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Institutional Investment Management: A Comparison of Portfolio Management Expenses of Mutual Funds and Defined Benefit Pension Plans

Mutual funds and defined benefit pension plans manage vast sums of publicly traded stocks, bonds, and money market instruments. Collectively, these two types of financial institutions had nearly \$10 trillion of assets under management and held roughly 37 percent of the value of stocks traded in U.S. markets at the end of 2002.

Given the significance of mutual funds and pension plans¹ in securities markets, interest has arisen at times in comparing the cost of operations and activities of the two organizations. However, a direct comparison of investment expenses is not straightforward because pension plans and mutual funds have different business purposes and objectives. Broadly speaking, pension plans provide participants guaranteed incomes in retirement, whereas mutual funds provide individuals with professional investment management through the pooling of assets. Thus, even though pension plans and mutual funds both invest in pools of securities, they provide different services to their customers. In addition, they are subject to different regulatory schemes and use different accounting and reporting conventions.²

These differences have important implications for studying and comparing the portfolio management expenses of mutual funds and pension plans. In particular, care must be exercised to ensure that a similar method is used to measure the investment management expenses of mutual funds and pension plans. Failure to standardize expense measures can lead to erroneous conclusions, as in the case of a recent study by John P. Freeman and Stewart L. Brown that concluded that mutual funds pay substantially more than pension plans for portfolio management services.³ In reaching this conclusion, the study miscalculated mutual fund expenses by including more than portfolio management-related expenses.

This issue of *Fundamentals* considers the relative magnitudes of the portfolio management expenses incurred by mutual funds and pension plans using comparable measures of these expenses. This comparison shows that such expenses are roughly the same at pension plans and mutual funds.

¹ Unless otherwise noted, the term pension plan refers to a defined benefit plan (as opposed to a defined contribution plan).

² For an in-depth comparison of mutual funds, pension funds, and other institutional investment managers, see E. Philip Davis and Benn Steil, *Institutional Investors*, MIT Press, 2001.

³ John P. Freeman and Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *Journal of Corporation Law*, 26(3), Spring 2001, pp. 609-673.

Portfolio Management Expenses of Pension Plans

Most pension plans manage a portion of their assets in-house and allocate the remainder to unrelated third parties or external investment managers. The portion allocated to external managers is typically spread among a number of managers, each of which manages assets in a particular sector, such as international bonds or small cap stocks. An external manager is responsible for selecting investments within a sector. In addition, the external manager executes transactions and provides periodic performance reports to the plan.

The pension plan pays the external manager a fee for these services. The fee depends partly upon the size of the portfolio and the type of securities under management. Actively managed stock portfolios, for example, generally have a higher fee than bond portfolios, and large portfolios typically have a lower fee than small portfolios. In addition, the external management fee may be lower if the manager has other portfolios of the pension plan under management. The fee covers the external manager's expenses for investment research, conducting securities transactions, reporting, staff, equipment, and other operations. It is also expected to provide the external manager with a competitive rate of return on capital.

The limited role of the external manager contrasts with the vast responsibilities of the pension fund's board of trustees, officers, and staff. These entities are responsible for allocating assets across broad asset classes and for satisfying portfolio limits and standards set by law or the board. The board, officers, and staff also are responsible for ensuring compliance with laws and regulations,

pension fund accounting and auditing, managing relationships with the external investment managers, disbursing benefit payments to beneficiaries, and collecting contributions from employers. In addition, officers and staff are responsible for managing plan assets that have not been allocated to external managers.⁴

Portfolio Management Expenses of Mutual Funds

Virtually all mutual funds rely on a third party, called the investment adviser or management company, to manage the fund's portfolio. Unlike the external investment manager used by a pension plan, the investment adviser provides services that extend beyond portfolio management. These include business, administrative, and other services required to operate the fund.

A mutual fund typically pays its adviser a single fee for these services. The fee compensates the adviser for managing fund assets, including selecting the individual securities to be held in the fund's portfolio, making securities trades and asset allocation decisions, and managing assets in accordance with the objectives stated in the fund's prospectus. In addition, the management fee covers general administrative and business services, such as fund and portfolio accounting, valuation of portfolio securities, oversight of the performance of the fund's transfer agent and custodian, legal analysis to ensure compliance with federal and state laws and regulations, preparation and filing of regulatory and tax reports, preparation and distribution of prospectuses and shareholder reports, and provision of information to fund directors. The management fee typically covers the salaries of fund officers and expenses for providing the fund with clerical staff,

⁴ This structure is reflected in the way that public pension plans report expenses in consolidated annual financial reports. Fees paid by the pension plan to external managers are reported as "investment advisory fees." All other fees and costs associated with managing the pension plan are typically reported as "administrative expenses." Thus, for a public pension plan, administrative expenses include salaries and benefits paid to analysts and portfolio managers on the pension plan's staff, rent to house pension plan staff and operations, computer costs, and the costs of monitoring external investment managers. In addition, the costs of responding to inquiries from pension plan participants, maintaining accounting systems, and providing the pension plan with legal advice typically would be considered administrative expenses. Finally, a public pension plan's administrative expenses often include fees paid to consultants for providing investment-related advice and actuarial services or for helping the pension plan to manage relations with its external managers, including hiring and retention decisions.

office space, equipment, and certain accounting and recordkeeping facilities. Finally, the fee must allow the adviser a competitive rate of return on its operations, as the adviser provides the capital needed to establish and operate the fund and assumes the risk that the fund might not attract sufficient assets to be economically viable.⁵

Comparison of the Investment Management Expenses

Freeman and Brown's study attempts to compare the portfolio management expenses incurred by mutual funds and public pension plans. For this purpose, their study uses public pension funds' external manager fees⁶ and mutual funds' management fees.⁷

However, the two expense measures do not encompass the same, or even virtually the same, set of activities. As described above, a pension plan's external manager fees are essentially for the management—securities selection, trading, and reporting—of the portion of the plan's portfolio that is allocated to third-party managers and not for the portion that is managed in-house. In contrast, a

mutual fund's management fee covers business, administrative, and other services, in addition to portfolio management.⁸

Given the broader range of services provided under the management contract for mutual funds, it is not surprising that Freeman and Brown found that mutual funds' management fees exceed the external manager fees for public pension plans.⁹ Their finding, therefore, says little about relative portfolio management expenses at mutual funds and pension funds.

It is possible, however, to compare the portfolio management fees incurred by public pension plans with the portfolio management expenses of those mutual funds that are "subadvised." For these funds, the investment adviser contracts with an unrelated third-party investment manager to provide investment advice for all or part of the fund's portfolio. A third-party subadviser to a mutual fund holds a position equivalent to that of an external investment manager to a pension plan. Like the pension plan's external manager, the mutual fund subadviser primarily provides security selection, trading, and reporting services.

⁵ In addition, the management fees may cover some transfer agent costs. The fund's transfer agent is responsible for maintaining shareholder records, calculating and disbursing dividends, preparing and mailing shareholder account and tax statements, and providing the fund with a shareholder service department to respond to shareholder inquiries and problems. While most mutual funds pay a separate fee for these services directly to the transfer agent, others pay an all-inclusive management fee that encompasses transfer agency costs.

⁶ For public pension funds, Freeman and Brown use fees paid to unrelated external investment advisers. To obtain the fees, they "sent questionnaires inquiring about portfolio management fees to the 100 largest public pension funds ... [that] were asked for information on the fees paid to their fund's external portfolio investment managers ... Because internally managed portfolios were excluded, each portfolio could be associated with a specific investment advisor [p. 630]."

⁷ Freeman and Brown obtained the management fee for mutual funds from Morningstar Principia Pro Database for the year 1999. That database reports the management fee included in the fee table of the mutual fund prospectus and therefore corresponds to the concept of the management fee described above.

⁸ In *Report on Mutual Fund Fees and Expenses*, December 2000, footnote 60 (www.sec.gov/news/studies/feestudy.htm), the SEC's Division of Investment Management noted the difficulty of interpreting the management fees of mutual funds as a proxy for the fund adviser's costs of portfolio management services:

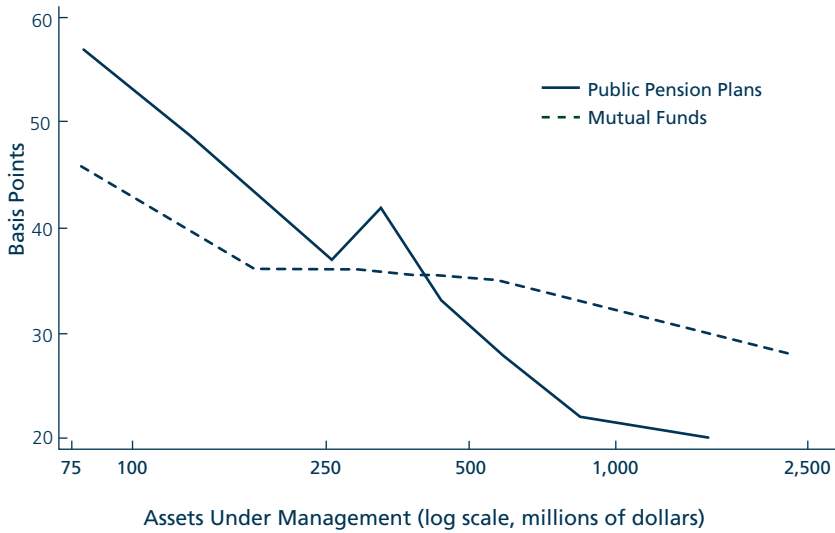
Some funds define the term management fee narrowly, to cover only the cost of selecting portfolio securities. These funds pay for administration, record keeping, and other services under separate contracts with other service providers. Other funds define the management fee broadly, to cover a variety of administrative and other services, in addition to expenses associated with selecting portfolio securities. A few funds have "unified" fees under which the management fee pays for all fund expenses (the management fee is equal to the expense ratio). Thus, if Fund A has a higher management fee than Fund B, it may mean that Fund A pays a higher fee to its adviser. Alternatively, it may mean that Fund A's management fee pays for services that are provided and charged for separately by Fund B's adviser, an affiliate of the adviser, or outside contractors.

⁹ Freeman and Brown acknowledge that the advisory fees paid by public pensions and the management fees of mutual funds can be difficult to compare. They note that "the 'management fee' reported in Morningstar sometimes includes not only fees for advisory services but some administrative services as well." They claim that they have corrected for this problem by "excluding from the [ir] sample funds shown by Morningstar to have no administrative fees." They further claim that "[t]hose funds that bundle administrative costs in the management fee are ... likely to be small and have minimal impact on category averages." These claims are dubious for two reasons. First, Morningstar does not report administrative service fees in its Principia Pro database. Second, many of the largest mutual fund complexes, which in turn advise many of the largest mutual funds, do in fact report management fees that bundle the costs of security selection and portfolio management more generally with the cost of administrative services and general business expenses. In addition, one of the very largest mutual fund complexes uses a "unified" management fee, which comprises transfer agent costs.

figure 1

External Management Fees of Public Pension Plans and Subadvisory Fees of Mutual Funds

(fees paid for active management of domestic equity portfolios)



Sources: Freeman and Brown (2001) for external management fees and Lipper Analytical (2000) and Strategic Insight Mutual Fund Research and Consulting, LLC (2000) for subadvisory fees of mutual funds.

For mutual funds that are subadvised, the subadvisory fee is reported separately and thus can be directly compared with the fee paid to the external manager of a pension plan. (Figure 1 shows the fees for actively managed, domestic equity portfolios at public pension plans and subadvised mutual funds.) The fees paid by mutual funds to subadvisers are similar to the fees paid by public pension funds to external investment advisers as reported by Freeman and Brown. For small-sized and medium-sized portfolios, mutual fund subadvisory fees are lower than those reported by Freeman and Brown for public pension plans. For large-sized portfolios, the fees paid by public pension plans to external investment managers are slightly lower. Overall, however, these fees are similar, averaging 28 basis points for public pension plans and 31 basis points for subadvised mutual funds.

Conclusion

The expenses borne by mutual funds for portfolio management are roughly the same as the expenses incurred by public pension plans for external management of their portfolios. The conclusion reached by Freeman and Brown that mutual funds overpaid for portfolio management is based on the inclusion of business, administrative, and other expenses in their measurement of fund portfolio expenses.