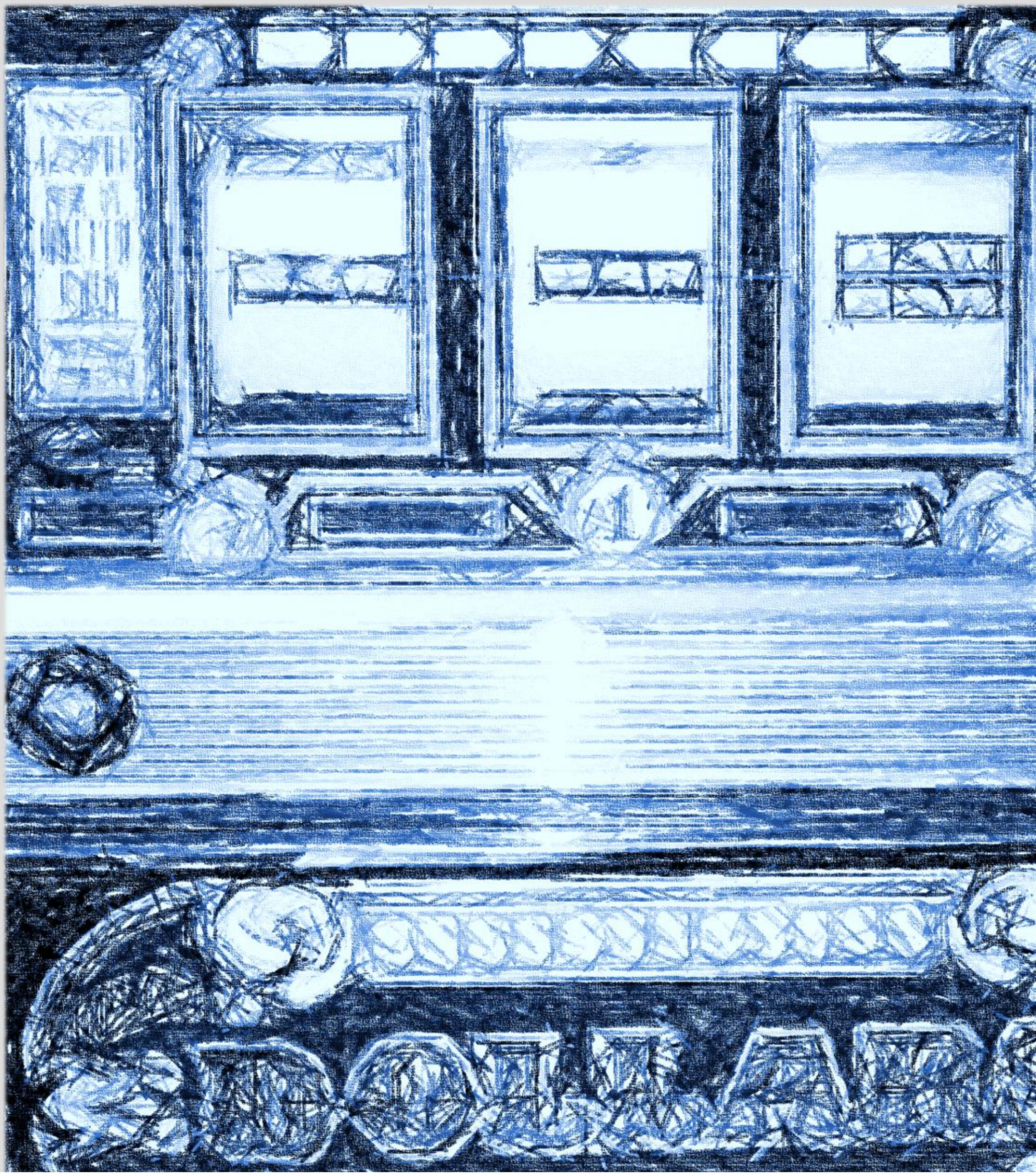


High Cost Mutual Funds Are Good For Everyone

Russell Campbell **Q2 2016** *Your Second Opinion, LLC*

Executive Summary

There is a lot of pressure on asset management firms to reduce fees.

But who suffers when mutual funds charge higher fees than the competition?

Fund families benefit from higher fees. Not only do they earn more money on existing assets, they also see faster growth in AUM.

But what about unitholders? They benefit too. Fund families and individual funds with relatively high fees exceed their investment performance benchmarks.

So charging premium fees and delivering premium results for both fund families and clients is a reality.

Russell Campbell

Introduction

Morningstar is the preeminent source of information on mutual funds. Their web site includes over 30,000 mutual funds. Morningstar offers information and opinions on the quality of many of these mutual funds.

One of the opinions that they offer is how expensive a fund is in relation to other similar mutual funds.

A recent review showed that Morningstar has flagged over 1100 funds for having relatively high fees.

Just 10 mutual fund families are the sponsors of 99% of these relatively "High Cost" mutual funds. These large fund families must recognize the rewards and risks of having "High Cost" mutual funds in the face of opposition from Morningstar and others. Clearly, these fund families have decided that the benefits outweigh the disadvantages.

Let's discover why "High Cost" funds are successful.

High Fees Are a Good Thing

In 2015, I wrote a report focusing on mutual funds called "Be Thankful for High Fees". Many of the themes of this report remain true today.

Some industry observers complain about the high fees charged by asset management firms. So you would think that with this pressure to reduce fees, firms with the highest fees would be struggling to grow assets. And their investment performance would also be hampered by the fees they charge.

In fact, the fund families that Morningstar believes charge high fees have had above average growth in assets in the last 5 years (as of 2015). These fund families also have above average investment performance.

Morningstar compares mutual fund fees in relation to other funds with similar strategies and share classes. Firms with low-cost funds earn the highest grades.

To quote from their literature;

"*In the U.S., Morningstar's assessment of funds' expense ratios is purely quantitative. Morningstar will determine the fund family's average Morningstar fee percentile rank, which results from peer-based comparisons and is calculated to determine each fund's Morningstar Fees Level of Low, Below Average, Average, Above Average, or High. The calculation is a straight average, where each fund share class offered by the firm carries equal weight*."

In 2015 there were 15 fund families with funds that Morningstar identified as having high fees and therefore low rankings from Morningstar. Surely, being called out for high fees must be dampening the sales efforts for these funds, and the friction from higher than average fees must be undermining their investment performance. Neither of these is true!

Of these 15 fund families, 9 were identified in a 2015 research report that I wrote, as *outstanding businesses*, based on growth in assets in recent years AND because they also demonstrate outperformance on average across their entire fund family.

Does Having Higher Fees Hurt Anyone?

Let's update the results of last year's study. There are 10 fund families that account for 99% of the mutual funds flagged by Morningstar for relatively high fees.

Are families offering funds with high fees constraining their growth?

8/10 have grown AUM over the last 5 years

Are these families with relatively high management fees only offering load funds as well?

8/10 have more than 50 % of AUM from their clients invested in no – load funds

Enough about fees, are these fund families earning excess returns for their investors?

Aggregate 5 year performance - 8/10 have exceeded their weighted investment performance benchmarks on average over the last five year period.

Consistency - 8/10 have exceeded their weighted investment performance benchmarks on average over each of at least 3 of the last 5 years

How Does the Performance (and Prospects) of Higher Cost Mutual Funds Compare

Morningstar flags 1100 funds for having relatively high fees. Earlier we discussed fund families, but let's look across these fund families, to see if there is evidence of investment under-performance – considering both return and risk (Most evaluations like this only consider return – and ignore risk).

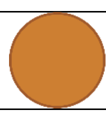
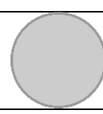
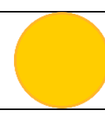
Of the 1100 mutual funds, 835 have received 1 or more Stars from Morningstar.

The overall distribution of Stars for all funds considered by Morningstar is shown in the table below. So 80% of all funds rated by Morningstar receive between 2 and 4 Stars.

86% of the high cost funds receive between 2 and 4 Stars!

"High Cost" Funds	**Info N/A**	**No Stars**	**1 Star**	**2 Star**	**3 Star**	**4 Star**	**5 Star**	**Total Funds w/ Stars**
TOTALS	59	187	74	205	340	166	50	835
Distribution of Stars in "High Cost" Group			9%	25%	41%	20%	6%	
Morningstar Overall Distribution			10%	22.5%	35%	22.5%	10%	

Morningstar also evaluates funds in a more fundamental way considering People, Process, Performance, Parent and of course, Price. Of the 1100 funds designated as being "High Cost", 143 of these funds are still awarded a bronze, silver or gold medal by Morningstar – *they like them*!

		
93	37	13
466 funds	314 funds	153 funds

Higher Fees: A Reality Check

In 2014, I wrote a report called "*Your Low Fees Are Costing You Staff Loyalty*". It is a challenge to overcome internal resistance to charging a premium fee.

So here are my questions to those who work in firms that price their products at or below, the competition:

- Have your low or average fees, helped you to bring in more business than the competition?
- Have your low or average fees helped you to keep clients?
- How do you know if your firm's fees have helped client acquisition or retention? Because clients tell you? Are they telling the truth?
- Do your sales people warn you against increasing fees?
- Is there any evidence to support clients choosing your firm because of low fees or leaving your firm because of dissatisfaction with your fees?
- Are you happy with your firm's profits?
- *Is your staff happy with their compensation?*

Higher Fees: Are You Selling a Commodity or a Brand – Name?

This is the second half of my report from 2014, "*Your Low Fees Are Costing You Staff Loyalty*" and let's address the pressure to reduce fees.

Premium products, like Ferrari, charge premium prices. But few asset managers are confident enough to ask a premium price for their product.

Morningstar reported data for 228 mutual fund families (2014). Just 21 families, or less than 10%, had more than 50% of their mutual fund assets priced at a premium to the competition.

Most mutual fund managers are more comfortable pricing their products as undifferentiated commodities.

56 fund families, or nearly 25% of all fund families, price their funds at a discount to their competitors. Companies in other industries, that stake out a low price position (e.g. Walmart), usually do it because they have a low cost position in relation to their competitors. It seems unlikely that there are any active managers that have a cost advantage over their competitors in the long run.

Most of the 56 fund families that price their funds at a discount are giving up profit margin, and a chunk of their staff's bonus pool.

One argument for lower fees is that volume rises with lower fees. So do fund families charging a discounted price grow assets faster? The evidence from looking at Morningstar data over the last 5 years is no.

For example, there are just 7 fund families that have lost mutual fund assets over the last 5 years. 5 have lower than average fees, and 2 charge premium fees. These proportions are in line with the ratio of firms charging premium and discounted fees.

Bottom line, there is no support for the belief that low fees spur asset growth.

Takeaways

- High cost funds are a good thing for fund families because they make more money for the owners and provide the resources to sustain the business.
- AUM growth of fund families that price at a premium is higher than average.
- High cost funds are not a disadvantage to clients in terms of performance - either looking backwards (Stars) or forwards (Medals).
- Strive for higher fees and stop looking at the competition for guidance as to where to set fees.

Appendix: 25 Assumptions That Clients Are Making When They Demand Lower Fees From Active Managers

Here are 25 assumptions that clients may be making when they insist on lower fees:

1. *"Whatever your fee is, it is too high"*
2. *"Fees for investment management shouldn't be based on a competitive market rate – they should be based on calculable value-added"* (unlike almost every other professional product or service in the world)
3. *"Savings from economies of scale should be passed through to clients"*
4. *"Compensation in the industry is just too high"* (compared to what?)
5. *"Money managers are not aligned with their customers"* (the relationship is not seen as a professional one from the client's perspective)
6. *"Managers should focus on absolute returns because, as they say, you can't eat relative performance"* (If a manager relatively outperforms, but the asset class is in negative territory, that is the responsibility/fault of the money manager)
7. *"All return is beta (market-related), and therefore can be purchased cheaply"*
8. *"Index funds are the baseline for measuring active management fees"*
9. *"Since the average money manager underperforms benchmarks, no money manager deserves a premium fee"*
10. *"Small amounts of incremental value over the index on an annualized basis are irrelevant" (*even if the aggregate amount of the client's assets in the long run is significantly higher from adding value in the short run)
11. *"The ability to retreat to cash during prolonged bear markets by active managers is of no value to expert asset-allocating intermediaries like consultants and clients"*
12. *"There is only one right way to manage money in hindsight, and managers must be conflicted because they seem to have done the wrong thing so often"*
13. *"Creating fee structures that make managing a portfolio management business doesn't have any consequences for a portfolio manager's investing actions"*

14. *“Low or complex fee structures won’t affect the retention of alpha-generating portfolio management talent in the industry”*
15. *“The benchmark isn’t client goals, preferences or demands, it is only the index return”*
16. *“Index funds are a better economic answer for allocating capital correctly in the capital markets. The active pursuit of alpha is a wasteful economic activity”*
17. *“Monthly draw-downs are important to long term investors, and portfolio managers should be punished for short term draw-downs”*
18. *“Managers should not benefit financially from unusual upside returns”*
19. *“Manager fees should be deferred and not paid in cash if not earned in the short run”*
20. *“All client portfolios are identical – clients never request customized portfolios”*
21. *“All clients have the same requirements for reporting, client service and there is no demand for any custom services”*
22. *“Performance fees carry no consequences for the economic value of the firm, and the volatility of performance fees doesn’t affect compensation or portfolio talent retention”*
23. *“Manager fees don’t need to reflect the average short term of the average client relationship”*
24. *“Lower management fees don’t affect the cost structure of a firm”*
25. *“I know another firm who charges a lower fee”*

”The CEO Adviser Program”
by Russell Campbell

The CEO Adviser Program is a 1-on-1 program for top leaders of asset management firms to spur business growth. We give you the strategies and tactics that you need to achieve your goals. This program is for CEOs only.

You meet with Russell Campbell by phone for regularly scheduled sessions to review progress, eliminate old obstacles and move forward on new opportunities including looking beyond current trends.

Additional support is available via unlimited calls, emails, or other means between regularly scheduled sessions.

Results My Clients Receive

- Reach beyond your ambitious growth plans - discover what more you can do
- Choose between equally attractive opportunities and allocate resources effectively
- Anticipate how your culture might change as the firm grows and preserve the essential elements
- Consider how other firms structure their top leadership teams
- Enhance your firm's attractiveness to potential acquisition targets
- Spend money to develop your firm's brand only in ways that show results
- Re - discover what once worked for your firm that you can repeat again
- Craft structural solutions to people problems - without the risks and uncertain results of coaching
- Hold onto your top sales and investment talent
- Understand if investment performance weakness is temporary or a symptom of a bigger problem

Russell Campbell Mini – Bio

Russell has been directly responsible for leading 5 investment businesses in his career. He has been a Chief Investment Officer twice. He has also led investment product sales efforts for multiple client segments several times. Russell has been an institutional client of investment firms, and 3x he has been in an intermediary role as an investment consultant, or manager of managers. These experiences have enhanced his 360 - degree perspective.

What People Say About Russell

- *"Addresses our most difficult questions frankly and directly"*
- *"Provocative"*
- *"An iconoclast; offers opinions that you haven't heard before"*
- *"Asks questions that go deeper"*
- *"Honest, no BS insights"*
- *"Intelligent common sense"*
- *"An authority"*
- *"Impressive listening skills"*
- *"Experienced facilitator with hands - on leadership experience in investments"*

Call me at 702-816-8430 for more information about "The CEO Advisor Program".

Russell Campbell is the CEO of Your Second Opinion, LLC, a management consulting firm focused on investment firm growth.

Russell has led 5 investment groups in his career. Prior to establishing his own firm, Russell was the CEO of The Marco Consulting Group, one of the largest institutional investment consulting firms, with a significant CIO outsourcing business. Previously, he was the EVP of AMCORE Bank, and led the Wealth Management Group which was one of the 60 largest bank wealth managers in the U.S. Earlier, Russell was the President and CEO of ABN AMRO Asset Management Holdings, Inc., which managed $75 billion in assets, and was the U.S. investment management affiliate of ABN AMRO Bank. Russell was promoted to this position after having been the CEO of ABN AMRO Asset Management Canada, Inc. He was previously a Vice – President and Partner of Beutel Goodman, Inc., one of Canada's largest investment counseling firms. His first leadership position was as Vice – President, Bank of Nova Scotia, where he led the investment management of the Bank's own pension fund, and a family office portfolio.

Earlier in his career, he held positions as an institutional investment consultant, in institutional equity sales and as a precious metals portfolio manager.

Russell has an MBA in Investment Finance and Marketing from York University, and he has a BA in Industrial Relations from McGill University. He also attended the Advanced Management Program at INSEAD in France.

He has earned the Chartered Financial Analyst designation, and has attended both the Financial Analyst's Seminar and the Investment Management Workshop. Russell has also acquired the Certified Financial Planner ™ certification. He previously held Series 7 and 24.

Russell has been a director of several for-profit and not for profit boards, and he is a member of numerous non-profit, civic and industry organizations.

He is quoted frequently in the media, and has been a speaker at many industry conferences.

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