Fund Democracy

Consumer Federation of America

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Investors Waste Hundreds of Millions Annually on Over-priced Money Market and S&P 500 Index Funds

Consumer Groups Urge Better Mutual Fund Cost Disclosure

Mutual fund shareholders pay more than $300 million a year in excess fees for just two types of mutual funds, according to data released Wednesday by Fund Democracy and Consumer Federation of America (CFA). The groups said the data clearly demonstrates the need for new approaches to mutual fund cost disclosure designed to encourage unsophisticated investors to make more cost-conscious decisions.

"Nowhere are excessive fund fees more apparent than in the exorbitant fees that some shareholders pay for plain vanilla index funds and money market funds," said Mercer Bullard, President and Founder of Fund Democracy. "These funds are essentially fungible. The higher fees provide no additional benefits to shareholders and serve only to reduce investors' returns and fatten fund managers' profits."

"We know that keeping costs down is one of the most important steps investors can take to improve their returns over the long-run," said CFA Director of Investor Protection Barbara Roper. "While many investors have clearly gotten that message, the fact that a significant number continue to pay far more than the best price available for money market and index funds shows that the current disclosure is not working nearly as well as it could or should to encourage investors to make cost-conscious decisions."

Money market funds operate under tight investment restrictions, limiting their holdings to short-term financial instruments such as U.S. Treasury bills, bank certificates of deposit, and commercial paper. S&P 500 index funds are unmanaged stock funds that buy the stocks of companies in the S&P 500 Index and seek to match the performance of that index. Because of these investment characteristics, relative performance of both types of funds is largely attributable to the amount of a fund's fees.[1]

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[1] See, e.g., Domian and Reichenstein, Performance and Persistence in Money Market Fund Returns, *Financial Services Review* (1998) found that fees explain 84 percent of variation in money market fund performance.

In order to estimate excess costs paid by investors in these funds, Fund Democracy and CFA asked Morningstar, Inc. to identify all money market and S&P 500 index funds with expense ratios that exceeded the expense ratio on the comparable Vanguard funds. For each fund, the assets in the fund were then multiplied by the number of basis points by which its expense ratio exceeded the Vanguard expense ratio. The resulting number was identified as the excess cost paid by investors in that fund. Vanguard was chosen as the benchmark because its funds are among the best known, are consistent top performers in these categories, and have among the very lowest expense ratios.

Excess Costs Exceed $300 million

Morningstar identified 57 S&P 500 index funds that in 2002 charged more than the 0.18 percent fee charged by Vanguard for its S&P 500 fund. The average expense ratio among the funds that charge more than Vanguard was 0.82 percent – or 4.5 times Vanguard's fee – with one fund company charging 2.18 percent and 20 fund companies charging over 1.20 percent. According to the Morningstar data, shareholders invested $59 billion in the higher cost index funds and paid over $140 million more than they needed to as a result.

Morningstar identified 65 money market funds that charged more in 2002 than the 0.33 percent fee on Vanguard's Prime Money Market Fund. The average expense ratio among the funds that charged more than Vanguard was 0.92 percent, or almost three times the Vanguard fee. One fund charged 1.89 percent, and charges of 1.20 percent or more were common. Shareholders invested $41 billion in the higher cost money market funds and paid over $160 million more than they needed to as a result.

Altogether, shareholders in these two types of funds paid approximately $300 million in unnecessary expenses in 2002.[2] Furthermore, many of the funds identified as charging higher fees also charge front-end and deferred sales loads not included in this analysis, magnifying by several times, in some cases, the amount that investors in those funds over-pay.

The good news is that a large majority of investors in these two types of funds appear to be making cost-conscious decisions. The data shows, for example, that well over half of the mutual fund assets indexed to the S&P 500 index are invested in funds that charge expense ratios equal to or lower than those charged by Vanguard.

Innovative Approaches Needed to Reach Minority of Shareholders Who Ignore Costs

"We are pleased that most investors appear to have gotten the message about the importance of fund costs, at least when it comes to these two types of funds," Roper said. "Nonetheless, a significant minority of investors are literally throwing their money away. These

[2] In fact, the data understates the extent to which retail investors are paying excessive fees, because the non-Vanguard group includes many institutional classes that carry relatively lower expense ratios not available to retail investors, and the Vanguard S&P 500 fund used for comparison is its highest priced S & P 500 index fund. (Vanguard also offers a retail class S&P 500 fund to long-term investors that has a 0.12% expense ratio.)

are likely among the least sophisticated of fund shareholders," she added. "As Congress and the Securities and Exchange Commission examine reforms in this area, they should focus on these investors and try to identify creative new ways to reach them with the type of information that will encourage them to change their buying habits."

Given the large number of broker-sold funds among the high-cost funds, one area that clearly needs further study is the adequacy of pre-sale disclosures in these funds, CFA and Fund Democracy noted. Unlike with direct-marketed funds, investors in broker-sold funds are not required to receive the prospectus disclosures, including cost disclosures, in advance of the sale. "Some form of mandatory pre-sale disclosure for broker-sold funds clearly deserves serious consideration," Roper said.

The groups released the data to coincide with mark-up of mutual fund reform legislation introduced by Rep. Richard H. Baker (R-LA), Chairman of the House Capital Markets Subcommittee. As introduced, H.R. 2420 encourages the SEC to adopt rules to provide individualized cost disclosure to mutual fund investors on their account statements. An amendment is likely to be offered, however, that would permit the SEC merely to provide hypothetical expenses incurred by a $10,000 account. CFA and Fund Democracy have criticized that approach as unlikely to be effective in communicating this information to the unsophisticated investors most in need of improved cost disclosure.

Also expected to be introduced, however, is an amendment to require funds to disclose the costs of comparable mutual funds. "Requiring funds to disclose how their fees compare to those of other funds would go a long way toward educating investors about fund expenses and promoting competition in the fund industry," Bullard said.

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Fund Democracy is an advocacy group for mutual fund shareholders that was founded in 2000.

Consumer Federation of America is a non-profit association of approximately 300 national, state, and local pro-consumer groups. It was formed in 1968 to represent the consumer interest through advocacy and education.