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Do Mutual Fund Fees Reduce Investor Returns?

As pundits and regulators repeat calls to drive down the fees charged by actively managed open-end mutual funds, a new research study argues that such a move could be devastating for investors, removing the incentive to manage actively and compromising investor trust.

It is a commonly held belief that actively managed open-end mutual fund fees are excessive and reduce investor returns. According to the authors, this belief is wrong except under the narrowest of circumstances. It is correct only if all things other than fees remain equal. Yet fund assets under management (AUM) vary with the fee per franc of assets; AUM in turn affect investor returns.

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Once we account for fund flows it follows that, for a wide range of fees, fees in equilibrium affect neither investor returns nor manager payoff. Investors receive a normal rate of return in expectation—that is, the return obtained by investing in an index fund of similar risk. The reason for this is simple, if not necessarily obvious. Consider a mutual fund manager whose investment skills are such that he or she can be expected to generate a positive after-fees alpha. Naturally, investors eager to partake in the fund's over-performance will invest in the fund. As AUM grow, the manager's ability to generate a positive after-fees alpha diminishes. Still, investors can be expected to continue investing in the fund until the after-fees alpha equals zero and the return is normal. This occurs at a low level of AUM if fees are high and at a high level if they are low; but in either case investors receive a zero after-fees alpha.

And the manager? For the manager too the fee per franc of assets is irrelevant. Conversely to investors, the manager receives the entirety of the added value created in the form of total fees. Since the manager creates this value by possessing the ability to beat the market, none of it accrues to investors, because they invest in the fund until they have driven the rate of return down to the normal rate. Regardless of whether fees are high and AUM low, or fees low and AUM high, their product remains the same and exactly equals the value created by the manager.

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The full paper can be found at http://bit.ly/1TwxnYW.

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This says nothing more than that, under competition, fund managers can be expected to earn what economists have long understood as their Ricardian rents. Three assumptions underlie this reasoning. The first is that of competitive equilibrium: AUM will adjust to ensure that fund returns equal the normal rate. While this generally will not be exactly true, it is nonetheless a relatively good and unbiased approximation of reality.

The second assumption is that fees are neither too low nor too high. Fees that are too low are those that fail to cover those costs the manager cannot charge to the fund, such as the opportunity cost of his or her own effort; fees that are too high are those that leave AUM below the level at which the manager can exploit all the value-creating investment opportunities he or she has identified.

Most important is the third assumption, which is that there is no managerial moral hazard in the sense that the manager can be trusted to actively seek all value-creating investment opportunities. This ensures investors do not end up with consistent below-normal returns. In reality, the third assumption fails, but at the same time allows us to better understand the incentive structure of management fees. Identifying value-creating investment opportunities is very difficult. The manager might promise to engage in active management and instead index the entire portfolio while charging a high per-franc fee well in excess of the cost of passive management. This is well known, and is referred to as "closet indexing".

"A premium fee ensures that the manager captures the value he or she stands to create through active management."

Even in noisy markets closet indexing will eventually be discovered, but that may take a while, during which investors will earn the below normal returns that are the combined consequence of the zero alpha of passive management and the high fees of active management. One way to avoid such shirking is for the manager to charge a per-franc fee sufficiently high to bond the provision of active management. A premium fee ensures that the manager captures the value he or she stands to create through active management. This is the sense in which fees matter. They need to be at least as high as the minimum necessary to deter shirking. Because of the payout structure of fund fees, a per-franc premium fee—even if not very high—will deter the manager from shirking. This is because mutual fund fees are "back-end loaded". Managers are paid a recurring share of AUM. A one hundred franc increase in AUM as a result of active management yields, say, an additional fifty centimes per year as long as investors stay with the fund. Investors who believe they have been cheated can withdraw and leave the manager without his or her trailing fees. The discipline imposed by investors' threat to withdraw on discovering managerial shirking is a potent one because it imposes a capital loss on the manager. Thus, only a relatively modest fee premium is needed to deter shirking.

Why does all this matter? If heeded, repeated calls to drive down fees would at best be neutral; at worst such a move could be devastating for investors. Mandated fee reductions would be neutral when lower fees simply increase AUM without compromising managers' incentive to engage in active management. In such a case, investors would still receive the normal rate of return. Mandatory fee reductions would be detrimental when fees are driven down so low that the manager loses the incentive to engage in active management. Trust would be lost between investors and active managers, passive management would prevail, and price discovery would suffer.

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