

FOR IMMEDIATE RELEASE

The Real Story behind Mutual Fund Fees **Q&A with Mark Eglund and Stan Ornstein of Analysis Group,** **Co-author of the New Book, *The Mutual Fund Industry***

Boston, April 6, 2010 — Mutual funds form the bedrock of retirement savings in the United States and are sure to be more critical in the future. Because the size of fees paid to mutual fund advisers can affect investors' returns, these fees have become a contentious issue in Congress and the courts, with many arguing that investment advisers grow rich at the expense of investors.

An important new book, titled *The Mutual Fund Industry: Competition and Investor Welfare* (Columbia University Press) set to hit bookstores April 12, 2010, not only conceptualizes a new economic model of the mutual fund industry, but also uses this model to test for price competition between investment advisers, evaluating the assertion that market forces fail to protect investors' returns from excessive fees. Experts [R. Glenn Hubbard](#) and [Michael F. Koehn](#), and Analysis Group, Inc. authors [Stanley I. Ornstein](#), [Marc Van Audenrode](#), and [Jimmy Royer](#), track the growth of the industry over the past 25 years, reviewing the regulatory history of mutual fund fees and discussing the key appellate court decision addressing excessive fees.

Revealing the extent to which the governance structure of mutual funds truly impacts fund performance, this book provides the best understanding of today's mutual fund industry and is a useful tool for investors, money managers, fund directors, securities lawyers, economists, and anyone concerned with the regulation of mutual funds.

Analysis Group Vice President Stan Ornstein, co-author of the book, and Managing Principal [Mark Eglund](#), who has worked on numerous mutual fund fee litigations, answer six compelling questions about investor fees and competition in the mutual fund industry:

Why is there so much focus today on the fees investors pay to mutual fund advisers?

Stan: Close to 100 million people in the U.S. have trillions of dollars invested in mutual funds through IRAs, pension plans, and individual investing, and they all pay fees to their funds' advisers for professional money management and administrative services. Given the predominance of mutual funds as a long-term investment for retirement, the relationship of fees to fund returns affects the financial well-being of millions.

The SEC paid little attention to fees until 1958, when it commissioned the Wharton school to study price competition among mutual fund providers. Based on fee data from the 1950s and early 1960s, this study and a follow-up SEC study in 1966 concluded that fees were excessive. In response, Congress passed a law in 1970 giving fund investors the right to sue advisers for breaching their fiduciary duty by charging excessive fees.

More recently, some academics have concluded that excessive fees are rampant and have called for a more activist SEC and court system to protect investors. However, in our research we noted that average investor fees, when load charges are taken into account, have actually declined annually since approximately 1980. (MORE)

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Mark: Excessive fee litigation has become commonplace as the amount of money invested in mutual funds has grown. For example, we recently worked with Glenn Hubbard, a co-author of the book, on one of the largest securities matters ever to go to trial, *In re American Funds Fee litigation*. We studied competition in the industry, and Dr. Hubbard examined the reasonableness of the challenged fees. We showed that the defendants had shared substantial portions of any benefits from economies of scale. His analyses, along with those of other experts, played a major role in achieving a decisive victory for American Funds in the first securities case to go to trial in the mutual fund industry in more than 20 years.

Why did you decide to revisit the issue of mutual fund fees in your book?

Stan: The U.S. mutual fund industry is dramatically different today from that of the 1950s and 1960s, with thousands of funds and close to 600 investment advisers. My co-authors and I thought it implausible that all 600 advisers were charging excessive fees, as the Wharton study claimed and present-day fee critics continue to claim.

We were not convinced that existing explanations for excessive fees made any economic sense, and found the empirical evidence from fee critics unconvincing. Given the importance of mutual funds to millions of households, we decided that price competition and investor sensitivity to fee levels deserved a new, more comprehensive examination using modern economic approaches and contemporary data.

Mark: The issue is also very timely in terms of litigation. We are often asked to analyze mutual fund performance and fee differences across funds, as well as fees for individual investors relative to those for institutional investors. The research undertaken for the book is directly relevant to this issue: for example, fee critics often point to price disparities between retail and institutional fund investors apparently for the same product as evidence of excessive fees. On the contrary, such disparities are perfectly consistent with price competition in the retail sector along with differences between retail and institutional products and therefore provide no basis for concluding that retail investors pay excessive fees.

Can you briefly describe your approach to the research presented in the book?

Stan: We reviewed the history of fund regulation and fee critics' arguments, the leading court decision on excessive fees, and empirical evidence of excessive fees. Much of our focus was on examining the dynamics and structure of the mutual fund market to assess price competition. We found direct evidence of price competition in the sensitivity of investors to prices and price changes. We went well beyond the 1960s' studies by developing an economic model of demand and supply for mutual funds, using that model to estimate how sensitive investors are to fees within and across fund complexes and channels of distribution, and, in turn, using the results to simulate economic outcomes in a simple model of the industry.

What are some of the implications of these findings for mutual funds, their directors, and investors?

Mark: One of the key findings is that retail mutual fund investors are very sensitive to the level of fees they pay – providing direct evidence that mutual fund advisers must compete on price to retain existing investors and to attract new investors. In particular, the research shows that the use of rivals' fees provides a valid economic basis for judging a fund's price competitiveness. Courts have commonly placed little weight on fund directors' use of rival funds' fees as a competitive benchmark, reasoning that directors at all funds are beholden to their advisers, so rivals' fees are not determined by competitive market forces. The book's research results, however, show the opposite, indicating that courts have frequently ignored highly relevant evidence. (MORE)

On March 30, the Supreme Court ruled on the *Jones v. Harris* excessive fee matter, remanding it to federal appeals court – what implications do you see for future cases involving excessive fee issues?

Mark: The Supreme Court essentially endorsed the standards set forth in the 1982 case, *Gartenberg v. Merrill Lynch*, which set the current precedent for evaluating whether fees are excessive. The High Court indicated that trial courts may consider the fees charged by other investment advisers, but cautioned that they shouldn't rely too heavily on these comparisons because these fees may not be the product of arm's length negotiating. The trial courts were also given the discretion to consider the fees charged to institutional investors – although this does not require "fee parity" between retail and institutional investors. Thus, the ruling will continue to allow the trial courts a fair amount of discretion in how they evaluate specific claims of excessive fees. Regardless of the ruling, however, our findings indicate that instances of excessive fees are likely to be rare. Why? Because price competition in the industry is intense and investors are both mobile and sensitive to fees, forcing advisers to price competitively to retain current and attract new investors.

Your research sounds rather technical. How accessible is the book for readers not trained in economics?

Stan: The book is written for anyone interested in price competition in the mutual fund industry, especially securities lawyers, regulators, fund investors, and students of competition and industry regulation. They should have little difficulty understanding our research findings and methodology. Technical aspects of the research methodology and results are in the back of the book, which the average reader can skip without missing the core findings.

The Mutual Fund Industry: Competition and Investor Welfare, by R. Glenn Hubbard, Michael Koehn, Marc Van Audenrode, Stanley Ornstein, and Jimmy Royer (Columbia University Press, April 2010).

About Analysis Group

Analysis Group (www.analysisgroup.com) provides economic, financial, and business strategy consulting to leading law firms, corporations, and government agencies. The firm has more than 475 professionals, with offices in Boston, Chicago, Dallas, Denver, Los Angeles, Menlo Park, New York, San Francisco, Washington, and Montreal.