STAFF SUMMARY OF GAO MUTUAL FUND FEE FINDINGS

Some of the studies, reviewed by GAO, that had looked at the overall trend in mutual fund fees since 1990 found that operating expense ratios and other charges were declining. Among these were a series of studies conducted by ICI. In contrast, other studies and analyses found that fees had been rising. The conclusions reached by studies in both groups have been criticized because of the methodologies used. Therefore, GAO conducted its own analysis using data collected on the 46 largest stock and 31 largest bond funds in existence from 1990 to 1998.

Academic studies and other research find that, as mutual fund fees grow, mutual fund advisers experience operational efficiencies or economies of scale that would allow them to reduce their funds' expense ratios. However, GAO was unable to determine the extent to which mutual fund advisers experienced such economics of scale because comprehensive data on total costs incurred by mutual fund advisers are not publicly available. Currently, mutual funds disclose to regulators and to their investors only those operating costs that have been deducted from the assets of the fund, but not the costs that the advisers incur to operate these funds. Industry officials told GAO that fund advisors' costs have been increasing, although that assertion is impossible to verify (pp. 9-10, Chapter 2 at pp. 33-45).

As shown in Table 2 on page 10, the revenues stock funds produced for their advisers and other providers increased over 800 percent from 1990 to 1998. Fee revenues for the largest funds similarly increased. Using data on 77 of the largest stock and bond funds, GAO found that the advisers and service providers operating these funds collected $7.4 billion in fee revenues in 1998. This was over $6 billion, or almost 560 percent, more than they collected in 1990.

Against this backdrop, GAO's principal findings are:

1. The average size of the 46 largest stock funds increased by about 1,100 percent from 1990 to 1998; the average size of all other stock funds increased by about 300 percent. Combined, the average size of the largest stock and bond funds grew by about 600 percent during this period as compared to the approximately 200-percent increase in the size of all other stock and bond funds (Table 3.1 at p. 48).

2. The average expense ratio per $100 of assets for largest stock funds declined from 89 cents in 1990 to 71 cents in 1998, which was a decline of 20 percent. The expense ratio for the largest bond funds was 66 cents in 1990 and 64 cents in 1998, a decline of three percent (Figure 3.1 at p. 49).

3. The decline in the fees charged by the 77 largest stock and bond funds did not occur consistently over the period from 1990 to 1998 (p. 49). The fees paid by the average dollar invested in the largest stock funds rose in the first years of this period from 74 cents in 1990 to a high of 81 cents in 1994 before declining in the last several years to 65 cents in 1998. The fees paid by the average dollar invested in the largest bond funds remained relatively constant in the 60 to 63 cent range but also declined in the most recent years to 58 cents in 1998 (Table 3.2 at p.

50). The average expense ratio declined by 12 percent for the largest stock funds and by 6 percent for the largest bond funds, although this decline did not occur steadily over this period (p. 11 and Table 3).

4. GAO's analysis and those by others indicated that the advisers for most large funds had reduced their funds' expense ratios. Of the 77 large funds for which GAO collected data, 54 funds, or 70 percent, had lower operating expense ratios in 1998 than they had in 1990. The largest bond funds were less likely to be charging lower fees than were stock funds; 48 percent of the bond funds had lower expense ratios compared to 85 percent of the stock funds (Table 3.3 at p. 50).

5. Overall, 23 of the 77 funds reported higher expense ratios in 1998 than in 1990. Table 4 at page 12 shows the changes in expense ratios for the 51 funds among the 77 largest funds that experienced asset growth of at least 500 percent from 1990 to 1998. Of these funds, 38 (74 percent) had reduced their expense ratios by at least 10 percent during this 9-year period. Of the remaining 13 funds, 7 (14 percent) reduced their expense ratios by less than 10 percent, and 6 (12 percent) had either not changed their fees or had increased them (pp. 11-12 and Table 4).

6. As shown in Table 3.4, the more the assets of the 46 largest stock funds had increased since 1990, the more likely they were to have lower operating expense ratios in 1998. However, not all funds had lower expense ratios, even when they experienced significant asset growth. As can be determined from Table 3.4, the assets of 40 of the large stock funds grew 500 percent or more from 1990 to 1998. Of these 40 funds, 10 funds, or 25 percent, had not reduced their operating expense ratios by at least 10 percent in the 9 years since 1990; and 2 of the funds were charging higher ratios in 1998 than they had in 1990 (p. 51 and Table 3.4 at p. 52).

7. Although bond funds generally experienced less growth than stock funds, a similar relationship between asset growth and operating expense reductions also was found to have existed for the largest bond funds analyzed by GAO. As can be seen from Table 3.5, the assets of 11 of the large bond funds grew 500 percent or more from 1990 to 1998. Of these 11 funds, 3 funds, or 27 percent, had not reduced their expense ratios by at least 10 percent in the 9 years since 1990 (Table 3.5 at p. 52).

8. Funds with higher operating expense ratios made greater reductions than funds with lower ratios. As shown in Figure 3.2, the average ratio for the 29 high-fee funds declined from $1.22 to 92 cents; the average ratio charged by 48 low-fee funds remained relatively flat at about 54 cents (p. 53 and Figure 3.2 at p. 54).

9. SEC officials that reviewed GAO's analysis noted that reviewing data for only the largest funds would bias the results towards those funds most likely to have reduced their expense ratios. As a result, a review of funds outside the largest funds could find that a much smaller percentage of funds had reduced their expense ratios to any significant degree (p. 51).

How Mutual Funds Lost Their Way

By John C. Bogle

In the past 50 years, mutual funds have gone from a $2.5 billion also-ran in the financial-services industry to a $7 trillion titan. Funds now enjoy an unchallenged position of leadership, accounting for 70% of the $2 trillion that U.S. families added to their savings over the past five years.

But while mutual funds may be the best game in town, they aren't playing nearly as good a game as they should. The returns of fund shareholders in stock, bond and money markets have fallen far short of what is available in those segments. A diminishing focus on stewardship, shrinking investment horizons and soaring costs are responsible. The mutual fund industry has lost its way.

Dramatic Change

I've been studying mutual funds since 1949, when I began researching my senior thesis at Princeton University. The change in industry direction has been dramatic. Back then, the mutual-fund industry was more a management business than a marketing business; today the reverse is true. We have moved from treating funds as investment trusts designed to serve their owner-beneficiaries to treating funds as consumer products, designed to attract the largest possible assets. This new approach has ill-served the interests of fund shareholders.

A dramatic decline in investment horizons has also changed the industry. In 1950-65, funds were long-term investments; fund managers were long-term investors; and fund shareholders held their shares for more than a decade. Costs weren't excessive and mutual-fund performance measured up to the reasonable expectations of investors.

None of this is true today. Funds, once investments for a lifetime, now come and go at a remarkable rate. Some vanish when they fail to achieve their investment objectives, liquidated or merged into other funds. Others, created to reflect the investment fashions of the moment, disappear when the fad passes. The go-go funds of the late 1960s and the government-plus funds of the late 1980s are but two examples. Many of today's Internet funds and technology funds will probably meet the same fate.

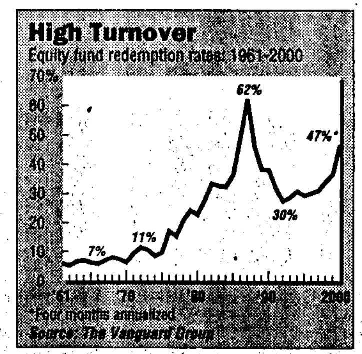
During the 1990s, 55% of equity funds failed, almost four times the 14% failure rate of the 1960s. Should the recent failure rate hold, 2,500 of today's 4,500 equity funds won't be around in 2010. Their owners will be victims of inferior performance and will be subject either to paying unnecessary taxes when they liquidate their shares or forced transfer to a new fund.

Fund managers, once long-term investors, have become short-term players—speculators, if you believe that holding stocks for an average of 406 days has little to do with investing. Fund portfolio turnover, averaging about 17% annually during my first 15 years in this industry, rose to 90% last year.

The hyperactive trading atmosphere of the day is partly responsible. But the shift in control from investment committee to portfolio manager has also played a major role. For better or worse, the industry's dominant force has changed from consensus to impulse. What's more, portfolio managers turn over at a rapid rate. The average manager lasts just six years, and then a new broom sweeps the portfolio clean. It seems there are few stars in the mutual-fund firmament, just many comets.

Mutual funds used to be run on behalf of shareholders with a longterm mindset. Now the speculators have taken over. Fees are up and performance is down.

Since most fund trading takes place with other funds, the returns of fund investors as a group can't possibly be enhanced by all of this turnover. Its heavy costs create benefits that go largely to those who execute the transactions. The biggest beneficiary is the federal government, which has reaped billions of dollars from taxes on long-term capital gains—not to mention higher income taxes on substantial short-term gains. The premature realization of gains accounted for a major portion of the $30 billion of federal taxes paid by fund investors in 1999.



This contagious short-term virus has now spread to fund shareholders. Share redemptions, which ran at about 8% of fund assets during the 1960s and 15% during the 1970s, leaped to 30% during the 1990s, and are running at an astonishing 47% rate in 2000 (as shown in the nearby chart). This dramatic increase suggests that fund shares—once held by long-term investors for an average of 12.5 years—are today held for an average of just over two years. This is a sad fate for an investment that was originally designed to be the perfect medium for the long-term investor.

Redemption rates, meanwhile, are about twice as high as those published by the industry. Its data exclude redemption proceeds that are reinvested in funds of the same fund family. These exchange redemptions are about equal in amount to the regular redemptions that find their way into other funds, or individual stocks, or the bank, or to purchase a home or car.

All of these measures of mutual-fund investment activity—funds that come and go, portfolio holdings that come and go, portfolio managers who come and go, and fund shareholders who come and go—frustrate the achievement of long-term investment objectives. Equally counterproductive is the heavy burden of mutual-fund fees and expenses. When I studied the industry 50 years ago, expenses amounted to 0.77% of the assets of the average equity fund. This expense ratio has risen ever since. In 1999, it reached 1.61%, an increase of over 100%.

Given the staggering rise in fund assets, the surprising fact about the expense ratio is that it failed to decline. There are huge economies of scale in mutual-fund operations, but they aren't adequately shared with fund shareholders. The Investment Company Institute reports that even the lowest cost decile of funds has raised prices by 27% since 1980.

It is true, as the Investment Company Institute reports, that the annual cost of purchasing equity funds (including expenses and sales charges) is "only" 1.32% when weighted by fund assets. But according to its data, mutual-fund shareholders now pay estimated annual fees, expenses, and sales charges of $75 billion. Adding in estimated portfolio turnover costs of about $45 billion, mutual funds are generating returns of some $120 billion annually to their managers, marketers, and brokers—dollars that are diverted from the returns of fund shareholders.

These costs, along with heavy taxes, are responsible for the inadequate returns funds have provided their investors, returns that have fallen far behind those of the great bull market. During the past 15 years, equity funds—at least those that survived the period—provided a net return (after costs and taxes) of just 11.7%. By way of comparison, an index fund that owned the entire U.S. stock market—represented by the Wilshire 5000 index—would have earned a return, also adjusted for costs and taxes, of 16.1%. This advantage of 4.4% a year is larger than it seems. Compounded over the period, the average equity fund rose 426%, compared to 839% for the index fund. The fund shareholder received barely one-half of what might have been expected.

Investment horizons that are too short and costs that are too high are the principal problems facing the mutual-fund industry. The root cause of these failings is the industry's failure to focus on the primacy of the fund shareholder. It's called stewardship. The Investment Company Act of 1940 warns against organizing, operating, and managing funds in the interest of investment advisers rather than the interest of shareholders, but that warning isn't adequately heeded today. It is high time that fund managers and independent directors, as well as public officials and the media, give these issues the attention they deserve.

Trusteeship Lost

While my voice has been a lonely one, I am not without some important support. Henry Kaufman's insightful new book, "On Money and Markets," notes: "Basic fiduciary duty too often has been forgotten in the high-voltage, high-velocity financial environment that has emerged in recent decades . . . the notion of financial trusteeship is frequently lost in the shuffle."

I hope that the mutual fund industry will find it, and will once again find its way.

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