American Enterprise Institute for Public Policy Research

May 2007

Financial Services Outlook

Price Competition: A Better Way to Reduce Mutual Fund Costs

By Peter J. Wallison

Mutual funds are now a $10 trillion industry, holding the retirement savings of millions of American families. Because the high fees and expenses associated with mutual fund ownership can, over time, substantially reduce returns, sound public policy should focus on ways to reduce mutual fund costs. Under the Investment Company Act of 1940 and Securities and Exchange Commission (SEC) regulations, the fees and expenses of the investment advisers who manage mutual funds must be approved by each fund's board of directors. This approval process, which does not differ substantially from the cost-plus system used by local utility commissions, reduces the incentives of investment advisers to operate efficiently and to compete on price. Eliminating the authority of boards to approve advisory fees and expenses would foster price competition among investment advisory firms and substantially lower the costs associated with owning mutual fund shares.

Mutual funds are probably the most successful financial innovation in history. Since its modest beginning in the 1920s, the industry has expanded such that today it consists of over 500 investment advisory groups offering over 8,000 funds and managing through these funds over $10 trillion in assets. By comparison, the banking industry—only a generation ago the largest financial industry in the United States—now has only $6 trillion in deposits. The mutual fund industry gives every indication of robust health and future success, except for one thing: the fees and expenses associated with mutual fund investments are a source of constant challenge and complaint. Critics in the media and the academy, former fund managers, and the industry's regulator, the SEC, have been complaining for years that the fees many investors have to pay for their funds are too high.

Conforming to a structure required by the Investment Company Act of 1940, each mutual fund is a separate corporation controlled by a board of directors. Funds have no internal management; in almost all cases, they are managed by an investment advisory firm under a contract approved by the fund's board. In fact, the manager is usually the investment advisory firm that initially established the fund and paid the expenses associated with its organization and registration with the SEC. The same board of directors usually serves as the board of directors of all the funds established by the same investment adviser. For the largest advisory groups, the same board could serve more than a hundred funds.

For forty years, many observers have considered the adviser's management of the fund under a contract to be the source of the high fees and expenses cited by the industry's critics. The SEC in particular has argued that there is an inherent conflict of interest between the adviser and the shareholders of the funds. The adviser, the agency claims, wants to extract the highest possible profit from its contract with the fund, and the shareholders of the fund want the adviser's services at the lowest possible cost.[1] Hence the "inherent conflict."

Peter J. Wallison (pwallison@aei.org) is a senior fellow at AEI and coauthor (with Robert E. Litan) of *Competitive Equity: A Better Way to Organize Mutual Funds* (AEI Press, 2007).

In managing a fund, the investment adviser charges a fee and incurs certain expenses that, together, as a percentage of each fund's assets, are called the fund's "expense ratio." Although each fund's shares are sold and redeemed at the fund's net asset value (NAV), the expense ratio slightly reduces the NAV and thus the value of each investor's shares. Over time, even small differences in expense ratios can have a substantial adverse effect on the growth of an investor's savings. The SEC has recognized this as a public policy problem, and following its inherent-conflict-of-interest theory, it has attempted over many years to increase the independence of mutual fund boards so that they can more effectively negotiate fees and expenses with the fund's adviser. In the last few years, the SEC has adopted regulations that would require funds to have an independent chair and a board that is composed of at least 75 percent independent directors. These regulations were struck down by the courts,[2] but there are indications that the SEC will try again.[3]

> Most salient is that with hundreds of competing fund groups and thousands of funds, the mutual fund industry has a highly competitive structure.

The Paradox of Mutual Fund Pricing

What is peculiar about the SEC's conflict-of-interest approach is that it completely ignores the implications of the most salient feature about the mutual fund industry: that with hundreds of competing fund groups and thousands of funds, the mutual fund industry has a highly competitive structure. What is more, it is an industry with no major barriers to entry and one in which the customers—investors—can move from one fund to another relatively easily and inexpensively. The question, then, should not be how to make boards of directors more independent, but why investment advisers are not competing on price—that is, reducing their fees and expenses in order to attract more investors. If advisers were competing on price, the so-called conflict of interest that has attracted the SEC's attention for forty years would be largely irrelevant. The fees and expenses of advisers would be reduced by the advisers themselves—as in any other competitive industry—without the need for intervention by a board of directors. The beneficiaries of this process would be the investors, who would get the services of mutual fund advisers for the lower costs that competition has always produced.

Indeed, the most striking fact about the mutual fund industry is the extraordinary disparities in the fees and expenses that investors are charged for the services and advice associated with their investments. In *Competitive Equity: A Better Way to Organize Mutual Funds* (AEI Press, April 2007), using data from Morningstar, Robert E. Litan and I found that for 811 ordinary equity funds, there was a difference of 300 percent between the lowest and highest expense ratios—without any appreciable difference in the quality of performance or service.[4]

It is difficult to understand how such disparities can occur in a competitive market. In competitive conditions, prices converge into a narrow range, with differences in service or product quality accounting for any large differences in price. But the 300 percent dispersion persisted even after we eliminated outliers by excluding 3 percent of the lowest and highest cost funds. It is very difficult to account for this dispersion by citing differences in product or service quality. Indeed, differences almost as large appear in the expense ratios of S&P index funds[5]—in which there can by definition be no significant difference in fund performance—and among the funds offered by the largest and most competitive advisory groups.[6]

This presents something of a paradox, at least until it becomes clear that there is something else about the mutual fund industry that sets it apart from most other industries in the United States: the expense ratios (that is, the prices) that investment advisers charge for their services are not set by the investment advisers in competition with one another. They are set in a cost-plus process by the boards of directors of the mutual funds themselves—the very agents that the SEC wants to empower to negotiate lower fees. In other words, the mutual fund industry is one of the few remaining industries in which prices are set in a cost-based process not materially different from the way that local electric utilities commissions regulate electric rates—and with the same result.

Studies of electric utility regulation have shown again and again that rate regulation eliminates the incentive to operate efficiently.[7] With profits allowed as a percentage of costs, the incentive to cut costs is eliminated. Of course, local utilities may be natural monopolies, so that regulation may be justified. But investment advisers are not in any sense natural monopolies. They should be competing on price with other investment advisers, seeking to attract more investors to their funds with lower prices. But this is not happening. In reality, investment

advisers as well as mutual fund directors are trapped in a legal system—the Investment Company Act of 1940, a New Deal artifact—that prevents both of them from achieving a reduction in the fees and expenses charged to mutual fund shareholders.

That this system has been allowed to continue for forty years to the detriment of investors is the fault of the SEC. In another example of its domination by lawyers and its exclusion of economists from policymaking roles, the agency fails to understand the consequences of encouraging rate regulation by fund boards. Rather than trying to make boards of directors more independent of investment advisers—a policy that has only made the problem worse—the SEC should have been advancing reforms that would engender competition among investment advisers. To do this, it is necessary to eliminate the board's role in approving the fees and expenses of investment advisers.

Thinking Marginally

In virtually every case in which rate regulation has been eliminated over the last quarter century—including airlines, trucking, long-distance telephone service, and securities brokerage—competition has brought prices down. Price competition is the natural result when a large number of firms are given the authority to set their prices free of government controls. Price-competitive markets thus exhibit a narrow range of prices—nothing like the 300 percent price dispersion mentioned above—unless there are substantial differences in product or service quality.

In competitive markets, it is not necessary that all consumers pay attention to prices; they do not have to. They are free riders on the consumers who *do* pay attention to price. It is to attract these last, picky, price-conscious consumers that competitors lower their prices, since they make a profit on every unit they sell over their marginal cost of production. Thus, a price-competitive market forces the competing firms to seek constantly a lower marginal cost of production, which in turn promotes efficiency and provides all consumers—even those who do not bother to compare prices—with lower prices. The low-cost producer will always have a profit incentive to seek the customers of other producers, and this provides a strong incentive for other competitors—if they want to remain in business—to find and employ more efficient ways to operate. This is literally Economics 101.[8] In a competitive market, the price of goods or services tends to converge on the marginal cost of the most efficient producer. But in the mutual fund industry, investment advisers never get to discover what their marginal costs are. The only costs they are concerned with are their average costs—the costs they must furnish to the boards in order to get approval of their fees. Similarly, the boards can never get the advisers to reduce their fees to their marginal cost because the advisers literally do not know what their marginal costs are. As Friedrich Hayek pointed out, competition is a discovery procedure[9]—and what is discovered is marginal cost. In this sense, both investment advisers and boards are trapped in a minuet dictated by law and SEC regulation—a dance that can never result in the low costs and prices that competition always produces.

Some argue that the dispersion in mutual fund expense ratios occurs because investors either do not care or are so ignorant of the consequences of high costs that they let their financial advisers put them into high-cost funds. This could well be happening in a market in which price competition is not occurring. In such a market, no firm would have an incentive to offer and advertise low prices. But in a competitive market, firms will advertise their low prices to attract new customers, and price discrepancies that are not based on real value differences will not survive.

Given the advantages of vigorous price competition, it is astonishing that the SEC has never sought to determine why this kind of competition has not occurred among investment advisers. Today, after deregulation of pricing in virtually every other economic sector, American consumers are benefiting from low prices for products and services—such as air travel—that were once beyond the means of the middle class. Yet for mutual funds—an industry with all the elements of a competitive market—prices are "sticky" and dispersed over a wide range. In *Competitive Equity*, Litan and I conclude that this phenomenon is the result of the process by which boards of directors approve the fees and expenses of advisers.

The Fee-Approval Process

In order to obtain the approval of its fees and expenses by a board of directors, an investment adviser furnishes to the board the actual costs of managing each fund. The board reviews the adviser's profit and compares it to the adviser's costs. If the profit seems reasonable, the board approves. This process reduces the incentive of the adviser to lower its fees and expenses in three ways. First, if the adviser lowers its expenses but does not succeed in

attracting more investors, the lower fees will simply have resulted in less profit. The board, which has a fiduciary duty to the shareholders to lower the fund's costs, would be unlikely to permit the adviser to raise its fees back to the original level. Some portion of that cost reduction would have to go to the shareholders, and this reduction could never be recovered unless the adviser is somehow able to show at a later time that its costs have actually increased.

Second, the adviser in these circumstances has very little incentive to cut costs and operate more efficiently. If the adviser succeeds in doing so, its profit *percentage* will rise and the board—pursuing its fiduciary duty—will ask for a reduction in fees to keep the profit within "reasonable" bounds. The rational response of an adviser in this context is thus the opposite of what a firm would do in a competitive market: instead of cutting costs, the most sensible and least risky course is to maintain steady costs, assuring itself of a stable profit.

Finally, if the adviser is successful in attracting more investors because of reduced fees and expenses, the board is obligated by its fiduciary duties and the policies of the SEC to introduce "breakpoints" into the adviser's fee in order to "recapture" for the shareholders some of the benefits of the economies of scale that the adviser has supposedly reaped from serving a larger number of investors. Again, the adviser is deprived by this requirement of some portion of the benefits that would ordinarily flow from taking the risks associated with lowering its fees.

Thus, the skewed incentives of investment advisers, altered by the fee-approval process in which they are required to participate, account for the wide dispersion of expense ratios among mutual funds and the absence of vigorous price competition among investment advisers.

But this is still only a theory and must be tested. In *Competitive Equity*, we sought to determine the effect of board intervention in pricing by comparing the price structure of U.S. mutual funds to the price structure of the collective investment industry in the United Kingdom, where investment advisers are not required to get the approval of boards before setting their fees and expenses. What we found was that, in the UK, the pricing structure looks much more like what one would expect in a competitive market. The difference between the lowest-cost and highest-cost funds, among a group of 456 equity funds, was 50 percent—*one-sixth* the disparity that we found in the United States.

Finally, in the United States itself, there is evidence that when investment advisers do not have to seek the approval of a board of directors in order to establish their prices, those prices tend to converge as they would in a competitive market. This occurs when investment advisers create the portfolio "strategies" that are used as the basis for separately managed accounts ultimately sold to investors by broker-dealers. These strategies are diversified portfolios of securities, like miniature mutual funds, but when investment advisers price their services in assembling them, they are not required to gain the approval of a board. Once again, where the pricing is established by the investment advisers themselves, in a competitive environment, prices converge strongly. Almost all fees are between 75 and 100 basis points.

> The mutual fund industry is one of the few remaining industries in which prices are set in a cost-based process not materially different from the way that local electric utilities commissions regulate electric rates—and with the same result.

None of this proves conclusively that requiring board approval of investment advisory fees and expenses prevents vigorous price competition and thus causes the dispersion of pricing that keeps expense ratios higher than they would be in a price-competitive market. But it is strong evidence for the proposition. At the very least, the fact that there is a correlation between a wide dispersion in pricing and a system of board approvals—and no such dispersion when approval of pricing is not required—should give the SEC pause in its efforts to increase the independence of boards of directors. If board approval of pricing is indeed interfering with competitive pricing, increasing the independence of boards is the opposite of a solution. It will only make the problem worse.

Diagnosis and Prescription

If the diagnosis set out in *Competitive Equity* is correct, the prescription must be to eliminate the authority of mutual fund boards of directors to approve the fees and expenses of advisers. This will encourage advisers to compete on price, advertising the benefits of lower prices for investors. The phenomenon of financial advisers and the managers of employer-sponsored 401(k) plans choosing high-cost funds will gradually disappear. High-cost funds will either cut their fees or leave the field.

The idea that boards of directors should be removed from the pricing decision is not a new one. It was proposed by SEC staff in 1982 and again in 1992,[10] but in neither case was the proposal based on a study of how mutual funds were priced. Once it becomes clear that eliminating the rate-making role of mutual fund boards will lower costs for investors by increasing price competition, such a reform ought to attract greater attention and support in Congress. The earlier SEC staff proposals never received any significant legislative attention. One of the questions immediately raised by this prescription is whether there is any continuing role for boards of directors. The proponents of a continued board role argue that even if fees and expenses fall as a result of competition, a board of directors is still needed to deal with other conflicts of interest. This was the conclusion of the SEC staff in 1992, when it proposed a "Unified Fee Investment Company." This structure would have eliminated board approval of advisers' fees and expenses, but would have retained the board to deal with conflicts of interest.

In *Competitive Equity*, we conclude that once boards are removed from the process of approving fees and expenses, it would be best to replace them entirely as supervisors of the investment adviser's activities. Accordingly, we propose a new structure for collective investment: a managed investment trust. In this structure, the investor would have a contractual relationship directly with the investment adviser without the need for an intervening corporation. The investor's funds would be deposited in a trust overseen by a bank and managed by the investment adviser. The bank would have fiduciary obligations to protect the interests of the investor, just as banks protect the interests of beneficiaries under testamentary trusts. The board's part-time role in addressing conflicts of interest would be replaced with full-time supervision by the professional staff of the trustee bank.

While boards are diligent in their efforts to protect investors, they are part-time nonprofessionals who meet quarterly or bimonthly and are required to oversee, in some cases, more than a hundred different funds. Some depredations of advisers—such as the actions that resulted in the late-trading scandal[11]—cannot be detected by boards at all because they occur at the level of the adviser. Only the regular and continuous monitoring provided by a trustee bank's professional staff would be likely to uncover conflicts of interest of this kind.

The skewed incentives of investment advisers, altered by the fee-approval process in which they are required to participate, account for the wide dispersion of expense ratios among mutual funds.

The key reform proposed in *Competitive Equity*, however, is eliminating the boards' role in approving advisory fees and expenses. If that reform were adopted, resulting in competition among advisers, it would substantially improve the results achieved over time by investors in mutual funds, even if boards were ultimately left in place.

There is no villain in the mutual fund drama. While boards of directors will resist changes that strip them of fee-setting power and perhaps lead to their abolition, they are locked with investment advisers in a contrived conflict created by a misconceived and poorly implemented statute. With its proposal to further empower the boards, the SEC will not solve the problem. But the managed investment trust, by freeing advisers to compete, will result in lower costs for investors.

AEI research assistant Daniel Geary and editorial assistant Evan Sparks worked with Mr. Wallison to edit and produce this Financial Services Outlook.

Notes

1. "Fees paid from an investment company's assets to sponsors [usually the investment adviser] and their affiliates—whether advisers' fees, principal underwriting fees, distribution fees, or fees for other services—directly affect shareholders' investment return. The higher the fee, the lower the return. The conflict of interest is inherent." (U.S. Securities and Exchange Commission [SEC], Division of Investment Management, *Protecting Investors: A Half-Century of Investment Company Regulation* [Washington, DC: Government Printing Office, 1992], 256).

2. *U.S. Chamber of Commerce v. SEC*, 412 F.3d 133, 141 (D.C. Cir. 2005) and *U.S. Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

3. Christopher Cox, speech (Mutual Fund Directors Forum Seventh Annual Policy Conference, Washington, DC, April 13, 2007), available at www.sec.gov/news/speech/2007/spch041207cc.htm (accessed May 2, 2007).

4. Peter J. Wallison and Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds* (Washington, DC: AEI Press, 2007, 9, figure 1-1, available through www.aei.org/book880/.

5. Ibid., 64, table 4-1.

6. Ibid., 12, table 1-1.

7. Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions*, vol. 2 (Cambridge, MA: MIT Press, 1988), 48.

8. See, for example, Paul A. Samuelson and William D. Nordhaus, *Economics*, 18th ed. (New York: McGraw-Hill, 2005), 149–50: "Total profit reaches its peak—is maximized—when there is no longer any extra profit to be earned by selling extra output. At the maximum-profit point, the last unit produced brings in an amount of revenue exactly equal to that unit's cost. What is that extra revenue? It is the price per unit. What is that extra cost? It is the marginal cost. . . . A profit-maximizing firm will set its output at that level where marginal cost equals price." See also Karl E. Case and Ray C. Fair, *Principles of Economics*, 2nd ed. (Englewood Cliffs, NJ: Prentice Hall, 1992), 235–36.

9. Friedrich A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas* (London: Routledge & Kegan Paul, 1982), 179–90.

10. SEC, "Investment Company Act," release no. 12888, December 10, 1982, and SEC, *Protecting Investors*, 332–45.

11. In the late trading scandals of 2003, investment advisers allowed a few hedge funds to buy or sell shares after the market had closed and thus to effectively place bets after a race had been run. The advisers did this because the hedge funds had agreed to leave substantial share purchases with other funds managed by the same adviser. The adviser thus benefited from these purchases and allowed late trading by the hedge funds in return.