ISSUES RELATING TO FEE DISCLOSURE IN AUSTRALIAN INVESTMENT AND SUPERANNUATION FUNDS

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ABSTRACT

In 2005, Rainmaker (2004b) predicts the total value of Australian sourced investment funds will, for the first time, exceed AUD$1 trillion ($1,000,000,000,000). This phenomenal achievement has been fuelled in part by compulsory superannuation and an insatiable appetite among Australian investors for indirect equity investments (i.e. managed funds as opposed to direct share investments).

In the first section of this paper, we examine the purchase decision for investors considering investment funds, highlighting the importance of fee disclosure in investment and retention decisions. Fee disclosure in the Australian investment market is expressed in a relative measure known as the management expense ratio (MER). This ratio is the only impersonal data source that can provide utility to an investor across the entire market.

In the second section of this paper, we catalogue 17 typologies of fees payable by an investor in an Australian investment fund. We also highlight some important issues relating to inconsistent classification and the selective disclosure of fees in investment funds. These issues ultimately undermine the reliability of the MER for an investor to accurately compare fee disclosure across investment funds.

In the final section, we review the current regulatory environment regarding fee disclosure, and examine the recent amendment to Australian legislation. We also provide a conclusion to the paper and highlight the potential issue that faces five million eligible superannuation investors who are considering switching investment in the wake of the Superannuation Choice legislation.

Keywords: financial disclosure, investment fund, superannuation, management expense ratio
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. The *Australian Financial Review* database lists 2,637 Australian sourced investment funds\(^1\) that have some asset exposure to Australian equities. In contrast, there are 1,679 companies listed on the Australian Stock Exchange\(^2\) (Sykes, 2005). Simply, there are more than 1.5 times the number of investments 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).

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 (Capon, Fitzsimons & Price, 1995).

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

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\(^1\) This database does not include licensed investment companies (LICs), hedge funds or private equity funds.

\(^2\) After eliminating the double counting of stapled securities.
generally provide qualitative data on four key performance metrics: (1) the fund size; (2) past performance; (3) disclosure regarding 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\(^3\) 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. Where the fund is rated by Morningstar, the star rating
4. The estimated management expense ratio (MER)

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

1. Fund Size

The size of *funds under management* (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 especially related to higher 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 (Sharpe, 1991).

\(^3\) APIR stands for Asia Pacific Investment Register and describes standard identifiers for products in the financial services industry.
However, in practice, this theory does not hold true. 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 (Gallagher & Martin, 2005). 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.

2. 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 (Rainmaker, 2004a).

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 (Kane et al., 1991; Patel et al., 1992; Sawicki, 2000).

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.

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 (Fama, 1965), 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 (Drew, Stanford & Veeraraghavan, 2002). Therefore, investors may be misguided in selecting investments based on past performance.

3. **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 (Finch, 2004, p. 46), 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 (Rainmaker, 2004b) where these funds are not covered by the rating agencies.

4. **Management Expense Ratio**

The *management expense ratio* (MER) is a method of fee disclosure that attempts 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 (Jensen, 1968; Elton et al, 1993; Malkiel, 1995; Carhart, 1997; Drew, et al, 2002). Simply, investment manager returns decline with higher expenses, so investors are 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 (Barber et al. 2003; Sirri & Tufano, 1998).

This may prompt the question, “If fees don’t buy improved investment performance, what do they buy?” Rainmaker (2004c) analysed the fees of 100 top Australian superannuation funds 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 (Drew, 2003, p.35).
Summary of Fund Selection

In summary, investors will rely on the following disclosures to assist them in selecting an investment fund: (1) the fund size; (2) past performance; (3) the funds rating by a reputable rating agency; and (4) the level of fees (MER) that may be payable by the investor.

The fund size and past performance disclosures, although widely used, provide little utility to the investor to assist them in selecting an investment fund with strong future performance potential.

The rating assigned to an investment fund may be a useful information source for the retail investor, but ratings are not available for all investments funds. The ratings that are published tend be limited to largest (FUM) investment funds that are dominated by the comprehensive investment managers.

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.

Considering the importance that fee disclosure plays in the selection of investment funds, it is worthwhile investigating how investment funds classify fees, and ensure there is consistency in the way they are disclosed.

In Section 2, we will discuss the types of fees and charges common to Australian investment funds, and highlight contemporary issues regarding fee disclosure in Australian investment funds.
SECTION 2. INVESTMENT FUND FEES

In this section we will discuss how investment funds charge fees and catalogue the various types of fees that may be levied. We will also 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 s. 601GA(2) of the Corporations Act 20014.

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. An extract of the costs clause in a constitution for a specialist investment manager is given below:

The Responsible Entity may pay out of the Fund all accounts, which are from time to time due and payable by the fund (including without limitation commissions, fees, rates, taxes, insurance premiums, expenses for repairs, administration and management charges, GST, compliance committee costs, and all proper costs and disbursements concerning the investments and administration of the Fund and the carrying on of any business by the Responsible Entity under its constitution).

(Source: PM Capital Limited, Constitution of the Absolute Performance Fund)

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

4 Section 601GA(2) of the Corporations Act (2001) states that “if the responsible entity is to have any rights to be paid fees out of scheme property, or to be indemnified out of scheme property for liabilities or expenses incurred in relation to the performance of its duties, those rights: (a) must be specified in the scheme’s constitution; and (b) must be available only in relation to the proper performance of those duties”.
in the fund. The law requires that under s. 1013D(1)(d) of the Corporations Act 2001, the PDS must disclose the following information:

(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

Section 1013D(1)(m) of the Corporations Act (2001) also requires any disclosure of fees and charges to be stated in dollars.

In practice, the actual fees payable by an 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 fees is illustrated 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 fees that may be payable by the investor, and it is selective in that it does not include all fee types payable by the investor.

Types of Fees

We have identified 17 unique fee types common among Australian sourced investment funds (see Table 1 below). 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.
<table>
<thead>
<tr>
<th>Fee type</th>
<th>Description of fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Establishment fee</td>
<td>a fee to set up an account in the fund</td>
</tr>
<tr>
<td>2 Contribution fee</td>
<td>a fee to deposit initial and subsequent investments into the fund</td>
</tr>
<tr>
<td>3 Adviser service fee</td>
<td>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</td>
</tr>
<tr>
<td>4 Investment manager fee</td>
<td>a fee paid to an investment manager of the fund</td>
</tr>
<tr>
<td>5 Performance fee</td>
<td>a fee paid to an investment manager of the fund for any out performance</td>
</tr>
<tr>
<td>6 Ongoing fee</td>
<td>a fee to cover asset administration, custody, trustee services, Master Trust fees, IDPS and WRAP fees</td>
</tr>
<tr>
<td>7 Issuer fee</td>
<td>a fee paid to the product issuer for overseeing the fund’s operations and/or for providing access to the fund’s investment options</td>
</tr>
<tr>
<td>8 Administration fee</td>
<td>a fee to cover the general administration of the fund</td>
</tr>
<tr>
<td>9 Member fee</td>
<td>a member account-keeping fee charged by the fund</td>
</tr>
<tr>
<td>10 Taxes and duties</td>
<td>expenses relating to stamp duties, superannuation tax, capital gains tax and taxes on investment income</td>
</tr>
<tr>
<td>11 Insurance fee</td>
<td>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)</td>
</tr>
<tr>
<td>12 Annuity fee</td>
<td>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</td>
</tr>
<tr>
<td>13 Expense recovery</td>
<td>out-of-pocket expenses entitled to be recovered from the fund, such as audit fees, compliance fees and communications</td>
</tr>
<tr>
<td>14 Switching fee</td>
<td>a fee charged to switch between investment options offered by the fund</td>
</tr>
<tr>
<td>15 Buy/Sell spread</td>
<td>a fee to recover any transaction costs of buying and selling underlying investments as a result of investing or withdrawing from the fund</td>
</tr>
<tr>
<td>16 Low account preservation fee</td>
<td>a fee charged within a superannuation fund or allocated pension for any costs associated with protecting the assets of members with low account balances</td>
</tr>
<tr>
<td>17 Exit fee</td>
<td>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</td>
</tr>
</tbody>
</table>

Table 1 – Common fee types levied in Australian sourced investment funds
In analysing the table of fee types above, it is apparent that investment manager fees (number 4 in our list of 17 fee types) make up only the minority of total fees charged to an investor in a fund (Rainmaker, 2004c, p. 5). 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 (ASIC, 2003, p. 26). This 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 spurious argument that has emerged recently, as a result of 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:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Opening balance</strong></td>
<td><strong>$100,000</strong></td>
</tr>
<tr>
<td><strong>Fund earnings</strong></td>
<td><strong>10,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Investment</td>
<td>$800</td>
</tr>
<tr>
<td>2. Fund</td>
<td>$1,075</td>
</tr>
<tr>
<td>3. Manager</td>
<td>$500</td>
</tr>
<tr>
<td>4. Account keeping</td>
<td>$100 (2,475)</td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td><strong>$107,525</strong></td>
</tr>
</tbody>
</table>

Example 1 – Disclosure of all fees and costs in investor’s periodic statement

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

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Opening balance</strong></td>
<td><strong>$100,000</strong></td>
</tr>
<tr>
<td><strong>Fund earnings</strong></td>
<td><strong>7,425</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Account keeping</td>
<td>$100 (100)</td>
</tr>
<tr>
<td><strong>Closing balance</strong></td>
<td><strong>$107,525</strong></td>
</tr>
</tbody>
</table>

Example 2 – Disclosure of fees only in investor’s periodic statement

It is clear from example 2, above, 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.
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 (Wright, 2005), 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 (Kahler, 2005a).

Two other issues that are worthy of discussion regarding contemporary fee disclosure are exit fees (otherwise called terminations fees) and trading costs. While exit fees have been included in our table of common fee types, above, they are often overlooked when calculating total fees. Trading costs have not been included in our table of common fee types because in practice, these costs are hidden within the rate of return of the investment fund and not disclosed to investors.
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, this Act will allow some employees a choice in selecting the investment fund to which their superannuation contributions should be directed. While investment fund industry groups, such as Investment & Financial Services Association (IFSA), claim that fees and charges on superannuation funds are trending downward (IFSA, 2005), 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 (ASIC, 2005). 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 (Kahler, 2005b), this termination fee would represent 5.67 per cent of the investor’s account balance. Another cost that is overlooked by investors and that can have a significant impact on returns is trading costs.

Disclosure of Trading Costs

A cost that is not included in our table of common fee types 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 (Ramsay, 2002, p. 164).

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 (Anon, 2004a, p.35).

Karceski et. al. (2002) 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. 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 study by Lipper (2004) 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. The 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.

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 (Robertson, 2002, p.3).

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. 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.

**Summary of Investment Fund Fees**

Fund managers who operate investment funds make their money by charging fees. These fees may be charged to each individual investor separately and/or levied against the investment fund as a whole. The fees payable by an investment fund are numerous (at least 17 unique fees types), the methods used to calculate fees vary and the nomenclature of fee types changes between funds. As a result, investment funds are inconsistent in their definition of fees, and the disclosures they make regarding fees is inconsistent. This practice does not allow for reliable and uniform comparison of total fees between different investment funds.

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. In Section 3, we will look at the way regulators have responded to fee disclosure in investment funds.
SECTION 3. REGULATORY APPROACHES TO FEE DISCLOSURE

In this section we will review the approaches that regulators have taken to improve fee disclosure, and comment on the amendments to the Corporations Act 2001 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 (Bogle, 2003, p. 16). 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 (Anon, 2004b, p. 12).

In January 2001, the SEC released its Report on Mutual Fund Fees and Expenses. 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 aimed at significantly 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).

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 for Investment Products*. 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 (ASIC, 2003, p. 14). The fee disclosure model sets out good practice for the disclosure of fees in a discreet section of a Product Disclosure Statement (ASIC, 2003, p. 22).

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:
<table>
<thead>
<tr>
<th>Significant fees</th>
<th>Ongoing fees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Establishment fee:</strong> This is the fee to set up your account in the fund.</td>
<td><strong>Administration fee:</strong> This is the fee to cover the general administration of the fund.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Contribution fee:</strong> 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).</td>
<td><strong>Investment management fee:</strong> This is the fee for managing the fund’s investments.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Withdrawal fee:</strong> This is the fee charged for each withdrawal you make from the fund (including any instalment payments and your final payment).</td>
<td><strong>Issuer fee:</strong> 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.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Termination fee:</strong> This is the fee when you close your account with the fund.</td>
<td><strong>Expense recoveries:</strong> This is an estimate of the out-of-pocket expenses the trustee is entitled to recover from the fund.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ongoing fees:</strong> This is the total of all ongoing administration, investment management, expense recovery and other fees charged by the fund.</td>
<td><strong>Member fee:</strong> This is a member account-keeping fee charged by the fund.</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Switching fee:</strong> This is the fee charged when you switch between investment options offered by the fund.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Adviser service fee:</strong> 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.)</td>
<td></td>
</tr>
</tbody>
</table>

Table 3 – ASIC fee disclosure templates (Source: ASIC, 2003, pp. 23-24)
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 (ASIC, 2003, p.14). 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 (Rainmaker, 2004c, p.6).

Amendments to the Corporations Act 2001

The Corporations Amendment Regulations 2005 are the latest amendment to the Corporations Act 2001 and are aimed at standardising fee disclosure across investment funds. These changes commence from 1 July 2005 for Superannuation funds and 1 July 2006 for Managed Investment funds. The amendment will focus on Schedule 9 of the Corporations Act 2001 as part of the Choice of Fund legislation and require 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 (ASIC, 2003) 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 (www.fido.gov.au) 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 legalese to a document that many retail investors would already find extremely complex 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. Until 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.
CONCLUSIONS

Fee disclosure and the management expense ratio (MER) lay at the heart of investment selection and retention decisions by investors in Australian investment funds. The key purpose of fee disclosure is to ensure that fees are transparent and readily understood by the average investor, and investors can compare the cost of making an investment against alternative products in the marketplace (Phillips Fox, 2000). We find that this objective is not being accomplished in the Australian sourced investment fund sector due to deficiencies in the way that expenses are classified and disclosed by investment funds.

The fees payable by an investor in an investment fund are numerous (at least 17 unique fees types), the methods used to define fees vary, and the nomenclature of fee types changes between funds. As a result, investment funds are inconsistent in their definition of fees, and as such the disclosures they ultimately make regarding fees are inconsistent. This practice does not allow for reliable and uniform comparison of the fees payable by an investor when comparing different investment funds.

This 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. From 1 July 2005, new laws in Australia will allow an estimated five million workers switch from their company super fund into another complying investment fund of their own choice (Kahler, 2005b). The majority of these investors will rely on impersonal data sources, such as the MER, to guide them in making this decision. It is likely that many of these investors will be unaware of the inconsistencies in fee disclosure between funds and the resultant deficiencies in the MER. As such, their decisions may be misguided, resulting in the selection of inappropriate investments.
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