Transcript

Better conversations. Better outcomes.

Episode 1.16 – Explaining mutual fund fees

Casey Hatch - I think that reading the prospectus, as exciting as that sounds -- as I do very often -- it's important to understand what those footnotes have in place.

Ben Jones - Welcome to Better conversations. Better outcomes. presented by BMO Global Asset Management. I'm Ben Jones.

Matt Smith - And I'm Matt Smith. In each episode, we'll explore topics relevant to today's trusted advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

Ben Jones - To learn more, visit us at bmogam.com/betterconversations. Thanks for joining us.

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Casey Hatch - My name is Casey Hatch. I am the head of product management at BMO Global Asset Management. We are at the headquarters of BMO Global Asset Management here in Chicago.

Ben Jones - Today, we're uncovering the complex world of mutual fund fees. I know, I know. This sounds like a really exciting one, right? As a note for our international listeners, this episode might be a bit US centric. Over the last three years, fees have become one of those hot button issues that drives a lot of conversations and certainly a lot of discussion. With fund fees, it's important to pop the hood and understand how those fees are derived so that you're able to better explain them to your clients in the most simple or detailed ways. Given the complex nature of prospectuses, and just the sheer amount of information contained in them, mutual fund fees are often misunderstood.

Matt Smith - That's where Casey is going to help us out. By helping you understand the world of fund fees and how they function. You in turn can help your clients by breaking down fees for them and helping them make more informed decisions. Casey is part of our BMO GAM family and he explained his role during his conversation with Ben.

Casey Hatch - To simplify my role, I sit in between sales, investments, and marketing, and really bridge the gap between the three groups. So, mainly working with our investment teams trying to translate their investment strategies to our sales professionals so they can help their clients better understand the investment side of the business.

Ben Jones - In light of the pending DOL rules, fees have become an intensely debated topic, one that has been discussed immensely in the financial industry as well as mainstream news outlets. Clients and advisors alike are more sensitive to the topic of mutual fund fees than ever before.

Ben Jones - I want to start first with a basic understanding, very high level, what are the two different fees stated most commonly for mutual funds?

Casey Hatch - Most common is gross and net.

Ben Jones - And what is the difference between a gross and a net fee?

Casey Hatch - Yeah, the gross fee is everything that goes into operating a mutual fund. Keep in mind that all fees, net or gross, are a percentage of assets in the funds. So, it's a dollar expense divided by total assets in the fund gets you to that percentage. You have the gross like I just said, it's everything that it takes to run that fund and deliver returns to clients. The net fee comes from a mutual fund board that is put in place to protect shareholders and keep their best interests in mind. That net fee is a cap or something that we've been contractually obligated to deliver to the clients and actually charge them. So, the gross fee is not charged to your clients. It's that net fee that's really important and they actually pay.

Ben Jones - So, the net fee is ultimately what clients pay for the services that they're delivered.

Casey Hatch - That's right.

Ben Jones - If the net fee is the net fee that's charged to the client, why is it important for an advisor to actually understand the gross fee?

Casey Hatch - Yeah, the gross fee is really important because it's everything else that goes into the fund. So, the operational expenses are really important to understand. So, what it actually takes to get that fund.

Ben Jones - Why?

Casey Hatch - So, why it's important to understand that is every fund operates differently. There's going to be fees to have the tax, legal, accounting audit all of those things. If you have two funds from different firms and they're about the same size and one has a really outsized other expense, there might be something else going on behind the scenes, whether their operational house isn't in order or there might be a special assessment being charged to their shareholders that you should be aware of so your clients are getting the best deal.

Ben Jones - So, there are some real insights that could be gained by understanding the gross fees.

Casey Hatch - Absolutely.

Ben Jones - I want to just talk for a minute maybe since we're on the subject of gross fees in breaking down what underlies the build up to that gross fee. So, maybe you could just kind of break down the components and explain a little bit about each.

Casey Hatch - Yeah, every fee table in every prospectus has a fee table where you're going to see fairly consistently the same things. There might be some different terminology from fund family to fund family, but for the most part it's very straightforward and I'll walk you through it. On the management fee is usually that first line. Sometimes it might say advisory fee. That is the fee paid to the portfolio managers and the portfolio management company to operate that fund. The next line is the distribution fee, or 12b-1 fee. This is help to pay for distribution costs, so helping to raise assets in the fund. A bigger fund is actually beneficial to all shareholders because the expenses are spread more evenly. So, not all share classes have a 12b-1 fee. Typically the A share and C share are the most common you'll see that on, but some classes don't have it at all. For example, the institutional share classes or many of the retirement share classes don't have a 12b-1 plan in place either. The other expenses -- this is where there could be multiple lines shown, or most often, they just show other. So, it can be broken into many pieces and this is where we need to take a deeper dive into what the real cost is there. The administrative fee is one of the first things within other expenses. It varies from fund family to fund family how much it is. There's no set amount where it has to be anywhere. You'll see between five basis points to twenty basis points I'll say, but every firm operates a little bit differently in how they use this fee. I'd say the most common is about 15, but like I said, it could vary from fund to fund. Administrative expense is exactly as it sounds. It's to help with the administrative duties of operating the fund. Operational expenses is where a number of different things are pushed into this other bucket of expenses. There's many things that make a fund run at the end of the day, whether it's legal, accounting, tax, audit, board of directors, there's a number of things that are charged to shareholders to make sure that they get a solid mutual fund at the end of the day. So, that operational expense though, those are all variable costs and many of them are fixed in nature or they don't move very much. So, when you have assets that are growing, those fees quickly drop, which creates that discrepancy between net and gross. That's really the biggest driver of the difference there.

Ben Jones - So, as a fund grows in size, you're saying the operational fees don't actually get smaller, it's that they're smaller as a percent of assets.

Casey Hatch - You got it. Operational expenses are very scalable. So, more assets in the fund, it gets distributed wider, and that operational expense shrinks really quick.

Ben Jones - You mentioned the idea of the difference between gross and net. How does that manifest itself in the prospectus?

Casey Hatch - The difference in gross and net, you'll see -- so, gross is very simple. You total up the management distribution and other expenses to get to the gross. To get to your net expense, there's a fee waiver involved. So, we mentioned earlier that there's a board of directors put in place for the best interest of the shareholders and every year they meet multiple times a year, but they decide on what the fee should be charged to the shareholders. They contractually obligate the fund company to keep the fee at a certain level and if there's a difference between that gross and net number, the mutual fund company has to pay that out of pocket to make sure that the shareholder is only paying the net expense.

Ben Jones - And what are some examples of a reason a firm would waive their fees?

Casey Hatch - The biggest reason for waiving the fees is to make sure the shareholder is getting a deal in line with the rest of the industry. We want to make sure that we're offering competitive services. We know that there's many mutual funds out there and many providers. We want to make sure that our costs are in line with each other or might be even a better deal for the shareholder. We put that cap in place to make sure that we're competitive.

Ben Jones - And so, some examples of reasons might be the fund is fairly new and small in assets?

Casey Hatch - Yeah, a cap is often put in place at the inception of the fund because with a smaller asset base, typically when you launch a fund, you don't have a ton of assets in there so that gross expense can look really high because some of those operational expenses. They don't evaporate just because you have a small fund. You've still got to pay the accountant regardless of the fund size. So yeah, you'll see, typically, a big gross fee and that cap in place early on in the fund life or when the assets are smaller because it's always an asset based fee. So, a smaller fund will usually have a cap in place to make sure that those fees are spread evenly.

Ben Jones - And how long are those contractual obligations in place?

Casey Hatch - Varies from fund family to fund family. Could be anywhere from a year, to 5, to 10 years. It just depends on the fund. But, it's always going to be in the prospectus, so it's always going to be a footnote at the bottom of the prospectus there. If there is a cap in place, it will say that the mutual fund board of directors is contractually obligated to keep X fee in place until Y date.

Ben Jones - And that's a really important thing for our advisors to understand so that they're not caught off guard down the road when that expiration happens and maybe they haven't had a chance to read through all of the materials and prospectuses yet.

Casey Hatch - Yeah, that's right. I think that it's important to understand what those footnotes have in place because that cap -- or the -- once the date comes, there's no obligation for us to reinstate that. So typically, those dates will coincide with the annual report date, which can vary as well from family to family. If they decide not to renew that contractual obligation of the total expense ratio cap, it could just go away with very little notice to you and you're shareholders.

Ben Jones - Yeah, that's interesting. You mentioned that you read a lot of prospectuses. My wife often says that I read a lot of boring books, but I'm going to make sure and tell her when I get home that you've got me beat.

Casey Hatch - Yeah. I'm happy to share some nice nighttime reading with everyone.

Ben Jones - So, you talked about the fixed cost of operating a fund as a percentage of fees. And as the fund is new, those might be really high; as the fund grows, they shrink as a percentage of the fund and therefore, scale, as you call it. But, we've been in a period of time where a lot of funds have experienced massive outflows and there's some funds that have been punished more to others due to whatever reason, a PM team leaves or a performance of a fund, etc. As the fund shrinks, do those fees as a percentage of the fund go back up?

Casey Hatch - Yeah. It works the exact opposite. As his assets go up, fees typically come down. Same thing. As assets decline, fees will typically go up. Keep in mind though, it's that gross fee. So, just because the assets are increasing or decreasing doesn't mean that the net will change as long as there's a cap in place.

Ben Jones - I think that's a really important point and I appreciate you pointing that out.

Matt Smith - As we mentioned, fund fees make for dense and complex subject matter, but as an advisor, being able to understand and explain these can be a real confidence booster with your clients. As Casey mentioned, there are two main types of fees, net and gross. The underlying fees are broken down line by line in a prospectus for a mutual fund. As implied, fixed costs are fixed and will shrink in proportion to the fund size as it grows, or works in reverse if the fund shrinks. Casey wrote a piece called *The Total Expense Ration Primer*, which talks in detail about some funds that don't follow the standard rules when it comes to fees. Ben and Casey talked about what advisors need to know about these funds that don't fit the standard mold.

Ben Jones - I want to talk about kind of the nuances of both of these and the first one is really the fund of funds. A lot of firms have these balanced or risk-based, or target-date based funds. So, these multi-asset funds that are investing in other mutual funds or other underlying mutual funds. Talk to our audience about some of the things they really need to pay attention to and understand relative to fund of funds.

Casey Hatch - Yeah, if you're purchasing a mutual fund of funds, there's a lot of great reasons on the investment side why. The portfolio manager can access lots of different asset classes in a scalable way. So, it makes a lot of sense -- the mutual fund of funds from an investment perspective -- why they've been created, why they can access lots of different asset classes through mutual funds. Something to be aware of though for you and your clients is how the performance is coming to your client. So, keep in mind we're investing in many funds within a single fund. We're getting those returns from each fund net of fees already. So, essentially, we've paid that fee in some way, shape, or form and it's all going to roll up into our fee table and we're going to be able to see that. So, your client is not directly being charged by that single fund you're buying. It's being charged by all the underlying funds you have in a portfolio. So, your client gets hit with a pro rata share of each underlying mutual fund that comes out of the return. So, you'll see that in the fee table under your acquired fund fee is where this has to be disclosed.

Ben Jones - And so just to use a really simplistic example and math that I can do, let's say that somebody was looking at their net expense ratio for a fund and it was 1%. Does that include the acquired fund fee, or is the acquired fund fees then added to that net expense ratio that they see?

Casey Hatch - So, that printed net number will include the acquired fund fee, but the prospectus is required to show that fee as a separate line item as well. Keep in mind, though, we can't cap that fee. It falls outside of the cap, so there's not a lot of control on it from a board standpoint. It needs to fall back onto the portfolio manager being aware of fees.

Ben Jones - Wow, that's really interesting. So, in my example, if the net expense ratio is 100 basis points, they might actually see an acquired fund fee of 50 basis points. It's already included in the 100 basis points, but they can actually see how much it costs to buy the remaining 10 mutual funds -- or the underlying 10 mutual funds.

Casey Hatch - That's right.

Ben Jones - And what is the information that an advisor could glean from knowing how much they're paying for those underlying funds?

Casey Hatch - In the most simplest term - you're able to see and get an idea of how expensive or inexpensive the underlying funds are of your multi-asset fund.

Ben Jones - Okay, and so it also maybe allows the advisor the opportunity to see if the manager is really choosing the lowest share classes available and looking out for the fee budget of the fund overall?

Casey Hatch - Yeah, that's absolutely right. You're also able to see what that allocator is charging for those services as well.

Ben Jones - I want to shift gears from the fund of funds concept to the other fund that you mentioned as a little bit nuanced. Now, over the last several years alternatives, and particularly liquid alternatives, has become a very popular sleeve that advisors are allocating to. And in your primer you really highlight that this is one type of fund in particular that's a little bit more complicated and has some nuances in the way that fees are reported. Could you maybe talk a little bit about some of those nuances and the things that advisors really need to pay attention to?

Casey Hatch - Yeah, a number of these alternative funds are able to short securities. So, what that means for your clients is hopefully they -- the fund, if they short something -- they're betting that it's going to go down. If it does, we make money and are happy. What that means from a fee perspective is one, you're going to have another line in the fee table that shows dividend and short-sale expense. And how that's calculated is really important. One, it's -- we've got to understand how that is being charged or not being charged to your client directly. But where that comes from on the short-sale, so why we see that line in there -- if we have one stock in the portfolio that we are shorting, say it's a $50 stock, pays a $1 dividend -- we owe now a dollar to someone that we borrowed that stock from. So, essentially, that creates a 2% expense, just 1 over 50. Simple math. The offset though -- so we owe that dollar to someone -- but now that stock when it goes X dividend, drops a dollar in value as well. So, now we have a $49 stock. That means for us though, we have an unrealized gain of 2% as well. So, 2% unrealized gain, 2% expense, those should offset each other in the wash there. So, your client is not directly being charged that expense. It's just part of the investment strategy, but it is required to be part of the fee table so you can see what is actually going on.

Ben Jones - Interesting. And so in the event that they close that position out, it really isn't ultimately detrimental to the client's expenses.

Casey Hatch - That's right. So, it's not directly charged to the client. It's all part of the performance of the fund, but it has to be reported on the fee table itself.

Ben Jones - So, I can see this causing some headaches for folks trying to analyze how much their clients are paying as far as for the mutual fund or the strategy itself. So, talk to me a little bit about how this would impact the fee that they see on a fact sheet.

Casey Hatch - Yeah, the fact sheet. So, net expense we have to show everything. These dividend and short-sale expense, or acquired fund fee from multi-asset, we can't cap those. So, they fall into that net expense ratio as just the single line item that you see everywhere, but you're not necessarily being charged that directly to your client. So, it's really important to understand what the cap is, what we talked about earlier, and where you can find the cap is once again in the prospectus right below the fee table. There will be a footnote and there should be -- where it says what that contractual cap is to bring us to a net expense ratio that's actually charged to the client.

Ben Jones - Okay, so in a long-short fund, this could be a significant part of the stated net expense ratio in the fund. Could you just give us like maybe a really simple example of this?

Casey Hatch - Sure, yeah. So, long-short funds, you might see for example -- we'll say it's 3% is what you see on the fact sheet.

Ben Jones - And that could be a shock and awe for someone.

Casey Hatch - Absolutely. What's important though is to look a little bit deeper and understand where the cap is for that fund and what the dividend short-sale expense actually was. So, if we pull it back to our last example and said we had a 2% expense for dividend and short-sale, that actually totals back with the cap -- that means we're only charging the client 1%. So, to get to that three, we have 1% of cap net expense, the 2% dividend short-sale expense is there as well.

Ben Jones - So, if you could put a warning label on your insights today for our audience, what would it be?

Casey Hatch - My biggest advice or warning label is read the footnote of the prospectus. Know what that cap is, where it's set, and how long it's set for.

Ben Jones - Fund of fund and liquid alternative funds have unique rules that require extra attention on the part of advisors to truly understand their fee schedules. Reading the prospectus, and especially the footnotes, can prove quite valuable in helping your clients make more informed decisions about their investments. At the end of the day, what's important is that your clients understand what they're paying for, how they're paying them, and the value they received for the fees they pay.

Matt Smith - For great reference information, check out the total expense ratio primer at bmogam.com/betterconversations. There you can also find other resources, links, and episodes of this podcast series. Thank you for listening to this episode. And Casey, thank you for breaking down this complex topic.

Ben Jones - Thanks again to the team at Freedom Podcasting, including Jonah Geil-Neufeld and Annie Fassler. We couldn't produce this episode without the wonderful team here at BMO GAM, which includes Pat Bordak, Gayle Gibson, and Matt Perry.

Matt Smith - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to bmogam.com/betterconversations.

Matt Smith - We hope you found something of value in today's episode, and if you did, we encourage you to subscribe to the show and leave us a rating and review on iTunes. And of course, the greatest compliment of all is if you tell your friends and coworkers to tune in. Until next time, I'm Matt Smith.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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