ABSTRACT. Prior research shows that mutual fund investors are often aware of up-front charges like sales loads, but they are less mindful of annual operating expenses, even though both types of fees lower overall performance. This study documents the historical trend and recent abuse of annual mutual fund expenses. As the industry becomes more adept at segmenting customers by level of investment sophistication, we claim that load mutual fund companies take advantage of this ability and charge higher expenses to their target customer: the less-knowledgeable investor. No-load fund companies, which tend to attract the more sophisticated investor, offer lower expenses. For example, over 2000–2004 the average annual expense ratio of load equity funds was 50 basis points higher than no-load equity funds. We show evidence of this widening cost disparity since the early 1990s among new and existing equity, bond, and index funds. We also document a growing abuse of sales distribution or 12b-1 fees among funds that are closed to new investors, almost all of which are load funds. Thus, load fund investors are more susceptible to paying higher expenses and receiving lower returns over time.

KEY WORDS: 12b-1 fees, asset management fees, expense ratios, mutual funds, sales loads

Introduction

Mutual funds provide investors with convenient access to professional asset management services and broad portfolio diversification. Investors can purchase funds that offer exposure to various financial markets such as stocks, bonds, or real estate. By pooling capital with many other investors, each mutual fund shareholder owns a fraction of a larger, well-diversified, and professionally managed portfolio. Fund investors also benefit from economies of scale. As total shareholder resources increase, transaction costs become a smaller portion of the total portfolio. This is particularly important since higher expenses directly reduce portfolio returns.

Given these benefits, mutual funds have been one of the fastest growing areas of the U.S. financial services industry. From total investments of just $47.6 billion in 1970, today the industry manages $8.1 trillion across more than 8,000 different funds. The Investment Company Institute (2005) estimates that mutual fund ownership has also risen from 5.7% of U.S. households in 1980 to 48.1% in 2004. In fact, mutual fund investments now comprise 19.5% of all household financial assets and represent the largest type of financial intermediary.

One reason for the popularity of mutual funds is that the industry has successfully marketed these investments to consumers. In essence, mutual funds are part investment vehicle, part consumer product. Fund companies attempt to differentiate their funds by aggressively marketing historical performance, investment policy, and quality of service. Yet, a General Accounting Office (2000) report notes that unlike most consumer products, mutual funds rarely endeavor to compete on cost.

This study documents the historical trend and recent abuse of annual mutual fund expenses for certain investors. Over the last 15 years, the fund industry appears to have become very adept at segmenting customers by level of investment sophistication. Using a sample that includes all U.S. equity and bond mutual funds from 1970 to 2004, we provide evidence that less-knowledgeable investors pay consistently higher asset management fees than more-knowledgeable investors holding similar
funds. This widening cost disparity is evident among new and existing equity, bond, and index funds.

Mutual funds are sold through two main distribution channels: directly from the fund underwriter or indirectly through a broker. We suggest that knowledgeable investors are more likely to purchase directly through a fund’s underwriter, avoiding all sales commissions or “loads.” Less-knowledgeable (or less confident) investors are more likely to seek assistance from a broker or financial advisor, who receives a commission for selling load funds to investors. Prior research has clearly shown that load funds do not outperform no-load funds; sales loads are a deadweight cost that reduces the returns earned by the investor. Thus, we use a fund’s load as a proxy for investor sophistication.

While mutual fund investors are often aware of up-front charges like sales loads, research shows they are often less cognizant of annual operating expenses, even though both types of fees are deadweight costs. Barber et al. (2005) document a negative relation between fund flows and sales loads, but no relation between operating expenses and fund flows. Alexander et al. (1998) also find that fewer than one in five mutual fund investors could estimate the annual expenses for their holdings. Since mutual fund returns are reported net of annual operating expenses, they are easily missed by investors. When a fund gains or loses over 20% in a given year, it is easy to see how investors might focus on the volatility rather than the cost of their funds.

Once invested in a high expense fund, investors may be less willing to search for lower cost alternatives. With thousands of mutual funds offered by hundreds of fund families, sorting through the choices is daunting. Sirri and Tufano (1998) contend that when search costs are high, individual investors turn to rating services and periodicals for advice. They document that fund flows relate directly to the size of the fund complex and level of media attention received by the fund. Since most mutual fund advertising focuses on past performance rather than cost, funds that spend disproportionately on marketing and distribution will tend to attract the less-knowledgeable investors that rely on these publications.

While load funds had significantly lower expense ratios in the early years of the sample, we find that the reverse is now true. Over 2000–2004, the average annual expense ratio of load funds was 50 basis points higher than no-load funds, 1.17% versus 0.67%. Although much of this increase results from the widespread use of sales distribution (12b–1) fees, we show that load funds also charge significantly higher expenses for core asset management and administrative services. These trends are even more evident among newly offered funds. For equity funds in their first year of operation, the average expense ratio charged by load funds is 1.68% compared to just 0.49% for no-load funds.

If sales loads proxy for the level of investor sophistication, then load fund investors appear more susceptible to paying higher expenses over time. These investors essentially pay high fees for the privilege of having funds marketed to them. Yet, unlike other consumer products, higher mutual fund costs are not associated with higher quality. In fact, the opposite is true; all else equal, higher operating expenses lower fund returns. Using different share classes to segment customers by level of investment knowledge allows the fund industry to boost profits at the expense of less sophisticated investors. The dramatic increase in the number of mutual funds over the last two decades may be as much a response to the growth of industry profitability as to the demand from investors.

**Mutual fund sales loads and operating expense ratios**

The direct costs of distributing and operating a mutual fund are levied against fund shareholders. These costs fall within two broad categories of fees: sales loads and annual operating expense ratios, expressed as a percentage of total fund assets. Funds are required to report their expenses in the prospectus using a standardized format.

Sales loads are one-time commissions frequently paid by investors who trade funds through a broker.