

## Profitability Benchmarks in Contract Renewal

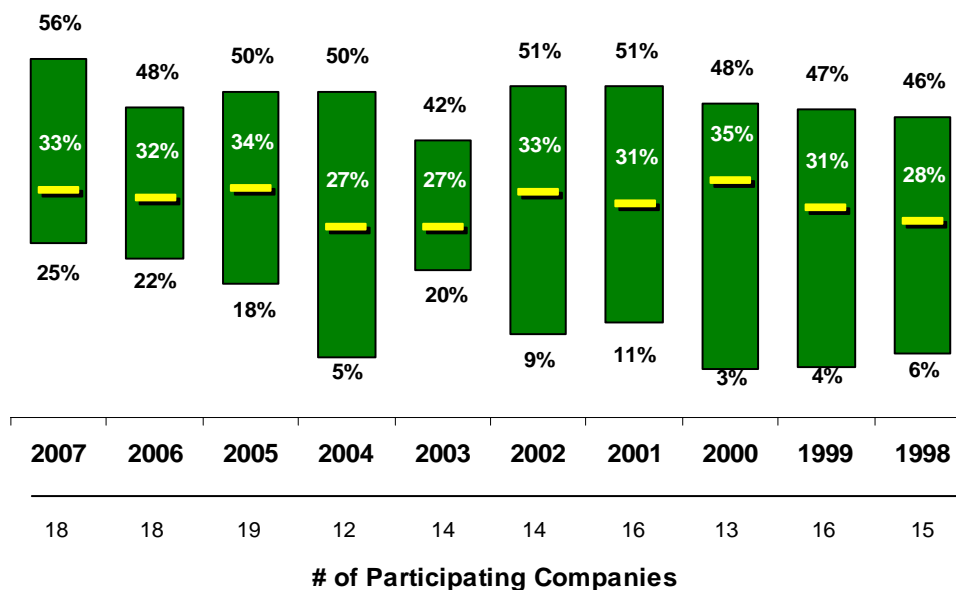
By C. Meyrick Payne and Sara Yerkey of Management Practice Inc.(MPI). Management Practice is currently holding a series of workshops on profitability in conjunction with the Mutual Fund Directors Forum.

The most important function served by mutual fund directors is the annual review of investment management arrangements. One of the most complex and potentially confusing factors in this review is the analysis of the investment manager's profitability. Not only is the computation of this factor difficult, but determining what weight to give the results of the analysis in renegotiation of the advisory contract can be even more puzzling. For example, if the manager's profit margins are high or consistently increasing, should directors take this as indicating a reason to reconsider certain terms of the contract? Or should adviser profitability be viewed in some other way?

The process that directors use to review profitability is critical. A thorough review process and adequate documentation will help demonstrate that directors have fulfilled their responsibilities as "watchdogs" of the interests of the shareholders. The courts have clearly rejected the Calvinistic notion that too much profit is in itself a cause for condemnation. There is no hard and fast rule for determining whether an adviser earns an unreasonable profit from a fund. One court found that, after considering all relevant factors, an adviser's pre-tax profit of 77% return on revenue was reasonable under the circumstances.

Nonetheless fund directors should have some benchmark against which to evaluate profitability. Over the past sixteen years, MPI has tracked the pre-tax profit margins of publicly traded companies significantly engaged in mutual fund management. Not surprisingly the range of profit margin has varied considerably, although the average return after all costs is usually about 30% of revenue as shown in the exhibit below.

**Operating Margin Ranges and Averages, 1998 - 2007**



Many mutual fund directors believe that profitability should be measured on both a fund by fund basis and on a complex wide basis. Fund by fund profitability is important because the directors represent shareholders of a particular fund. Generally fund by fund profitability is based upon the advisory fee alone, whereas overall profitability tends to be measured on the basis of overall investment management activities, including marketing and shareholder services. Needless to say with both fund by fund and overall profitability there is considerable reliance upon the allocation of overhead.

Advisory fee profitability on a fund by fund level is typically simply the difference between the advisory fee paid by the fund to the manager and the manager's expenses related to managing the fund. Using this formula directors can compare a fund's profitability to that of other funds illustrating that certain fund types are more or less profitable to manage than others. The following information prepared by MPI reflects the profitability of different fund types for a hypothetical fund group.

<b>Advisory Contract Profitability as % of Manager's Revenue</b>	
Single State Tax Free Bond	40%
Small Cap Value Equity	48%
High Yield Corporate Bond	50%
Large Cap Growth Equity	70%
Money Market	72%
<b>Complex wide</b>	<b>56%</b>

MPI has typically found that small funds (generally under \$100 million in assets) are unprofitable as are funds within two years of inception.

Imbedded within the profitability measures are inevitably allocations of costs common to several funds. These include corporate overhead as well as services, such

as transfer agency, custody, fund accounting and administration. Any one of these costs may be allocated. Fund directors need to understand that these allocations are appropriate. Generally there are five bases of allocation: (1) asset based, which tends to make the largest funds less profitable, (2) revenue based, which takes the assets and multiplies by the advisory fee, which tends to allocate even more expenses to the largest equity funds, (3) time based, which requires keeping some sort of time expended records, (4) cash flow based, which tends to allocate costs to those funds which have the greatest sales and redemptions, and (5) occupancy based, which tends to allocate costs to those funds which have the largest number of staff assigned to them.

Assessing profitability is one of the most sophisticated judgments a mutual fund director makes. As a result they often retain an independent third party to develop appropriate benchmarks, to understand the different levels of profitability and to attest that the allocations are done on a consistent and appropriate basis.