MANAGEMENT PRACTICE®

Comparing the "Degree of Difficulty": A New Approach to Fund Director Compensation

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In addition to the myriad duties mutual fund directors must carry out with regard to the funds they oversee, they are faced with the added burden of setting their own pay. The demands of the job, including the expertise required and time involved, justify being paid fairly. However the optics of being overpaid would not be perceived favorably by fund shareholders or the financial press.

A common approach to solving this issue is to refer to annual studies that provide compensation data based on the dollar amount of assets, or perhaps the number of funds, overseen by other boards in the fund industry. While these studies are certainly of use and can provide some comfort to boards year to year, MPI has long believed that these numbers are meant to be descriptive, not prescriptive. That is, while they may provide a snapshot of current industry pay levels, it does not automatically follow that this data should be used when setting pay.

The financial crisis of 2008 made this entirely evident. Assets under management (AUM) plummeted due to the decrease in values of the underlying securities, as well as negative net flows as investors fled to safety. This caused a few issues in the compensation data. As an example, in 2007 our survey found that directors in the $9 billion to $25 billion group earned a median of $77,942. In the 2008 report the median for this group was $117,500. This does not mean that directors in this group received a significant pay increase, but rather that the group likely became populated by a very different set of directors, many of whom were in a different/higher group in the previous year due to their larger asset size. There were additional anomalies in the data due to the dynamics of the industry, wherein the median pay levels for some asset size groups were lower than groups with lower assets levels. This would imply that directors should take a pay cut as assets grow, which of course would not be rational.

Additional problems lie in the fact that the governance duties associated with mutual funds do not generally decrease with decreases in AUM, and in fact for many over the past year the job has become ever more demanding. Furthermore there are some boards that may experience a high degree of complexity or effort, but have relatively low AUM. An example would be a fund manager that is steadily opening new and cutting-edge funds, but has relatively few assets in the early stages.

With so many boards seeking guidance for their particular situations, MPI has endeavored to try to alleviate this problem. In going beyond measuring by AUM or the number of funds governed, we have outlined a more comprehensive model that captures and measures the numerous variables that impact the "degree of difficulty" associated with fund governance.

While still in the formative stage, this new methodology examines the complexity of the job across four broad dimensions: **Structural Complexity, Product/offering Complexity, Investment Complexity, and Organizational Complexity/Breath of Exposure.** Each is discussed below.

Structural complexity examines the board's duties as pertains to the various activities of the manager. This includes the marketing platforms or distribution channels the funds are placed in, such as retail supermarkets, insurance products, retirement vehicles and workplace offerings such as 401(k) and 403(b), savings platforms like 529 plans, etc. It also considers any impact of cluster board structures, as well as the number of sub-advisors overseen. Finally it takes into account the level of new, closed, or merged fund activity initiated by the manager.

Product/offering complexity looks at the array of funds/products overseen by the board. This includes the different types of funds (equity/fixed income and money market funds, open end/closed-end, variable annuity funds, life-cycle, target date, allocation, funds of funds, international/emerging markets, specialty or alternative strategy funds, etc.) It also takes into account the total number of funds, as well as the number of share classes, and (where applicable) the variety of fee structures.

At the **investment complexity** level, an analysis of the funds' investment strategies and the makeup of the securities held in the funds is performed. This assesses the full spectrum of investments, whether they be long-only equity index funds, fixed-income, international/emerging markets securities, all the way up to the use of derivatives and alternative/hedging strategies. An attempt is also made to determine whether the fund lineup is relatively stable, or if the advisor is known for continuously producing new funds based on cutting-edge financial innovation, requiring significant continuing education for the directors. Other aspects such as tax strategies and securities lending programs are also considered.

Finally, to gauge **organizational complexity and breadth of exposure,** we look at a number of measures including analyzing the number of so called "SEC events" (e.g. mergers, liquidations, sub-advisor changes and other occurrences which require an SEC filing), as well as any public legal activity by the SEC or otherwise. AUM is a factor, as is the number of meetings and the number of sub-advisors.

Data for a "degree of difficulty" analysis can be derived from a variety of sources, including both private and proprietary databases, public filings, company websites, and even interviews with directors and industry executives. This approach helps to provide a relative framework of comparison against other fund complexes.

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As has always been the case, only the directors themselves can truly gauge the intricacies and complexities of their job, and how they should be compensated. With this new set of tools and a broader perspective, they will have better comparable data to make their compensation decisions.