New fee framework

Nigel Finch and *Guy Ford* discover some distortions in the calculation of fund management expense ratios and propose a new approach.

Investment funds under management (FUM) in Australia will grow on average 12 per cent per annum to around $2.99 billion by 2014, driven one-quarter by net inflows and three-quarters by investment performance, according to financial services information group, Rainmaker.

Investors are sensitive to fees – higher fees will impact on their investment returns – and they use expense ratios, such as the management expense ratio (MER), as aids to compare the costs of different investment fund.

Many attempts have been made to reform Australian fee disclosure over the past few years with some staggered amendments to the Corporations Regulations produced during 2005 and 2006. These reforms are intended to improve the disclosure of fees in product disclosure statements (PDS). However, they are not systematically addressing all the issues that affect the reliability of MER as a useful disclosure across the entire industry.

In a study of 50 investment and superannuation funds in Australia, we identified as many as 17 multivariant fee types charged during the investor's lifecycle of investment, retention and redemption, and determined four significant problems undermining the reliability of expense ratios and hence limiting their usefulness for investment decision-making:

- Ambiguity in the way in which fees are classified leading to inconsistencies between investment fund disclosures (e.g. performance fees, termination fees)
- Inconsistencies between investment funds in the disclosure of taxation expenses (e.g. before-tax basis or after-tax basis)
- Inconsistencies in the way assets are valued when calculating the expense ratio (e.g. gross assets versus net assets, average assets versus actual assets)
- Distortions in the MER disclosure where actual assets are used because of differences in the frequency of fee calculation and growth in FUM over the period, as identified in the growth distortion model (GDM).

A fund which calculates the MER using an actual asset valuation, rather than an average asset valuation, may achieve a competitive and/or price advantage over similar funds, and this advantage may be amplified where the fund achieves positive growth in FUM. Investors who rely on the MER to interpret the magnitude of fees in these funds will be misled, as the disclosure will be grossly understated.

To overcome this problem, we developed the GDM, which is useful for investors to compare the MER disclosure of a fund using actual asset valuations with a fund using average asset valuations. The GDM is also useful for those funds which use actual asset valuations to adjust the fee accrual in the fund to take account of FUM growth and the periodicity of fee calculation.

A NEW FRAMEWORK FOR FEE DISCLOSURE

We also propose the performance cost ratio (PCR) as an alternative approach to fee disclosure which is designed to overcome the deficiencies identified in the MER (see full paper for PCR equation). The PCR removes ambiguity in the way fees are classified by including all expenses paid or payable. The PCR recognises both total expenses and investment performance on an actual 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 identified in the GDM.

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Fee types levied in Australian funds

Function	Type	Description
Financial Advice	Adviser service	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
Fund Administration	Ongoing	Fee to cover asset administration, custody, trustee services, Master Trust fees, IDPS and WRAP fees
	Issuer	Fee paid to the product issuer for overseeing the fund's operations and/or for providing access to the fund's investment options
	Administration	Fee to cover the general administration of the fund
	Expense recovery	Out-of-pocket expenses entitled to be recovered from the fund, such as audit fees, compliance fees and communications
	Switching	Fee charged to switch between investment options offered by the fund
	Buy/Sell spread	Fee to recover any transaction costs of buying and selling underlying investments as a result of investing or withdrawing from the fund
	Low account preservation	Fee charged within a superannuation fund or allocated pension for any costs associated with protecting the assets of members with low account balances
Investment Management	Investment manager	Fee paid to an investment manager of the fund
	Performance	Fee paid to an investment manager of the fund for any out-performance
Investment Product	Establishment	Fee to set up an account in the fund
	Contribution	Fee to deposit initial and subsequent investments into the fund
	Member	Member account-keeping fee charged by the fund
	Insurance	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)
	Annuity	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 and annuity or pension product
	Exit	Includes 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
Taxes and Government Charges	Taxes and duties	Expenses relating to stamp duties, superannuation tax, capital gains tax and taxes on investment income

As many as 17 unique fee types apply to Australian investment funds. They 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.