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Highlights from Discussions on Mutual Fund Profitability and Economies of Scale

By Jay Keeshan and C. Meyrick Payne of Management Practice Inc.(MPI). Management Practice is currently holding a series of workshops on profitability in conjunction with the Mutual Fund Directors Forum.

Throughout 2007, MPI, in cooperation with the Mutual Fund Directors Forum, held a series of workshops across the US to discuss the issues of profitability and economies of scale and their role in the mutual fund advisory contract renewal process. More than 75 attendees expressed their thoughts at these interactive "boardroom" style discussions. Among the participants were mutual fund independent directors and independent counsel, MFDF representatives, management company executives, and partners from PricewaterhouseCoopers (PwC hosted the events). MPI will continue this series in 2008 with workshops in Philadelphia, Denver and San Francisco.

Each day began with a prominent '40 Act attorney reviewing the current legal guidelines for reviewing profitability as currently interpreted, along with a discussion of any recent cases or relevant regulatory action. Once this initial groundwork had been laid down, it prompted discussions around the topic for the first half of the day. The discussion then turned to economies of scale which provided a second half day of spirited debate.

PROFITABILITY ANALYSIS

Nearly 25 years old, the Gartenberg case, in which the 77% return on revenue profitability earned by Merrill Lynch was judged to be "not unreasonable," is still the most commonly relied upon standard when assessing fund profitability. However, most attendees agreed the industry has changed significantly since 1982 and that this standard should be updated. Many boards find comfort using other benchmarks and ranges that are available through third party providers.

Attempting to put the true meaning of profitability review in the proper context, some felt that while the profitability of *all* funds must be reviewed *every* year, the profitability level of certain funds -- those with both relatively higher fees and lower performance -- certainly deserve an extra dose of scrutiny.

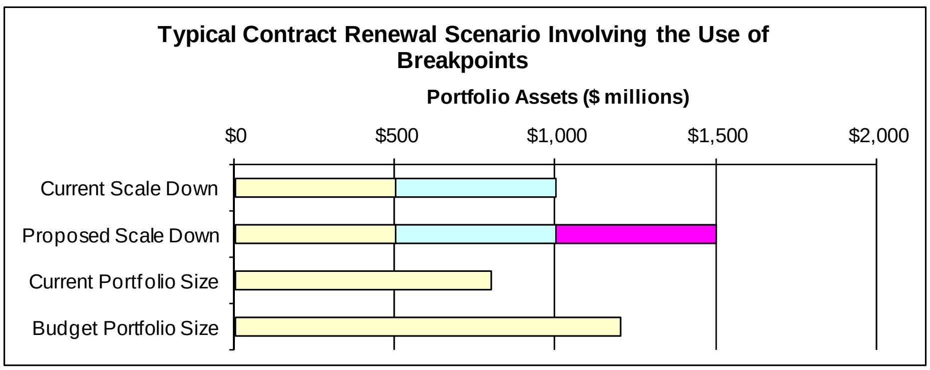
Another hot topic was the allocation of expenses when determining profitability across a family of funds. There are a few methods commonly used—by assets, revenues, or activity—each with its own set of potential problems depending on the makeup of the funds. "One size does not fit all," said one attorney. "Methods must be adjusted to fit different complexes." A commonly suggested practice in this area was that the process should be reviewed each year by a third party, and for additional scrutiny, the data could be run using a second method for comparison to see if there is any significant difference. As one director put it, "It is important that the profitability numbers are useful to management and are not just window dressing."

ECONOMIES OF SCALE

The discussion of sharing economies of scale provided plenty of debate among the attendees. Mutual fund directors are required to share any reductions in costs with the shareholders as the fund grows in size. The prevalent method for this is through the imposition of breakpoints. A scenario was presented that displays a typical scale down in which the effective management fee decreases as assets grow. The end benefit to shareholders surprised many fund directors. The imposition of a new breakpoint at $1 billion only gave the shareholders a 4% sharing of economies of scale.

In this scenario:

- A fund is currently charging a 60bp advisory fee at $800 million AUM
- Board sets break point of 5bp at $1 billion as fund is expected to grow to $1.2 billion
- On the additional $400 million, shareholder gets 5 bps on $200 million or $100,000
- Advisor gets 60 bps on $200 million and 55 bps on $200 million or $2,300,000
- Sharing of economies of scale is 4% to shareholders and 96% to advisor



The fact that breakpoints as currently applied lead to such a small sharing of economies of scale caused directors to debate whether fee caps and waivers might provide a more meaningful impact.

The use of sub-advisors brought up another interesting issue: If a sub-advisor provides a breakpoint once a certain level of assets are reached, should this be shared directly with the fund shareholders? While at first glance this might appear to be an obvious "yes," there may be issues to consider. As an example, was the breakpoint taken into account when the initial advisory fee was first set, allowing a lower fee while the fund was in the start up phase?

While opinions on these and numerous other topics varied among the attendees over the course of the year, there was one overarching concept with which all agreed: when reviewing profitability and economies of scale, process is king. As one fund counsel put it, "If the process is sound, directors should be protected, and advisors should be protected."