

# The Trouble with MER: The Disclosure of Fees and Charges in Australian Superannuation and Investment Funds

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## Abstract

*Investors and advisers see the Management Expense Ratio (MER) as a useful means of comparing the cost of investing in one superannuation or investment fund against another.*

*This paper, however, contends that the MER is an unreliable and naive method of fee disclosure that does not allow a uniform comparison between funds. This is because there is no consistency in the definition of management expenses for the purpose of the MER calculation, and due to variations in the methods used to calculate funds under management.*

*In all, five significant issues are identified that reveal the MER is an unreliable tool for investment decision making. Using a hypothetical investment fund, the distortion on MER is illustrated between funds when taking account of differing asset valuation techniques, changes in the periodicity of fee calculation, and the growth in funds under management. This variance is evaluated using the Growth Distortion Model.*

*The paper proposes a new framework for fee disclosure, the Performance Cost Ratio, which overcomes the current deficiencies in Australian investment fund fee disclosure.*

*Keywords: Management expense ratio, investment performance, creative accounting*

## Introduction

This paper comprises seven sections. Section one looks at the important role of impersonal data disclosure in helping investors select from the 2,637 Australian sourced investment funds that have asset exposure to Australian equities. It finds that investors will rely on fund size, past performance, expense ratios, such as the Management Expense Ratio (MER), and, where available, a fund rating to assist them in making an investment decision. It also finds that the only disclosure that provides any valuable utility to an investor across all Australian investment funds is the MER.

Section two looks at trends in growth across the various styles of Australian investment funds by looking at projected growth in Funds under Management (FUM) across the three market segments: comprehensive, specialist and boutique. It finds that the boutique and specialist investment funds will experience high levels of growth as the market share of the dominant comprehensive investment fund contracts. It also finds that the fastest growing sectors of the Australian investment fund market have yet to standardise its fee disclosure.

Section three discusses how investment funds charge fees, and catalogues 17 unique fee typologies common among Australian sourced investment funds. It finds that the fees payable by an investment fund are numerous, and the methods used to calculate fees vary. It also identifies the issue of multi-variant fee structures, inconsistencies in the classification of fees, and poor quality in fee disclosure from investment funds, all of which presents a challenge for investors and regulators.

Section four looks at the recent efforts by regulators to increase consistency and transparency in the disclosure of

fees in investment funds, however, investors continue to rely upon expense ratios, such as the MER, as a primary tool for investment decision making.

Section five analyses the three common types of expense ratios: the MER, the Ongoing Management Charge (OMC) and the Total Expense Ratio (TER). It also identifies five issues in the calculation of expense ratios that make them an unreliable tool for investment decision-making.

Section six models a hypothetical investment fund to illustrate several alarming deficiencies in MER disclosure. These deficiencies distort the MER and are caused by the asset valuation technique used to value FUM, the periodicity of fee calculations and the rate of growth in FUM. These inter-relationships are explained in the Growth Distortion Model, and the paper hypothesises that investment funds may choose their method of MER disclosure to gain financial advantage by increasing the dollar amount of fees charged to the fund, thereby improving their profitability, or disclosing an artificially lower MER and gaining price advantage over comparable funds. The paper proposes a new framework for fee disclosure, the Performance Cost Ratio (PCR), which overcomes the current deficiencies in Australian investment fund fee disclosure. Finally section seven provides a conclusion for this paper.

## Section 1. Selecting an Investment Fund in Australia

Australian investment funds comprise a huge range of financial products, including managed investment schemes, superannuation funds and allocated pensions, retirement savings accounts (RSA), investment life insurance products and deposit products. Australia has more investment funds than

listed equities, and hundreds of new investment funds are being developed every year. During 2005, the *Australian Financial Review* database listed 2,637 Australian sourced investment funds<sup>1</sup> that have some asset exposure to Australian equities. In contrast, there are 1,679 companies<sup>2</sup> listed on the Australian Stock Exchange<sup>3</sup>. Simply, there are more than 1.5 times the number of investment funds investing in Australian equities than there are Australian equities. Given this enormous range of equity based investment funds, how can investors reliably choose the most appropriate one?

The purchase decision for an investor is complex, and is based upon multiple attributes derived from two principle information sources: *impersonal* sources (advertising, published fund performance statistics) and *interpersonal* sources (family and friends, financial planners)<sup>4</sup>.

Research into the buying behaviour of investors has observed that the impersonal performance-related variables are both the most important information source and selection criteria. Published performance rankings are the most important impersonal information source, and both historical investment performance and management fees are the two most common impersonal quantitative selection criteria for buyers of investment funds<sup>5</sup>.

In Australia, published performance rankings are a key criterion for investors making decisions regarding investment funds, and are widely available from newspapers, investment magazines, financial planners and the Internet. These rankings will generally provide qualitative data on four key performance metrics: (1) the fund size; (2) past performance; (3) the level of fees (MER) that may be payable by the investor; and (4) the funds rating by a reputable rating agency.

The Australian Financial Review Top Sector Performers table is typical of the format used by retail investors to compare the performance of investment funds. Here, the table includes the APIR<sup>6</sup> code and the name of the investment fund, as well as qualitative data on four commonly used investor metrics:

1. The fund size (FUM)
2. The investment performance over the past three months, one-year, three-year and five-year rolling periods
3. The estimated management expense ratio (MER)
4. Where the fund is rated by Morningstar<sup>7</sup>, the star rating

Given the important role that these metrics may have in the selection and retention of investment funds by retail investors, the utility of these disclosures will be briefly reviewed.

### **Fund Size**

The size of FUM in an investment fund is a key metric commonly used by investors to assist them in decisions regarding investment selection. Many investors believe that fund size has implications for future performance, and in particular the level of expected future transaction costs. These investors are of the view that size may act as a performance constraint in the long term for large equity funds and that smaller size funds should outperform larger size funds, after allowing for transaction costs. This view was popularised with Sharpe's law, which suggested that the probability of a large-

size investment fund achieving superior returns to the market must decline as their relative size increases<sup>8</sup>.

However, available empirical evidence is not consistent with this theory. Analysis of investment returns and fund size in Australia of actively managed equity investment funds over the period 1991-2000 finds no statistically significant performance differences between funds on the basis of portfolio size<sup>9</sup>. These findings are consistent with other reported results internationally, and suggest Sharpe's hypothesis, that performance will decline with an increase in fund size, is not supported empirically.

Given that small-size equity retail funds (typically the specialist and boutique funds) do not significantly outperform larger retail funds (typically the comprehensive funds), and portfolio size has been shown to be unrelated to portfolio performance, investors may be misguided in selecting investments based on the size of FUM.

### **Past Performance**

Despite the disclaimers issued by investment funds and regulators about past performance not being an indicator of future performance, investors do use past performance as one of their most important guides<sup>10</sup>.

Empirical research provides conclusive evidence that investors continually direct investments into funds that have had recent superior performance and out of those that have had recent poor performance<sup>11</sup>.

Past performance can be misleading because it may not take into account risk factors and general market conditions. It is also possible that past performance accounts for chance as equally as it does skill in measuring the performance of an investment fund<sup>12</sup>.

The ability to predict the future performance of an investment based on ex-ante information has been the topic of intense debate. The efficient market hypothesis<sup>13</sup>, implies that historical performance is no guide to future performance and that any excess performance achieved by an investment manager is the result of chance, not the skilful application of active stock selection techniques.

A growing body of empirical research continues to demonstrate that on both a raw and risk-adjusted return basis, prior annual performance has little influence on returns<sup>14</sup>. Therefore, investors may be misguided in selecting investments based on past performance.

### **Management Expense Ratio**

The Management Expense Ratio (MER) is an attempt to measure the ongoing management fees and expenses paid by an investment fund, as a percentage of the value of the fund's assets. It is widely used by investors and a key criterion in the selection of investment funds.

In line with the market efficiency notion, evidence suggests an inverse relationship exists between ongoing manager fees and investment manager returns<sup>15</sup>. Simply, investment manager returns decline with higher expenses, so investors should be mindful not to select managers with overly high ongoing fees.

Up-front fees (also called front-end load fees, establishment fees and contribution fees) are fees that may be payable upon initial investment in an investment fund. These

fees are not considered part of the ongoing fee structure of the investment fund, and tend to be excluded in the calculation of MER. Empirical studies show a significant negative relation between fund flows and fees, providing evidence that investors are sensitive to fees (in particular, up-front fees) and investors base their investment decisions largely on the amount of fees payable<sup>16</sup>.

This may prompt the question, “If fees don’t buy improved investment performance, what do they buy?” Rainmaker analysed the fees of 100 top Australian superannuation funds<sup>17</sup> and compared them to the number of investment options offered by each fund. Its findings suggested funds that charge higher fees typically provided a greater number of investment options. Some high-fee funds offered more than 250 investment options to each investor. They also found that investments that offered a greater number of investment options did not generate improved investment performance after the deduction of the higher fees. Simply, higher fees did not buy more investment performance; they bought only more investment options, which would appear to be, from the investor’s perspective, a non-value-adding extra.

With investors sensitive to the level of fees they pay to a manager for managing their investments, disclosure on the MER (and any other fees payable, such as up-front fees) helps to inform investors of the cost of the investment given the range of investment options. The MER lies at the heart of fund manager evaluation and is the central criterion for investors when making fund selections<sup>18</sup>.

### Rating Agencies

The final technique that assists investors in choosing an appropriate investment fund is a rating agency. Rating agencies play an important role in informing investors and their advisers about the performance of managed funds. The agencies may issue a rating or ranking that might be helpful in selecting an appropriate investment fund.

The analysis by the rating agency may include historical returns, qualitative factors regarding the investment manager, investment style, and estimates of fees and charges. Yet these agencies report only on a small sample of the total universe of Australian investment funds. For example Morningstar, the largest independent fund rating agency in Australia<sup>19</sup>, monitors the performance of 303 retail and 242 wholesale investment funds (total 545 funds), which are managed by 187 different investment managers. This coverage represents around 20 per cent of the total number of Australian sourced investment funds and is dominated by large-scale comprehensive investment

funds, with very little coverage of the specialist and boutique funds.

Despite the convenience that rating agencies may offer in the evaluation and selection of investment funds, their utility does not extend across the smorgasbord of choices available in the Australian sourced investment market. Accordingly, investors cannot rely exclusively on a rating agency to help evaluate or select investment funds, especially in the fast-growing specialist and boutique sectors of the market where these funds are not covered by the rating agencies.

Of all the impersonal information sources, the only disclosure that provides any valuable utility to an investor across all investment funds is the MER. Accordingly, the MER should be the key selection criterion for investors when making choices regarding investment funds. Next, this paper will examine trends in growth across the various types of Australian investment funds, and identify issues that affect the quality of fee disclosures.

## Section 2. Trends in Australian Sourced FUM

A major trend in recent years has been the growth in Australian sourced FUM mandated to boutique and specialist investment managers, and the market share contraction of comprehensive investments managers. Together these three management types comprise the entire Australian investment management market<sup>20</sup>.

In June 1996, comprehensive investment managers accounted for approximately 95 per cent of FUM. In June 2004, they accounted for 68 per cent of FUM and, by 2014, they are projected to account for only 47 per cent of Australian sourced FUM<sup>21</sup>.

Australian sourced funds under management are forecast to grow over the next 10 years, from \$928 billion in 2004 to just under \$3 trillion by 2014. This represents a CAGR (compound annual growth rate) of 12 per cent, driven three-quarters by investment performance and one-quarter by net inflows. Over this period, FUM mandated to comprehensive investment managers are forecast to grow by only 8 per cent CAGR, while specialist managers will grow FUM by 13 per cent CAGR, and boutique managers will grow FUM by 32 per cent CAGR (see Table 1)<sup>22</sup>.

It is estimated that over the next 10 years, investment inflows directed to the specialist and boutique sectors will exceed 170 per cent of the dollar amounts directed to the comprehensive sector over the same period. With such a high proportion of investment inflows targeted to the smaller

Manager type	2004 actual		2014 projection		CAGR
	FUM (\$ billion)	Market share	FUM (\$ billion)	Market share	
Comprehensive	629	68%	1,395	47%	8%
Specialist	250	27%	843	28%	13%
Boutique	49	5%	759	25%	32%
<b>Total market</b>	<b>928</b>	<b>100%</b>	<b>2,997</b>	<b>100%</b>	<b>12%</b>

Table 1 – Manager type FUM projections, market share and growth rates 2004 to 2014

specialist and boutique managers, a sector of the market that is not well covered by the rating agencies, investors will be increasingly more reliant on fee disclosure by these funds to guide them in their investment decisions.

Historically, the quality of fee disclosures has been poor regarding investment funds as a result of the myriad ways fees have been calculated and reported. The metrics used over time to report fee disclosures (especially the MER) have suffered from high novelty rates and low survivability rates<sup>23</sup>.

However, the quality of fee disclosures is gradually being improved, with a number of attempts by investment industry groups and regulators to standardise the ways in which fees are calculated and reported. In particular, the Investment & Financial Services Association (IFSA) has released guidelines for its members regarding the disclosure of ongoing fees<sup>24</sup>. IFSA comprises only 82 investment managers among its members<sup>25</sup>, and these are predominantly the largest of the comprehensive investment managers. This means that the fastest growing sector, the specialist and boutique managers, have yet to standardise their fee disclosures and methods for MER calculation.

During 2005, the Australian Securities and Investments Commission (ASIC) introduced several reforms that will affect the investment fund industry. These reforms are aimed at standardising fee classifications by using common definitions. This may improve disclosure on the types of fees levied by all investment funds, but it is unlikely to improve any inconsistencies in the methods underpinning MER calculation used by each investment fund, especially the specialist and boutique funds. The inconsistencies between investment funds in fee disclosure and issues affecting the reliability of MER calculations will be the focus of subsequent sections of this paper.

Australia has long suffered from complexities in fee disclosure<sup>26</sup>, as a result of variations in fee structures, inconsistencies in fee nomenclature and variations in methods of fee calculation. This has resulted in convoluted disclosure practices across investment funds and jeopardises the value that fee disclosure offers investors in making informed decisions about fund selection. As a result, the major implication of Australian regulators and industry bodies concerns the disclosure of fees and charges by providers of financial services<sup>27</sup>.

### Section 3. Investment Fund Fees

This section will discuss how investment funds charge fees, catalogue the various types of fees that may be levied and discuss some contemporary issues in the classification and selective disclosure of certain fees.

#### The Right to Charge Fees and Recover Costs

The responsible entity of a managed investment scheme (otherwise called an investment fund) is entitled to pay all costs, charges and expenses incurred in the proper performance of its duties in administering an investment fund out of the capital or income of the investment fund. This entitlement is granted under the constitution of the fund and legislated under the Corporations Act<sup>28</sup>. The wording regarding fees and charges in the constitution of any managed investment scheme is fairly liberal, allowing the responsible entity to use its discretion to charge fees and recover expenses from the fund as it sees fit<sup>29</sup>.

In Australia, the product disclosure statement (PDS) is the public offer document for the investment fund and is issued by the responsible entity. The PDS also contains information about fees and charges payable by the investor in making an investment in the fund. The law requires that the PDS must disclose the following information<sup>30</sup>:

- i. The cost of the product
- ii. Any amounts that will or may be payable by a holder of the product in respect of the product after its acquisition, and the times at which those amounts will or may be payable
- iii. Any amounts that will or may be deducted from the fund by way of fees, expenses or charges if the amounts paid in respect of the financial product and the amounts paid in respect of other financial products are paid into a common fund.

In practice, the actual fees payable by the investor are not disclosed in the PDS. Rather, a selection of estimated fees is shown as a percentage of estimated FUM, and the dollar amount of these selected fees is approximated using a hypothetical investment scenario (\$10,000, for example, assuming a constant investment value for a one-year term). This level of disclosure is inadequate as it will understate the amount of actual fees that are payable by the investor, because the selective of fees included in the sample does not include all of the numerous fee types payable by the investor.

#### Types of Fees

To determine the exact number of fees and charges that are payable by an investor, primary research was conducted using a sample of 50 PDS relating to various types of superannuation and managed investment funds. Each PDS was reviewed and the types of fees and charges were catalogued using a coding system that distinguished the following fee functions: (a) relating to investment management; (b) relating to financial advice; (c) relating to administration of the investment product; (d) relating to administration of the fund; (e) relating to taxes and government charges. The prospectuses were selected at random, all prospectuses were current, and all had been issued by well-known product issuers<sup>31</sup>.

The research found that there are 17 unique fee types common among Australian sourced investment funds (see Table 2). These fees are charged as either a percentage or a flat dollar amount, and they may be levied on a one-time, recurring or per transaction basis. They may be charged to the account of an individual investor or levied against the investment fund as a whole. Investment funds levy different combinations of these fee types and not all fee types are used by all investment funds. Also, the nomenclature of the fee type changes between investment funds, but the intention of the fee is the same.

In analysing the table of fee types above, it is apparent that investment manager fees (number 4 in the list of 17 fee types) make up only the minority of total fees charged to an investor in a fund<sup>32</sup>. This has implications for investors in that the disclosure of fees by many investment funds tends to be centred on investment manager fees rather than total fees.

Also, the diversity in fee structures (including the number of different fee types and the use of descriptions in different ways) presents a barrier to achieving standard terms<sup>33</sup>. This

	Fee type	Description of fee
1	Establishment fee	a fee to set up an account in the fund
2	Contribution fee	a fee to deposit initial and subsequent investments into the fund
3	Adviser service fee	a fee charged by an investment adviser for advice about investing in the fund, which may also include a recurring asset commission to the adviser for the term of the investment
4	Investment manager fee	a fee paid to an investment manager of the fund
5	Performance fee	a fee paid to an investment manager of the fund for any out performance
6	Ongoing fee	a fee to cover asset administration, custody, trustee services, Master Trust fees, IDPS and WRAP fees
7	Issuer fee	a fee paid to the product issuer for overseeing the fund's operations and/or for providing access to the fund's investment options
8	Administration fee	a fee to cover the general administration of the fund
9	Member fee	a member account-keeping fee charged by the fund
10	Taxes and duties	expenses relating to stamp duties, superannuation tax, capital gains tax and taxes on investment income
11	Insurance fee	a fee to cover insurance policies and premiums that may be offered to the investor (usually only available where the underlying investment product is a superannuation fund or allocated pension)
12	Annuity fee	The fees deducted from term-certain and lifetime annuities prior to the quoting of the purchase price, and income payment charges applied to each payment under an annuity or pension product
13	Expense recovery	out-of-pocket expenses entitled to be recovered from the fund, such as audit fees, compliance fees and communications
14	Switching fee	a fee charged to switch between investment options offered by the fund
15	Buy/Sell spread	a fee to recover any transaction costs of buying and selling underlying investments as a result of investing or withdrawing from the fund
16	Low account preservation fee	a fee charged within a superannuation fund or allocated pension for any costs associated with protecting the assets of members with low account balances
17	Exit fee	including termination fees, terminating plan charges, terminating member charges, withdrawal fees, early redemption fees, and handling fees for each withdrawal from the fund and/or the closure of an account

**Table 2 – Common fee types levied in Australian sourced investment funds**

impacts the way in which fees are defined and disclosed by different funds, and ultimately erodes the usefulness of investment fund fee disclosure, such as the MER. One issue that has significantly eroded the usefulness of fee disclosure is the confusion between fees and costs.

#### **Fees vs. Costs**

One argument that has recently emerged, and is resulting in ambiguity in investment fund fee disclosure, is the distinction between a *fee* and a *cost*. Proponents are suggesting that a fee is a charge levied directly against an investor's contribution or their individual account; while a cost is an expense that is levied against all the assets in the fund as a whole.

The obvious result from this interpretation is that if only the fees are required to be disclosed in any detail, and the fund is able to categorise a greater volume of its expenses as costs, then surely the fees of the fund are less? This proposition is misleading and the argument does not hold true, simply because the quantum of fund expenses has remained the same, only the classification between fees and costs has changed.

Irrespective of whether an expense have been allocated to the fund as a whole or apportioned to an individual's account, the fact remains that the expense has been appropriated out of the income and/or capital of the investment fund. The effect of the fee is immediately passed on to the investor in the form of a lower unit price and a lower rate of return. As the price

of a unit in an investment fund is reported on an ex-fee basis, expenses that are charged directly to the assets of the fund as a whole will wash through and typically go unnoticed by the investor as they will not be identified on the investor's periodic statements. Only expenses that are charged directly to an individual investor's account will be disclosed on their periodic account statements with some detail. Consider the following example of disclosure in an investor's periodic statement where an investor has an initial balance of \$100,000 and the fund earns a 10 per cent return before all fees and costs:

In example 1, the fund is showing all fees and costs incurred. However, if one took the view that the first three outgoing (investment, fund and manager) were not *fees*, but, rather, costs that should be charged directly to the fund, the investor's periodic statement could be presented as follows:

<i>Opening balance</i>		<i>\$100,000</i>
<i>Fund earnings</i>		<i>10,000</i>
<i>Expenses</i>		
1. <i>Investment</i>	<i>\$800</i>	
2. <i>Fund</i>	<i>\$1,075</i>	
3. <i>Manager</i>	<i>\$500</i>	
4. <i>Account keeping</i>	<i>\$100</i>	<i>(2,475)</i>
<i>Closing balance</i>		<i>\$107,525</i>

**Example 1**  
**Disclosure of all fees and costs in investor's periodic statement**

It is clear from example 2, that while the closing balance is the same, the investor has been misled over the total fees incurred where they are charged directly to the fund.

<i>Opening balance</i>		<i>\$100,000</i>
<i>Fund earnings</i>		<i>7,425</i>
<i>Expenses</i>		
1. <i>Account keeping</i>	<i>\$100</i>	<i>(100)</i>
<i>Closing balance</i>		<i>\$107,525</i>

**Example 2**  
**Disclosure of fees only in investor's periodic statement**

Without standardisation regarding the disclosure of fees (and costs), many funds have repositioned the marketing of their investment products and now promote themselves as low-fee investment funds. For example, three leading superannuation funds REST, STA and Sunsuper, who have combined membership of 2.5 million, or one-quarter of all Australian workers, and \$18 billion in superannuation assets<sup>34</sup>, all claim to have lowered their fees. Upon closer inspection, perhaps what they really mean is that the expenses associated with running the fund are deducted from the funds investment earnings (and capital) prior to the declaration of unit prices,

thus ensuring that a whole range of fees are no longer charged directly to the investor's account.

The PDS of these funds will certainly give an indication of the range of estimated fees likely to be paid on behalf of the investor, and given the fund's constitutional privilege, it will recover the actual cost of managing the fund whether higher or lower than these originally estimated. So, in some low-fee investment funds, the majority of expenses are paid by the fund as a whole, where there is very limited (or no) disclosure on the individual investor's account statement, and only a small (or no) fee is charged directly to the investor's account where there is disclosure on the investor's periodic statement.

Notwithstanding, the total operating expenses of the investment fund will be disclosed in the fund's annual report, so it possible to reconstruct the actual fees paid and estimate the average fees payable where the fund has made meaningful disclosure regarding the amount of FUM. But this is a cumbersome task and complicated by the fact that few investment funds list their fees on statements in the same way as banks or other businesses<sup>35</sup>.

The argument around fees and costs seems spurious at best, yet any uncertainty about the classification of expenses has very real implications for distorting fee disclosure and compromising the ability to compare funds. Two other contemporary issues regarding fee classification and disclosure are *exit fees* (otherwise called terminations fees) and *trading costs*<sup>36</sup>. Both of these fees types will be examined below.

**Disclosure of Exit Fees**

While the impact of any exit or termination fee will differ on each individual investor's account, depending upon their term of investment, termination fees are a significant fee and often overlooked. For example, any simulation of fees by a product issuer in a product disclosure statement (PDS) used to illustrate the impact of fees on an investment, will typically include contribution fees and ongoing management fees, but will not include termination fees.

The lack of disclosure of termination fees will become especially problematic given the introduction of the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004*. From 1 July 2005, the Act allows some employees a choice in selecting the investment fund to which their superannuation contributions should be directed. While investment fund industry groups, such as IFSA, claim that fees and charges on superannuation funds are trending downward<sup>37</sup>, their analysis fails to take account of the contingent liability that exists for investors regarding termination fees. While investors have increasingly elected a lower contribution fee and/or ongoing fee, in lieu of a higher termination fee, the amount of fees *paid* would have fallen, which is consistent with the IFSA statement, but the amount of fees *payable* (i.e. the contingent liability) would have increased.

Given the problematic situation that the Choice of Fund Act will have on triggering a liability for some investors, ASIC recently commissioned an inquiry into termination fees in superannuation funds<sup>38</sup>. ASIC estimated that 550,000 superannuation investors are subject to *significant* termination fees if they try to move their money out of these funds. ASIC has estimated that the contingent liability for superannuation

investors is currently sitting at approximately \$950 million. This fee would be payable if the investors were to exercise their choice in changing superannuation funds in accordance with the new legislation. This termination fee is approximately \$1,700 per investor, and given the average size of an investor's account subject to termination fees is \$30,000<sup>39</sup>, this termination fee would represent 5.67 per cent of the investor's account balance.

### Disclosure of Trading Costs

A cost that is not included in Table 1 (above) is *trading costs*. Nevertheless, every investor in an investment fund will pay trading costs. Trading costs include brokerage and commissions paid by the fund for buying and selling stocks, bonds and other securities. These costs will not appear on the investor's periodic statement, but the cost is charged against the fund assets and removed from the total rate of return.

In the United States, the Securities Exchange Commission (SEC) requires disclosure by mutual funds of the amount of brokerage and commission paid. Each fund is required to lodge a Statement of Additional Information (SAI), the contents of which the SEC has determined is not necessary in the interests of investor protection but may be useful to those seeking more detail<sup>40</sup>.

Item 16 of the SAI deals with brokerage allocation and other practices, and requires each fund to disclose:

1. The aggregate amount of any brokerage commissions paid by the fund during the previous 3 fiscal years
2. The aggregate dollar amount of brokerage commissions paid by the fund during the three preceding years to any broker affiliated with the fund directly or via another person affiliated with the fund

Currently, there is no requirement for an Australian investment fund to make any disclosure regarding trading costs, despite these costs being a material cost to the fund.

Investment funds that engage managers whose strategy is to buy and sell frequently (trading frequency) will incur higher trading costs. This trading frequency is reflected in the fund's turnover rate, which in 2004, was 126 per cent for the average stock fund in the United States<sup>41</sup>.

In 2002, researchers investigated the trading costs across 5,000 equity funds in the United States and concluded that trading costs are a significant expense that are not disclosed in funds' expense ratios<sup>42</sup>. They found that trading costs averaged: 43.1 per cent of stated expense ratios for large-cap growth funds; 86.0 per cent for mid-cap growth funds; and 123.2 per cent for small-cap growth funds. The study found that trading costs for value funds are lower than growth funds.

A later study in 2004<sup>43</sup> of trading costs across 3,753 mutual funds in the United States also found that these costs are significant on top of fund expenses, and in more than 100 funds, the trading costs exceeded the funds' operating expenses. This study also found that many funds use a technicality in reporting the trading costs to avoid reporting these costs as an expense. In these cases, the fund would choose to capitalise the cost of the brokerage and commissions as part of the purchase price of the security. This way the brokerage and commissions are not technically recorded as an expense, rather they become an asset. Upon the disposal of the subsequent security, the

fund would choose to recognise only the net proceeds (after brokerage and commission) of the sale, again avoiding the recording of the brokerage and commission expense in the accounts of the fund<sup>44</sup>.

The disclosure of trading costs is significant because many funds will choose to pay higher brokerage and commission rates in the hope they will participate in future corporate actions managed by the broker (such as placements and IPOs), attend broker sponsored meetings and conventions, and receive complimentary or subsidised data, analytics and propriety research. These so-called soft dollar arrangements are also a convenient way to keep management expenses off the books of the investment fund<sup>45</sup>.

Trading costs are a necessary cost for many investment funds. Edelen (1999) observed trading costs incurred in a fund are in part related to the provision of liquidity in the fund, to allow for withdrawals by investors and payment of fund expenses<sup>46</sup>. Chalmers et. al. (1999) concluded that while trading costs are less visible than other fund expenses, they are large (on average 0.78 per cent of fund assets), they have a substantial cross-sectional variation across fund types, and they are an important cost to be considered when analysing investment funds. What is more significant, they found that trading costs are negatively related to fund returns and that there is no evidence that on average trading costs are recovered in higher gross fund returns<sup>47</sup>.

### Section 4. Regulatory Approaches to Fee Disclosure

The issue of multi-variant fee structures, inconsistencies in the classification of fees and poor quality in fee disclosure from investment funds presents a challenge for investors and regulators alike. This section will review the approaches that regulators have taken to improve fee disclosure, and comment on the amendments to law aimed at standardising fee disclosure in investment funds.

#### The Regulator's Approach to Fee Disclosure in the United States

In the United States, the Securities and Exchange Commission (SEC) regulates the US\$7 trillion mutual funds industry. A major industry failing was the unwillingness of investment funds to break down expenses so that investors can determine how much they are spending on fees and for what purpose. John Bogle, the former CEO of Vanguard Group, estimated that in 2002, US investors spent US\$72 billion on mutual fund fees<sup>48</sup>. Bogle also estimated that of these fees, only \$5 billion (7 per cent) is spent on researching stock, bonds and money market instruments, the expertise for which consumers pay a premium<sup>49</sup>.

In January 2001, the SEC released its report on Mutual Fund Fees and Expenses<sup>50</sup>. This report presented the results of a two-year study by the Division of Investment Management of trends in mutual fund fees and expenses and included recommendations on the oversight of fund fees and the disclosure that investors receive regarding fees.

As a result of this report, the SEC adopted several amendments to its rules<sup>51</sup> aimed at improving the disclosure of mutual funds and other registered managed investment companies. These improvements included:

- i. Disclosure of total expenses borne by shareholders

- ii. The cost in dollars associated with an investment of \$1,000 based on the fund's actual expenses
- iii. The cost in dollars associated with an investment of \$1,000 based on the fund's actual expense ratio for the period and an assumed return of 5 per cent per year

#### The Regulator's Approach to Fee Disclosure in Australia

In 2002 Australia, ASIC commissioned Professor Ian Ramsay to prepare a report entitled *Disclosure of Fees and Charges in Managed Investments: Review of Current*

*Australian Requirements and Options for Reform* (the Ramsay Report)<sup>52</sup>.

ASIC's Ramsay Report is part of its ongoing commitment to ensure that the objectives of the Financial Services Reform Act 2001 are being achieved. The report focused upon one aspect of disclosure – disclosure of fees and charges in Product Disclosure Statements and member or investor periodic statements. The report also proposed a number of options for improved disclosure.

In July 2003, ASIC released its policy response, *A Model for Fee Disclosure in Product Disclosure Statements*

Significant fees	Ongoing fees
<b>Establishment fee:</b> This is the fee to set up your account in the fund.	<b>Administration fee:</b> This is the fee to cover the general administration of the fund.
<b>Contribution fee:</b> This is the fee for the initial and every subsequent investment you make to the fund (or that may be made on your behalf, e.g. by an employer).	<b>Investment management fee:</b> This is the fee for managing the fund's investments.
<b>Withdrawal fee:</b> This is the fee charged for each withdrawal you make from the fund (including any instalment payments and your final payment).	<b>Issuer fee:</b> This is the fee for the product issuer's services in overseeing the fund's operations and/or for providing access to the fund's investment options.
<b>Termination fee:</b> This is the fee when you close your account with the fund.	<b>Expense recoveries:</b> This is an estimate of the out-of-pocket expenses the trustee is entitled to recover from the fund.
<b>Ongoing fees:</b> This is the total of all ongoing administration, investment management, expense recovery and other fees charged by the fund.	<b>Member fee:</b> This is a member account-keeping fee charged by the fund.
<b>Switching fee:</b> This is the fee charged when you switch between investment options offered by the fund.	
<b>Adviser service fee:</b> This is the fee charged by your adviser for advice about your investment(s) in the fund. (An adviser may also receive other amounts as commission.)	

Table 3 – ASIC fee disclosure templates (Source: ASIC, 2003, pp. 23-24)



for *Investment Products*<sup>53</sup>. A key feature of this voluntary disclosure model is a table of “significant and ongoing fees”. The purpose of this table is to disclose fees in an easy-to-understand, comparable format and ensures the following key aspects are covered:

- i. What the fee is for,
- ii. The amount of the fee, in dollars preferably or if a percentage-based fee applies, illustrated by a dollar example,
- iii. How/when the fee is charged (e.g. against assets, against contributions).

The ASIC fee table template reflects a compromise position (among industry stakeholders), where the most common significant fees are included, with preferred nomenclatures, and a short description of the fee’s purpose<sup>54</sup>. The fee disclosure model sets out good practice for the disclosure of fees in a discreet section of a Product Disclosure Statement<sup>55</sup>.

The table of “significant and ongoing fees” would include the following 12 fee types and disclosure about the amount payable, and how and when it is paid:

The ASIC fee table template does not encourage any separate disclosure about the following common fee types:

1. Performance fee
2. Taxes and duties
3. Insurance fee
4. Annuity fee
5. Buy / sell spread
6. Low account preservation fee

ASIC’s disclosure model also allows the investment fund to report its fees either gross or net of tax, provided the basis is stated and applied consistently<sup>56</sup>. While it is not always apparent to the investor whether the fees described in a PDS are gross or net of tax, separate disclosure on this issue will be useful. However, given the complexity of Australian taxation legislation, the investor is faced with an impossible task when attempting to compare the fees between investment funds when some funds disclose their fees gross and others net of tax.

The ASIC fee template may not be a perfect disclosure framework, but it is a step towards standardising the way funds describe and disclose their fees. Its introduction has already had a significant impact in the superannuation sector. For example, 29 not-for-profit public-offer superannuation funds now declare ongoing fees through the template that in many cases were previously undeclared<sup>57</sup>.

#### **Amendments to the Corporations Act 2001**

The Corporations Amendment Regulations 2005 are the latest amendment to the *Corporations Act 2001* (Cth) and are aimed at standardising fee disclosure across investment funds. These changes commenced from 1 July 2005 for Superannuation funds and 1 July 2006 for Managed Investment funds. The amendment focuses on Schedule 9 of the Corporations Act as part of the Choice of Fund legislation and requires the PDS of all investment funds to include standardised fee disclosure, examples of fee calculations, and a consumer advisory warning alerting readers to the compounding impact that fees will have

on their investment.

The standardised fee disclosure in Part 2 of the Regulation is based on the ASIC fee template<sup>58</sup> and is intended to simplify the disclosure of the fees and costs and allow for more effective comparison across investment products. In addition, the regulations require the issuer of the PDS to show an example of the likely fees payable. This example assumes an investment of \$50,000 with a balanced investment option, plus a one-off contribution of \$5,000 during the year. The example is intended to allow a like-for-like comparison of fees between different PDS, but this example scenario may not be representative of the size, style or timing of the transaction the investor is likely to make, and, as such, the fees shown in the example may be significantly different. In response to this scenario and the unpredictability of fees based on fund performance and as well as other investor-specific requirements, the legislation now requires that a consumer advisory warning be included at the beginning of the fees section in the PDS. The warning is intended to highlight to the investor the variability in actual fees based on each investor’s circumstances, and invites the reader to visit the ASIC website<sup>59</sup> to use its Fee Calculator to “help check out different fee options”.

The outcome of this new legislation seems to be a push towards disclosing to the investor the likely fees and charges that could be incurred based on a hypothetical investment scenario. Couching all of this with a consumer advisory warning gives no comfort to the investor, rather, it suggests that the legislators have erred in their approach to fee disclosure, and the best they can do is to put a warning on the front of each PDS. The likely short-term beneficiaries of these changes to the law will be the printers of the PDS who have just been given a mandate to add many more pages of fine-print and complex language to a document that many retail investors would already find extremely difficult to navigate and understand.

It is too early to tell if these legislative changes will increase transparency in the disclosure of fees in investment funds or have a positive impact on consumers by allowing a more informed decision on the cost of making an investment. During 2006, Australia will be in a transition stage as this new legislation comes into effect. In the meantime, investors will continue to rely upon expense ratios (such as the MER) as a primary tool for their investment decision-making. The next section identifies issues in the calculation of expense ratios that limit their usefulness for investment decision-making.

#### **Section 5. Issues in the Calculation of Expense Ratios**

An expense ratio is a disclosure of a fund’s operating expenses, expressed as a percentage of its assets. From the perspective of an investor, it is desirable to invest in funds with lower expense ratios, as these funds will be able to distribute a higher proportion of earnings back to the investors when compared with a similar performing fund that has a higher expense ratio.

Expense ratios are widely used by investors and their advisers, and are a key criterion in the selection of investment funds<sup>60</sup>. There are three common types of expense ratios: the management expense ratio; the ongoing management charge; and the total expense ratio.

This section explore the three common types of expense ratios and identifies issues that affect the reliability and utility

of expense ratios as a means of comparing expenses across different investment funds.

### Management Expense Ratio (MER)

The Management Expense Ratio (MER) is intended to provide a measure of ongoing costs and expenses. It is an attempt to measure the *additional* ongoing costs arising from investing in an investment fund. Consequently, the MER excludes a number of significant fees, in particular: entry and exit fees (as these are not ongoing costs); government taxes and charges, unless a direct investor would not have paid these; transaction costs, such as brokerage and stamp duty, as these would be incurred by a direct investor; and operating costs and expenses that would be incurred by a direct investor in the case of property investments, repair, maintenance and refurbishment costs<sup>61</sup>.

Many funds, especially the specialist and boutique managers, may also exclude performance fees from the calculation of MER as these fees are contingent upon exceeding a performance benchmark, and are not deemed an ordinary operating expense.

As the MER is selective in its classification of management expenses, only a fraction of all the expenses will be included in the calculation. This means that the MER will always understate the actual fees payable by the consumer. For multi-optioned retail products, where a wide range of fees is payable depending on the investment option, the MER will reflect only investment management costs, which might be only one-quarter of the total costs paid by a consumer<sup>62</sup>.

This partiality regarding fee identification and inclusion creates significant integrity issues for the MER, in that the definition of what is deemed a relevant fee is at the discretion of each investment fund and, as such, there is significant variation in what the ratio represents and how it is calculated<sup>63</sup>.

However, this substantial deficiency regarding fee disclosure has not stopped the popularity of this ratio. The MER has been in use in Australia for more than 15 years, and similar operating expense ratios are used in other countries such as Canada, New Zealand and the United States. Despite its persistence and popularity as a key ratio for investment funds, there continues to be a great deal of variety in the way in which fees are selected for inclusion in the ratio, and how the MER is calculated.

The MER can be calculated using a formula similar to Equation 1, below:

$$\text{MER} = \frac{\text{ME}}{\text{FUM}} \quad (1)$$

and is expressed as a percentage, where:

“FUM” is the net value of the funds under management

“ME” is the amount of relevant management expenses charged for the year

There are many alternatives that are used to calculate MER, all of which will result in a different value. Apart from the plethora of alternatives for calculating ME (management expense) there are also alternative measures of FUM (funds under management). These alternatives include:

**Method A – Average net asset value:** the fund’s average value during the year, determined by mean average of net asset valuations made during the year

**Method B – Net asset value:** the fund’s net asset value at the end of the period

There is also the opportunity for a geared fund to use the gross asset values to calculate its MER. For example, if investors have contributed \$10 million to a fund that maintains a gearing ratio of 50 per cent, then the gross assets of the fund would be \$20 million. Electing to use the gross asset value as the denominator in the MER equation would have a substantial and diminutive effect on the disclosed MER.

In 1999, IFSA, introduced the first version of its IFSA Standard No. 4.00, which specifies the principles to be adopted by its members when calculating the ongoing fee measure (OGFM), a variation of the MER. The OGFM technique for calculating the expense ratio relies on the average net asset value of the fund as described in Method A, above.

The IFSA Standard uses the following two-step calculation to determine the total ongoing fees as a percentage of assets:

#### Step 1

$$\text{E}(\%) = \text{investment management fee}(\%) + \text{administration fee}(\%) + \text{performance fee}(\%) \quad (2)$$

Where:

$$\text{E}(\%) = \text{the Expense Fee}(\%)$$

#### Step 2

$$\text{Fee}(\%) = \text{E}(\%) + \left( \frac{\text{OE} + \text{RE} - \text{ITC}}{\text{AV}} \right) \times 100 \quad (3)$$

Where:

$$\text{AV} = \text{Average Scheme Size}$$

$$\text{E}(\%) = \text{the Expense Fee}(\%)$$

$$\text{Fee}(\%) = \text{Total fees as percentage of assets}$$

$$\text{ITC} = \text{Input Tax Credits}$$

$$\text{OE} = \text{Other Expenses}$$

$$\text{RE} = \text{Recovered Expenses}$$

Step 1 of the model (Equation 2) includes the *direct* costs as a percentage fee. Step 2 (Equation 3) of the model converts the *indirect* dollar costs to a percentage by dividing by the average FUM – this second calculation is commonly referred to as the *indirect cost ratio*.

In calculating the average scheme size (AV), above, IFSA uses an *average* asset value approach and, where the fund is geared, the fund can elect to calculate the MER on either a gross or net value. However, increasing the denominator by using the gross value of assets will have the effect of reducing the indirect cost ratio and understating the OGFM expense ratio.

### Ongoing Management Charge (OMC)

The ongoing management charge (OMC) is the only expense ratio that is defined in Australian law and used in superannuation fund disclosures. Other investment funds (such as managed investments and deposit accounts) do not use this method.

*Schedule 10 of the Corporation Regulations* (2001) provides a definition OMC and sets out in detail how the OMC is to be calculated and disclosed in the PDS of a superannuation fund. The OMC is calculated in Equation 4, below:

$$\text{OMC} = \frac{\text{MC}}{\text{AV}} \quad (4)$$

and is expressed as a percentage, where:

“AV” is the average value of the net assets of the fund or product during the year of income, worked out in the following way:

- (a) Add each of the net asset valuations made during the year of income
- (b) Divide the result by the number of valuations added in (a) above

“MC” is the amount of ongoing management charges charged for the year of income.

Here, the dominator is clearly defined in the regulation and it is calculated using the average net asset value as described in Method A, above.

The definition of management charges (MC) for the purpose of OMC is selective and specifically excludes the following charges: contribution charges; death and disability insurance charges; exit charges; switching charges; any charges paid or payable by an employer-sponsor of the fund; or any charge that is made for a service requested by the investor. However, unlike the MER, the OMC does include brokerage in the calculation of total management charges.

A Parliamentary Joint Committee issued a report that included substantial criticism from consumer and industry groups regarding the calculation of the OMC<sup>64</sup>. Some of the major issues raised before the committee related to the selective approach used to determine which fees are included in the calculation. Concerns were also raised about the usefulness of the OMC where it does not capture entry and exit charges. These charges are often significant and they can have a severe impact on potential returns to the investor, and their exclusion may therefore underestimate the costs of the superannuation product<sup>65</sup>.

Another concern related to differing terminology used by superannuation funds to describe their fees and the distinction made between *fees* charged to members and fund *costs*. While the regulations refer to *fees*, they do not refer explicitly to fund *costs*. This subtle distinction between these notions can lead to ambiguities because a superannuation fund can claim lower fees because more of its costs are paid by the overall fund. From the investors' perspective, there is no material difference between fees and costs because they all affect members' returns. This issue can cause difficulty in assessing the true cost of investing in a superannuation fund<sup>66</sup>.

### Total Expense Ratio (TER)

The *total expense ratio* (TER) is the model proposed by the International Organisation of Securities Commissions (IOSCO) to disclose costs in investment funds. The TER is calculated in much the same way as the MER and the OMC in that it represents the total amount of selected expenses and expresses them as a percentage of fund assets. However, the TER has a much broader definition of expenses than the MER and the OMC in that it includes entry fees, performance fees and exit fees in its calculation. Still, the TER does not include transaction costs, brokerage costs and buy-sell spreads in its calculation.

Equation 5 shows the calculation of TER :

$$\text{TER} = \frac{\text{TE}}{\text{AV}} \quad (5)$$

and is expressed as a percentage, where:

“AV” is the average value of the net assets of the fund or product during the year of income, worked out in the following way:

- (a) Add each of the net asset valuations made during the year of income
- (b) Divide the result by the number of valuations added in (a) above

“TE” is the total relevant expenses charged for the year of income

The TER technique for calculating the expense ratio relies on the average net asset value of the fund as described in Method A, above.

While the TER assumes a much broader definition of expenses in its calculation, it should be noted that the actual fees paid by an investor are likely to differ from the published MER, OMC or TER. Therefore, all of these ratios can be misleading and they need to be used cautiously<sup>68</sup> because they report the estimated expense of an average investor, rather than the actual expenses borne by an investor.

Another definitional issue regarding fees that is common across all the expense ratios is the treatment of taxation expense.

#### Impact of Taxation of Fee Disclosure

Currently, there is no consistency in the disclosure of the taxation impact on fees. As a result, some investment funds quote the gross fees and others quote fees net of tax. For example, in a superannuation fund where the disclosure of fees is made on a net-of-tax basis, a 1.0 per cent p.a. gross management fee could be expressed as 0.85 per cent p.a. net-of-tax fee (assuming 15 per cent tax rate on a superannuation fund). The issue for the investor is those funds that disclose their fees on a net-of-tax basis will appear to be cheaper than those that disclose the gross fees.

For those funds disclosing their fees net-of-tax, the calculations are usually made by assuming the maximum rate of tax, even though the actual tax rate can be different due to accounting adjustments<sup>69</sup>. Therefore, the net-of-tax disclosure may be inappropriate given the actual taxation liability of the fund, and the unique circumstances of the individual. Also, the

Fee types	MER	OMC	TER
Entry fees	NO	NO	YES
Exit fees	NO	NO	YES
Brokerage and transaction costs	NO	YES	NO

**Table 4 – Inclusion of common expenses types in the calculation of expense ratios**

net-of-tax disclosure does not reflect the actual amount charged by the investment fund.

Ensuring that only gross fees are used in disclosure would improve the comparability of fees disclosure between investment funds as all funds would report on a consistent basis without the impact of tax. It would also ensure that the disclosure reflected the amount the investment fund was actually paid.

#### Summary of expense ratios

The MER, OMC and TER are fundamentally calculated the same way – relevant expenses divided by fund assets. The difference between each of these ratios lies in the determination of relevant expenses, and these differences can be summarised in Table 4, below:

While ambiguity in the definition of expenses undermines the reliability of expense ratios as a useful disclosure of fees, a much more alarming deficiency in expense ratios is the distortion created by the growth in FUM over time, particularly where the fund calculates the MER based on *actual* assets rather than *average* assets. This is examined in Section 6 below.

#### Section 6. Distortions in the Calculation of MER

There has been much attention placed on the disclosure of fees in Australian investment funds over the past few years<sup>70</sup> and staggered amendments to the Corporations Regulations during 2005 and 2006. These reforms are intended to improve the disclosure of fees in PDSs and periodic statements. However, investors continue to rely upon fee disclosure, in particular the MER, as a key criterion for investment decision making.

One of the issues affecting the reliability of MER to compare one fund with another is the lack of a consistent treatment for management expenses: gross or net of tax; inclusive or exclusive of performance fees. Another issue is the inconsistency in the way that the fund assets are measured: gross assets or net assets; average assets or actual assets. Yet there is another factor at play that undermines the reliability of MER, and that is the hidden impact of growth in FUM over time where the MER is calculated using actual assets as the measure of fund assets.

An investment fund will grow its assets (FUM) from two principle sources: *net inflows* and *investment performance*. Net inflows is the dollar amount of surplus new investment into a fund after deducting any withdrawals and redemptions. Factors that contribute to a growth in net inflows include, among other

things, a strong economy, high levels of employment and compulsory superannuation. Investment performance will also grow the FUM through a surplus of income over expenses, plus a surplus of realised and unrealised capital gains in the fund. Investment performance is contingent upon timing and an array of market factors, but over the past 15 years, the Australian sourced investment fund market has averaged about 9.3 per cent per annum<sup>71</sup>.

It is predicated that over the next 10 years, this market will grow on average by 12 per cent per annum, driven one-quarter by net inflows and three-quarters by investment performance<sup>72</sup>. However, as identified in Table 1, while the entire market is predicted to grow at this average rate, various segments should experience different growth rates. Comprehensive investment managers are forecast to grow FUM by 8 per cent; specialist managers are forecast to grow FUM by 13 per cent; and boutique managers are forecast to grow FUM by 32 per cent CAGR over the next 10 years.

The growth in FUM over time can create a distortion in the MER calculation and where the growth is positive (as is the case), the reported MER will decrease. This hypothesis will be illustrated by comparing two popular MER calculation techniques and modelling the various predicted growth rates for the Australian investment sector.

Firstly, two methodologies that are widely used for calculating MER are: (A) the accrued management expense divided by the average net asset value; and (B) the accrued management expenses divided by the net asset value. These will be referred to these Method A and Method B respectively.

#### Method A – average net asset value

The Method A calculation of the expense ratio divides the relevant expenses by the average net asset value determined by the sum of each net asset valuation and dividing the result by the number of valuations made during the period. This methodology for valuing the FUM is the same method that is prescribed by the OMC (Equation 4) and the TER (Equation 5). In addition, this method is also used in the OFGM (Equations 2 and 3), the method described in IFSA Standard No. 4.00. IFSA represents the funds management and life insurance industry with 82 full members who are responsible for investing \$790 billion<sup>73</sup> on behalf of more than nine million Australians. IFSA will direct its members to use this method when calculating the expense ratio.

**Method B – net asset value**

The Method B calculation of the expense ratio divides the relevant expenses by the net asset at the end of the period. This method is widely adopted by funds who are not members of IFSA and is the method described by the Association of Superannuation Funds of Australia (ASFA) in its Dictionary of Superannuation<sup>74</sup>. AFSA is the peak body representing Australian superannuation funds and trustees. Method B is also commonly used by the smaller specialist and boutique managers, as well as newly established investment funds that do not have actual historical performance and will estimate a MER in their PDS.

**The distortion in the MER**

Using Method A and Method B the impact of growth on MER calculations will be modelled on both a monthly and a daily basis using the assumptions in Table 5:

Based on the assumptions in Table 5, the following results are derived at the end of one year:

An inspection of the results in Table 6, identifies that different periodicities in fee calculation will result in different asset values and differences in accrued fees. In the example above, calculating the annual growth with the largest number of compounding events over time (in this case, daily compounding) will result in a larger FUM at the end of the period. In the example, this translates to an increase of \$443. The results also find that calculating the average FUM with fewer numbers of asset valuations (in this case, 12 monthly valuations) will result in a higher average FUM. In this example an increase of \$4,011. Finally, the results find that accruing fees by using the least numbers of compounding periods (in this case, monthly compounding) will result in an increased amount of fee. In this example, an increase of \$80 in fees between the two methods.

Using the figures above, table 7 compares the MER disclosures for monthly and daily compounding under the two asset valuation methods:

Table 7 summarises the findings and confirms that Method A (average net assets) returns an accurate result of 2 per cent, however, Method B (actual net assets) understates the fund expenses by disclosing a MER of 1.912 per cent for monthly compounding and 1.904 per cent for daily compounding.

It would appear that Method A is a reliable method of calculation in that the MER that is disclosed (2.0 per cent) mirrors the actual accrued fees (2.0 per cent of FUM). However, Method B is an unreliable method in that it significantly understates the MER (by a factor of 4.8 per cent in the case of daily calculation). As the annual rate of growth in FUM increases, the MER will fall under Method B. This will be demonstrated below by modelling only Method B using the same assumptions in Table 5, and using the use the predicted FUM growth rates from Table 1:

Table 8 summarises the calculations assuming that the 2 per cent annual fee is calculated using Method B. It is clear that as the growth in FUM increases, the disclosed MER decreases. This means that funds who calculate MER using Method B will continually disclose a lower MER than a Method A fund, where the growth in FUM over the period is positive. Also, a Method B fund that accrues fees on a daily basis will be rewarded by disclosing an even lower MER.

Chart 1 shows the extent to which a 2 per cent MER under Method B would be understated by using the predicted growth from the different sectors. This distortion in the MER due to positive growth would allow a fund who chooses to disclose under Method B to either (a) increase the dollar amount of fees charged to the fund during the year and increase its profitability, or (b) continue to disclose a lower MER and gain a competitive advantage over comparable funds who have experienced lower growth or who are Method A disclosers. The findings from this research have found that the majority of the comprehensive funds are Method A disclosers, and the majority of fast-growing specialist and boutique funds use the inaccurate Method B model to calculate their MER.

Attribute	Assumption
Growth in FUM	FUM will grow at a constant rate of <b>10 per cent per annum</b> over the period.
Fund Fees	Total fees are accrued at the rate of <b>2 per cent per annum</b> of FUM calculated at the end of each period.
Opening FUM	The balance of FUM at the start of the period will be <b>\$1 million</b> .
Monthly Periodicity	Fees will be accrued at the <b>end of each month</b> . The annual growth rate of FUM and the annual fee rate will be <b>divided by 12</b> and these amounts will be the monthly equivalent.
Daily Periodicity	Fees will be accrued at the <b>end of each day</b> . The annual growth rate of FUM and the annual fee rate will be divided by <b>365</b> and these amounts will be the daily equivalent.

**Table 5 – Key assumptions used in comparative model**

### Growth Distortion Model

The impact of the positive FUM growth on distorting the MER can be modelled using the *Growth Distortion Model* in Equation 6 below.

$$\text{MER} = \frac{F}{g} \times \left[ 1 + \frac{g}{n} \right] \times \left[ 1 - \left( 1 + \frac{g}{n} \right)^{-n} \right] \quad (6)$$

and is expressed as a percentage, where:

“F” is the annualised accrued fund fee expressed as a percentage

“g” is the annualised growth in FUM over the period expressed as a percentage

“n” is the periodicity of fee calculations expressed as number of days

The Growth Distortion Model can calculate an increased fee rate (F) that could be charged to the fund which, after allowing for the distortion of the growth rate (g) and periodicity (n), would produce a target MER. For example, assuming the fund has a 2 per cent annual fund fee rate, it would be possible to accrue an amount larger than 2 per cent, yet still show a target MER of 2 per cent. Given the MER calculations in Table 8 above, the actual fee rate can be inflated to increase the MER yet still achieve a target rate of two percent. These results are summarised in Table 9.

Interpreting the results in Table 9, it is apparent that a fund with a positive growth in FUM can charge an actual fee rate significantly greater than its disclosed MER. Based on the earlier assumptions of accrued fees and growth rates, a comprehensive fund could charge 4.05 per cent more in fees, a specialist fund could charge 6.60 per cent more in fees and a boutique fund could charge 16.80 per cent more in fees, while

still reporting a MER of 2 per cent under Method B.

To allow a meaningful comparison of the MER between investment funds, an investor would be required to identify whether the MER is calculated using average net assets (Method A) or actual net assets (Method B). Where Method B is used, to accurately compare the MER disclosures between funds, an investor would require two additional disclosures, being: (1) the periodicity of fee calculation in days, and (2) the growth in FUM over the period. Without these additional disclosures, the comparison of the MER between investment funds using Method B is not possible because of the factors that have been identified in the Growth Distortion Model (Equation 6).

### A New Framework for Fee Disclosure

Expense ratios are widely used by investors, and are seen as a convenient way of comparing costs of different investment funds. Expense ratios, such as the MER, are also seen as a valuable impersonal data source for investment decision-making. However, as identified throughout this paper, there are five significant problems that undermine the reliability of expense ratios and hence limit their usefulness for investment decision-making. These five problems are:

1. Ambiguity in the way in which fees are classified leads to inconsistencies between investment fund disclosures (e.g. fees versus costs, capitalisation of trading costs versus expensing trading costs)
2. Different ratios are used for different fund types (eg MER or TER for managed investment funds, and OMC for superannuation funds) and these ratios are inconsistent in the way they treat common expense types (e.g. entry fees, exit fees, brokerage and transaction costs)
3. Inconsistencies between investment funds in the disclosure of taxation expense (e.g. disclosures made on a before-tax basis versus disclosures made

Periodicity	FUM at end of period	Average FUM	Total fees accrued
Monthly	\$1,104,713	\$1,055,857	\$21,117
Daily	\$1,105,156	\$1,051,846	\$21,037
Difference	\$443	\$4,011	\$80

Table 6 – Results from assumption at the end of one year

MER calculation	Method A (average net asset)	Method B (actual net asset)	Absolute Difference (A – B)	Relative Difference $1 - (B / A) \times 100$
Monthly	2.000%	1.912%	0.088%	4.400%
Daily	2.000%	1.904%	0.096%	4.800%

Table 7 – MER calculations based on data in Table 6, above

on an after-tax basis)

4. Inconsistencies in the way assets are valued when calculating the expense ratio (e.g. gross assets versus net assets, average assets versus actual assets)
5. Distortions in the MER disclosure where actual assets are used because of differences in the periodicity of fee calculation and growth in FUM over the period, as identified in the Growth Distortion Model

Fundamentally, investors will invest in a fund to (hopefully) generate a return. Irrespective of the inconsistencies in the disclosure of fees by the investment fund, all fees (and costs) will ultimately manifest themselves as a lower rate of return in the investment.

Financial economists will interpret an expense ratio (such as MER) as a signal of quality, specifically, the quality of asset selection decisions made by an investment fund in the creation of alpha<sup>75</sup>. Highly skilled managers with asset selection skills will charge higher MERs as compensation for their ability to generate economic rents, in this case, to consistently generate positive alpha<sup>76</sup>.

So, investors are interested in the amount of fees charged in proportion to the investment performance. Expenses ratios, such as the MER, attempt to describe the amount of fees charged in proportion to the level of assets. A change in an asset value (FUM) does not indicate investment performance, as FUM is affected by both net inflows and investment performance.

Based on the FUM growth projections in Table 1, the rate of growth in net inflows will outpace investment performance for specialist and boutique investment funds over the next 10 years, as these sectors rapidly gain market share. These high levels of growth will have an exaggerated effect on distorting the MER.

**The Performance Cost Ratio**

An alternative fee disclosure model is the *Performance Cost Ratio*. Rather than taking an asset based approach to fee disclosure, this model is based on absolute investment performance.

The Performance Cost Ratio (PCR) is shown in Equation 7, below:

$$PCR = \frac{TE}{IP} \tag{7}$$

and is expressed as a percentage, where:

“TE” is the total after-tax dollar amount of all expenses, fees, costs, disbursements, entry fees, exit fees, commissions, trading costs, brokerage, transaction costs and other outgoings, paid or payable for the period

“IP” is the total after-tax dollar amount of investment performance earned by the investment fund during the period, including all income, dividends, interest, and all realised and unrealised capital gains and losses, and adjusting for net inflows and total after-tax expenses (TE). The calculation of IP is shown in Equation 8, below:

$$IP = FUM_t - FUM_{t-1} - NI - TE \tag{8}$$

“FUM<sub>t</sub>” is net asset value of the fund at the end of period “t”

“FUM<sub>t-1</sub>” is net asset value of the fund at the start of period “t”

“NI” is dollar amount of net inflows during period “t” calculated as inflows of capital from investors (deposits and distribution reinvestments) minus outflows of capital from investors (redemptions and withdrawals)

“TE” is the total after-tax dollar amount of all expenses, fees, costs, disbursements, entry fees, exit fees, commissions, trading costs, brokerage, transaction costs and other outgoings, paid or payable for the period

The PCR attempts to remove any ambiguity in the way fees are classified by including all expenses, such as trading costs, and entry and exit fees. The PCR recognises both total expenses and investment performance on an after-tax basis, which allows for uniform comparison between investment funds. The PCR avoids any of the inconsistencies in measuring asset values by removing this measure, and by ignoring the periodicity of fee calculations, the PCR is not affected by the distortions that identified earlier in the Growth Distortion Model.

**Section 7. Conclusion**

The key purpose of disclosure in the area of fees and charges is to ensure that fees are transparent and readily

Manager type	Predicated FUM growth	Method B MER (Monthly)	Method B MER (Daily)
Comprehensive	8%	1.929%	1.922%
Specialist	13%	1.886%	1.876%
Boutique	32%	1.738%	1.712%

**Table 8 – Method B MER calculations using predicated FUM growth rates**

understood by the average investor, and investors can compare the cost of making an investment against alternative products in the marketplace<sup>77</sup>. This paper finds that this objective is not being uniformly achieved in the Australian sourced investment fund sector due to deficiencies in the way the expenses are disclosed.

This deficiency in fee disclosure coupled with a distortion in the MER, which is identified in the Growth Distortion Model (Equation 6), ensures that the MER is an unreliable measure that does not allow uniform comparison between funds. Given this distortion, this paper hypothesises that investment funds may gain financial advantage by increasing the dollar amount of fees charged to the fund without increasing their expense ratio, thereby improving their profitability, or conversely, disclosing an artificially lower MER and gaining price advantage over comparable funds. This is an alarming situation that has not been systematically addressed across the entire industry by the regulator or other industry groups. Recent efforts at reform have focused on standardising the disclosure of the absolute dollar amount of fees in a PDS. But it is the relative measures of fees, such as the MER, that is important because this is what investors rely upon for their decision-making.

The broad objective of relative fee disclosures, such as expense ratios, is to provide consumers with sufficient information to make informed decisions in relation to the cost of acquisition and retention of investment funds, including the ability to compare a range of products. Without standardising the method by which expense ratios are calculated, this objective will never be met in the Australian market. To this end, this paper proposes the Performance Cost Ratio (Equation 7) as an improved framework for fee disclosure.

From 1 July 2005, new laws in Australia have allowed an estimated five million workers to switch from their company super fund into another fund of their own choice<sup>78</sup>. The majority of these investors will rely on impersonal data sources, such as expense ratios, to guide them when making this decision. It is likely that many of these investors are ignorant of the fact that they may be looking at unreliable and inconsistent data when they consider this significant investment decision.

Manager type	Predicated FUM growth	Actual fee rate (Monthly)	Actual fee rate (Daily)
Comprehensive	8%	2.074%	2.081%
Specialist	13%	2.121%	2.132%
Boutique	32%	2.302%	2.336%

**Table 9 – Actual fee rates to achieve a 2 per cent target MER under Method B**



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