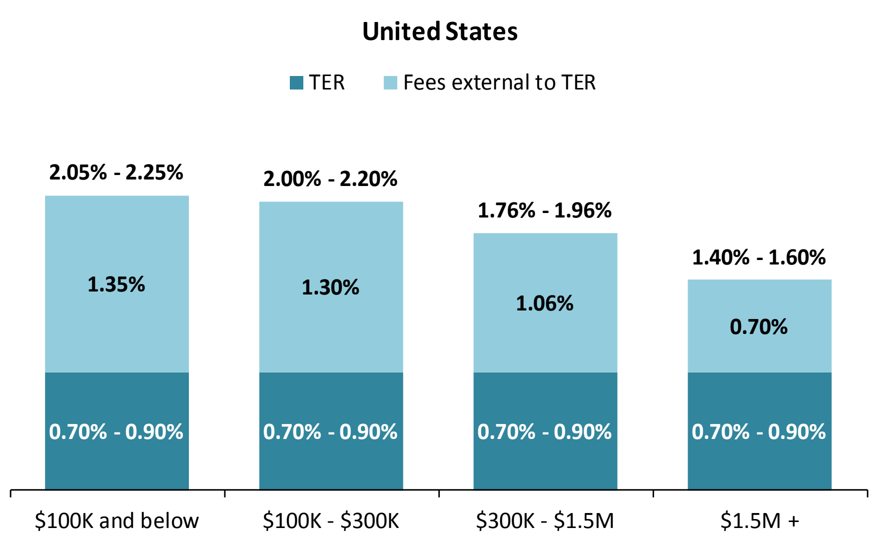
For more modest account sizes, the average Canadian mutual fund cost of ownership in advice channels can be lower than the U.S. This is the result of the potentially higher fee-based account fee ranges for U.S. investors. However, emerging competitive pressures in the U.S. are pushing the fee-for-advice fee levels towards the lower end of the fee range.

In Canada, similar pressures have resulted in an overall decline in fee levels charged to clients using fee-based brokerage and advisor managed accounts, as well as declining fund management fee levels. This is particularly the case in the unbundled F-series and the HNW-series, both of which target the high end of the fund investor spectrum.

Figure 7: Cost of ownership by Account Size—2013
Segments expressed in local currency



**Cost of ownership by account size estimated based on fee-based account and mutual fund series assets.*
Source: Investor Economics.



Source: Strategic Insight.

In both Canada and the U.S., most distributors and mutual fund firms offer a lower price point for clients with mutual fund holdings in a specific fund above certain thresholds. These discounts are applied either via discounted share classes and/or by lowering the level of fees in fee-based accounts. **Figure 7** shows the typical price points by account size in both countries. The segments overlap to the extent that is possible, given the available data for each country and reflect the average fee of mutual fund series relevant to each segment plus account and servicing fees (if applicable). Pricing in this figure does not reflect a wide range of discretionary managed solutions typically available to high end investors.

Based on this sample, compared to the U.S., Canadian mutual fund manufacturers and distributors offer a considerable discount in mutual fund and advisory fees to clients with between $100,000 and $1 million. In Canada, this segment is typically referred to as the mass-affluent.

According to Strategic Insight, in the U.S., by contrast, the discount in fees becomes more significant when client assets reach $1 million and this discount deepens for multi-million dollar accounts. This is not the case in Canada, where the fee level for accounts with more than $1 million dollars is only marginally lower than that of mass-affluent clients.

A number of factors associated with the composition of each market in terms of household wealth accumulation and the products and services available to HNW clients explain why the level of fee discounts in both countries differs for each client segment. These factors include the difference in size and composition of the HNW communities in Canada and the United States; the nature of investment options available to HNW households; and the role of mutual funds in discretionary managed solutions. Unlike the case in the United States, funds in Canada are not as widely used in the construction of discretionary portfolios.

Disclaimer

Monitoring Trends in Mutual Fund—Cost of Ownership and Expense Ratios
A Canada — U.S. Perspective is published by Investor Economics, a division of Strategic Insight, an Asset International Company

400 University Avenue, Suite 2000, Toronto, Ontario, Canada M5G 1S7
Telephone: (416) 341-0114 • Fax: (416) 341-0115 • Email: iei@iei.ca
Website: www.InvestorEconomics.com

Key contacts: Goshka Folda, Carlos Cardone, Keith Sjogren

Disclaimer: This publication is intended only to convey information. The publisher and its data providers have taken all usual and reasonable precautions to determine that the information contained in this publication has been obtained from sources believed to be reliable, and that the procedures used to summarize and analyze such information are based on approved practices and principles in the financial services industry. However, the market forces applicable to the subject matter of this report are subject to sudden and dramatic changes and data availability and reliability varies from one moment to the next. Consequently, neither the publisher nor its data providers makes any warranty as to the accuracy, completeness or timeliness of information, analysis or views contained in this publication or their usefulness or suitability in any particular circumstance. The publisher and its data providers disclaim all liability of whatsoever kind for any damages or losses incurred as a result of reliance upon or use of this publication. Past performance is no guarantee of future results.