IFIC | THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

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JOANNE DE LAURENTIIS
President and CEO *Présidente et chef de la direction*
jdelaurentiis@ific.ca 416 309 2300

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Delivered By Email: comments@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3

Dear Sirs and Mesdames:

RE: CSA Discussion Paper 81-407: Mutual Fund Fees

We are writing to provide you with comments on behalf of the Members of the Investment Funds Institute of Canada ("IFIC") with respect to the Canadian Securities Administrators' ("CSA") *Discussion Paper 81-407 – Mutual Fund Fees* (the "Discussion Paper"), published on December 13, 2012. We appreciate the opportunity to participate in this discussion.

General Comments

We are pleased that the CSA has chosen to initiate this policy review in the form of a Discussion Paper rather than in the form of draft regulations as we appreciate the opportunity to participate in this important consultation. In particular, we have concerns regarding the context of certain arguments presented in the paper, and the reach of potential regulatory changes the CSA may be considering. In presenting these concerns, we consider them from the perspectives of the industry and its investors.

In the Discussion Paper, the CSA recognizes that there are other investment fund products whose fee structures may raise similar issues for investors as mutual fund fee structures. We view it as unfortunate that the CSA, nevertheless, has chosen to focus the Discussion Paper solely on mutual funds without meaningful reference to other retail investment products. This may incorrectly imply to readers that there is a singularly high level of conflict and risk to investors posed by the pricing of mutual funds.

The mutual fund is one of a wide range of investment products available commercially in Canada to retail investors. Its manufacture and distribution are tightly regulated through the rules and regulations of provincial and territorial securities commissions and self-regulatory organizations ("SROs"). Existing regulations for the disclosure and management of conflicts in the distribution of mutual funds are extensive and will likely be strengthened further through the introduction of new rules for the Fund Facts disclosure document and the Client Relationship Model ("CRM").

We believe that the current regulatory environment in Canada is serving investors well. While there have been significant gaps in the regulatory structures in other jurisdictions, such as Australia and the UK, securities regulation in Canada has been ranked among the best in the world. Evidence from international research bodies confirms the strength and effectiveness of Canada's regulatory environment – an OECD study[1] ranked Canada second in securities market regulation and investor protection, while a recent World Bank study[2] ranked Canada fifth in terms of investor protection.

Supporting these findings is the fact that investor research in Canada consistently demonstrates that investors have very high levels of trust in their advisors. Recent examples are: the Investment Industry Association of Canada research which shows that 84 percent of Canadian investors have high levels of trust in their advisor;[3] the 2012 CSA Investor Index which found that 9 in 10 investors are comfortable bringing forth concerns and questions when speaking with their financial advisor;[4] and the 2012 Pollara study which found that 93 percent of investors agree they can trust their advisor to give them sound advice.[5] Most recently, 88% of participants in an online consultation carried out for the OSC's Investor Advisory Panel agreed with the statement, "I generally trust the advice I receive from my financial advisor."

Based on the facts that: funds and fund distribution in Canada are highly regulated; there are further regulations being implemented which may mitigate the CSA's concerns; and that the examples provided of regulation in foreign jurisdictions are in very early stages of implementation and may have been initiated in a context very different from Canada's, we strongly advise the CSA to monitor the international developments carefully and to undertake further research and analysis before proceeding with such further regulatory changes as those outlined in the Discussion Paper.

Embedded Fees – Conflict of Interest Analysis

In the Discussion Paper, the CSA focuses on the predominant pricing structure for mutual funds in Canada – which includes embedded fees for advice usually within trailer commissions - and identifies a number of areas where the CSA feels potential conflicts may be posed by this structure.

[1] Alain de Serres et al., "Regulation of Financial Systems and Economic Growth in OECD Countries: An Empirical Analysis," *OECD Economic Studies*, No. 43, 2006.

[2] The World Bank and the International Finance Corporation, Doing Business 2012.

[3] Investment Industry Association of Canada, Economics of Loyalty Report 2012, January 2013, prepared by Advisor Impact.

[4] Canadian Securities Administrators, 2012 CSA Investor Index, October 2012, prepared by Innovative Research Group, Inc.

[5] Pollara, "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry," Report prepared for IFIC, 2012.

We do not believe that the payment of embedded fees represents a conflict of interest for manufacturers. The management fee charged on fund assets is used by manufacturers to pay for a variety of expenses such as trailing commissions, sales fees, sub-advisory fees, salary and benefits for employees, office expenses, technology costs, marketing expenses and other general administrative costs. Manufacturers are commercial enterprises that, within the confines of reasonable regulation and legislation, are entitled to choose how they run their businesses and spend their revenue. It is unreasonable and would be inappropriate to characterize a decision to, for example, increase benefits to employees, or increase a marketing budget, or to pay trailing commissions as being potentially conflicted. We note that the types of payments, including the payment of trailing commissions a manufacturer makes with its management fee is not an issue that is described as a conflict in National Instrument 81-107 and it was not raised in Ontario Securities Commission's Staff Notice 81-713. We are surprised that it was raised as part of this Discussion Paper.

While it is true that the potential for conflict may exist for mutual fund distributors with respect to the embedded fees on mutual funds, this is equally true with embedded fees in other financial products and other retail products generally. The question is, does the potential for conflict rise to a level requiring additional regulatory controls beyond the extensive regulations already in place? The evidence does not support this.

The Discussion Paper leads the discussion on this question with a few misconceptions about trailing commissions. We will take the opportunity to correct them here.

The first misconception is found in the Discussion Paper's underlying theme that trailing commissions are used exclusively for the compensation of advisors. The reality is that trailing commissions are paid to the dealer firm to cover a whole host of regulatory and supervisory functions and services in addition to advisor compensation. The dealer may retain one half or more of the trailing commission to pay for, for example: tier 1 and tier 2 supervision and the systems that support it, regulatory costs including fees to fund the SROs, OBSI, and securities commissions, client complaint handling processes, advisor investigation and enforcement requirements, general compliance obligations of the SROs, OBSI, and securities commissions, client reporting, due diligence on products, etc. These components of the trailing commission which support the regulatory obligations of a dealer are well aligned with investor interests.

The portion of the trailing commission that goes to the advisor also benefits clients through the provision of client services. These services include but are not limited to: suitability reviews, reviews on transfers, reviews of material changes in client circumstances, responses to client questions, general financial advice that can be unrelated to mutual funds, the rebalancing of portfolios, advice on registered products, the setting up of savings programs and the encouragement of good investment behaviours.[6] Since the trailing commission is based on a percentage of assets, the advisor has a joint interest with the client in seeing their assets grow.

In addition, the Discussion Paper states that a trailing commission may incent advisors to sell a particular mutual fund to investors over another comparable mutual fund with a lower commission. The incidence of this conflict, however, is minimal in the Canadian market since trailers are largely standardized: 1.00% for an equity fund, 0.50% for a fixed income fund, and 0.25% for a money market fund; and the percentages that flow to the advisor fall within a narrow range. While there may be some funds paying higher than standard trailers, the variance is small and unlikely to provide an incentive to offer one fund over another similar fund or to offset the aligned client/advisor interest of optimizing asset growth within the client's risk profile. The practice of recommending a lower than suitable asset allocation in bond funds, for example, in order to earn

[6] Significant benefits derived from financial advice are analysed and documented quantitatively in Montmarquette, Claude and Nathalie Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Advisor, CIRANO Institute, July 2012.*

higher trailer fees would not be in compliance with an advisor's duty of care and suitability obligations.

Embedded Fees – Common to Financial Products

Secondly, by referring exclusively to mutual funds, the Discussion Paper implies that embedded fees, and the potential conflicts they represent, are unique to this product. It is quite evident, however, that mutual funds are not the only financial product held by Canadian households where the cost of distribution is embedded in the product price. Compensation for distribution is typically embedded in the margins and spreads of other investment products including deposit instruments, fixed income products, equities, and segregated funds, which together account for nearly three quarters of the total household balance sheet.[7] It is also the norm for retail products generally, that distributor charges are embedded in the price of the product.

Mutual funds are already required by regulation to publish their costs completely and transparently. Virtually all of a fund's costs, including distribution costs, are required to be included in the fund's management expense ratio (MER) and published in the fund's regulatory documents. In 2011, the overall mutual fund cost-to-customer, an asset-weighted measure of acquisition costs, ongoing costs and disposition costs for all funds in all channels of the Canadian market was estimated by Investor Economics to be 2.10%.[8] This compares with an industry aggregate asset-weighted MER for all funds in all channels of 2.08%.

Contrast this with the embedded distribution costs of other financial products which make up the Canadian Household Balance Sheet. For example, GICs, an important deposit product held in Canadian portfolios, are advertised and sold based only on their return and without mention of fees earned by their distributors. The fee charged to customers on this product, however, is ultimately the spread, or a portion of the spread, between the interest paid on GICs and the rate charged on credit products of the bank issuing the GIC. Similar distribution costs, which may not be disclosed to the client, are embedded in the prices of other financial holdings shown in the following table.

Household Balance Sheet – Breakdown of Financial Wealth as at December 2011		
	Assets ($bn)	As a % of Financial Wealth
Deposits and Cash Equivalents	1,225	41.2%
Equities and Fixed Income	771	25.9%
Mutual funds	805	27.1%
Segregated funds	120	4.0%
Other investment funds	48	1.6%
Other financial assets	4	0.1%
Financial Wealth	2,973	100%

[7] Investor Economics. *Household Balance Sheet 2012*.
[8] Investor Economics, *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives,* September 2012.

Embedded Fees - History

The Discussion Paper also fails to fully describe the history and evolution of trailing commissions in the Canadian mutual fund market. In the early decades of growth of the market, fund sales were dominated by the front-end load option. Payments for distribution and advice were timed to occur with the provision of services to the account, which were largely front-ended – the opening of the account, the assessment of the client's circumstances, objectives and risk tolerance, and the development of an investment plan. In the early 1980s, front-end loads on some funds were as high as 9%, paid out of the amount invested.

Front-end loads gave way over time to structures in which dealer and advisor services, though still principally front-ended, were paid for on an amortized basis over the period in which an investor stayed invested – through trailing commissions based on a percentage of the amount invested and internalized, or embedded, in the management fee of the fund. These structures had the advantage that investors were able to see all, or most, of their principal go to work immediately at the time of investment. Since compensation was based on a percentage of the assets in the account, rather than awarded up front on a transactional basis, the interests of investors and advisors became better aligned.

Over the subsequent years, distributor costs have become increasingly internalized within fund management fees, first with the growth of the deferred sales charge (DSC) option in the 1990s, which replaced the investor-paid sales commission with a fund company-funded payout up front and an ongoing trailing commission at a lower rate than the front-end option, and then the rapid growth of no load options in the 2000s with no initial sales charges and higher trailing commissions than the DSC option. Throughout, the market gravitated to embedded fees because it was a better model - both for investors in terms of protecting their interests and providing them with access to affordable advisory services, and for the dealers and advisors who were provided more stable revenues in exchange for serving their clients on an on-going basis.[9]

Mutual Fund Fees – Cost of Ownership

Finally, any justification for singling out mutual funds for additional regulatory scrutiny based on a view that mutual fund fees are too high in Canada has now been completely dispelled by a research report produced in late 2012 by recognized third party mutual fund experts - **Investor Economics** in Canada and **Strategic Insight** in the United States. Their research shows that, for investors helped by a financial advisor, the management and distribution of mutual funds in Canada are priced at similar levels with the management and distribution of funds in the United States, the world's largest mutual fund market.[10]

Specific Comments on Possible Regulatory Changes

i) Advisor services to be specified and provided in exchange for trailing commissions

The industry supports measures that would better inform investors on what is being paid in the form of trailing commissions, and what services should be expected in return. We have appreciated the efforts made by the CSA in recent years to increase transparency for investors, including initiatives taken to rework rules relating to the Fund Facts disclosure document and the CRM. We look forward to seeing how the final versions of these rules, taking into account comments received from the industry, will develop and play a role in increasing investor awareness of the costs of investing.

[9] A more fulsome description of the development of the Canadian market can be found in Investor Economics, *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives,* September 2012

[10] Investor Economics and Strategic Insight, "*Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada- U.S. Perspective*", November 2012.

It is possible that once these new regulations have been fully implemented and given the time needed to measure their impact, it may be determined that more is needed to be done to clarify the level and use of trailing commissions. The industry agrees that it is important for this to be better understood by all stakeholders, and, in the meantime, will be pleased to work with regulators to see how this might be achieved. For example, it is important for all to understand that trailing commissions are not used solely to compensate advisors for their services. In fact, it is typical for one half or more of the trailing commission to be used by dealer firms to support a whole host of regulatory and supervisory functions and services which are well aligned with investor interests (see the discussion in the above section 'Embedded Fees – Conflict of Interest Analysis').

Similarly, an important consideration will be that any new measures brought in to clarify trailing commissions and what they pay for not confuse investors into thinking that trailing commissions are additional charges over and above the management fees already elsewhere disclosed in regulatory documents.

We do not agree, however, that consideration should be given to the establishment of a minimum level of ongoing services or a requirement for advisors and their dealer firms to record and monitor the nature, extent and frequency of the services provided. This highly prescriptive approach raises a number of questions and concerns: How would prescribed service levels impact innovation and the development of alternative distribution models? How would a minimum level of service be defined for different business models, for advisors who sell multiple types of products, and across the different advice relationships within an advisory practice? Who would determine the standard? Would there be different service 'minimums' and proficiency standards for different asset levels? Would the minimum, in effect, become the maximum – ultimately reducing service? And how would service levels of individual advisors be monitored against such a requirement?

The SROs already have comprehensive sales compliance regimes in place, with focus being placed in recent years on the merits of reducing unnecessary prescriptiveness. We are concerned that these prescriptive measures would create a huge administrative burden for the industry, and raise distribution costs and the cost of the product without commensurate benefit to investors.

ii) A standard class for DIY investors with no or reduced trailing commission

The industry does not believe that the incidence of full trailer funds distributed through non-advice channels is an issue that can be addressed by mandating the manufacture of a standard class of funds for DIY investors. The vast majority of Canadians rely on advisors for the purchase of mutual funds [11], and advice has been shown to create substantial value for investors in terms of developing a savings culture, maintaining a disciplined approach to savings, and building wealth for retirement.[12]

In a competitive industry, such as the mutual fund industry, manufacturers are constrained in the products they offer by their business models and by the demand they see in the marketplace. Since mutual fund sales in the discount channel remain quite limited, mandating the creation of a separate series for this channel would be a costly and uneconomic solution for most companies. To mandate the creation and maintenance of a special class of units that may not sell enough to be sustainable would be artificial and unfair and would generate additional expenses for the manufacturer. Managers who may not see a competitive opportunity here, or for whom the non-advice market does not fit their business model, should not be required to create products specifically for DIY investors.

[11] Investor Education Fund, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study.* Written by The Brondesbury Group, 2012.

[12] Montmarquette, Claude and Nathalie Viennot-Briot, Econometric Models on the Value of Advice of a Financial Advisor, CIRANO Institute, July 2012.

Alternatively, if the requirement were for non-advice channels only to be permitted to distribute classes of funds with no or reduced trailing commissions, this could limit the investment choices available to individuals, as many manufacturers would not find it economical to issue a separate class for this purpose.

As noted above, trailing commissions, even in advice channels, do not pay only for advice, but for a wider array of dealer services and regulatory functions. At discount brokers, trailer commissions pay for dealer services such as the provision and upkeep of online tools, economic and market research, technology infrastructure, telephone and internet support services, and a wider product choice than is generally available at full service brokers.

The sale of mutual funds through discount brokerages is another aspect of the industry that is subject to competitive pressures and the development of alternative business models. The CSA noted in the Discussion Paper that there is a discount brokerage that rebates trailing commissions in exchange for monthly and per transaction fees. This is an example of the market developing alternative business models to address the desires of investors. The CSA should allow the market to continue to develop and innovate rather than impose regulatory obligations which may have the effect of unnecessarily limiting investor choices.

We believe that investors who use non-advice channels should have access to the information they need to make informed investment choices, and to decide for themselves if the trailing commissions paid to their discount brokerages are a concern to them. As mentioned earlier in this letter, trailing commissions are disclosed to investors in a fund's prospectus and in fund facts. The Fund Facts disclosure document and CRM changes will likely enhance the level of transparency further. We believe that regulation should continue to be focussed on allowing investors the opportunity to make informed decisions, rather than on actions which would have the effect of limiting or controlling investment choice.

iii) Trailing commission component of management fees to be unbundled and charged/disclosed as a separate asset-based fee

As noted above, the industry supports the provision of effective and informative disclosures. We would like to point out, however, that unbundling trailing commissions from the management fee rather than merely separately disclosing the trailing commission may create adverse tax effects for investors. Currently, the Tax Act allows a deduction for funds for the payment of management fees, which are currently charged in an amount to compensate the manager for the trailing commission it pays to dealers. Once unbundled from the management fee, the trailing commission would only be deductible if the deduction were specifically provided for in the Tax Act. The tax implications of this option need to be studied further. In general, the industry would not be supportive of a measure that would end up increasing the taxation of Canadians' savings.

If the objective is to ensure that the investor is aware of the trailing commission, this is achieved through disclosure, particularly through the new initiatives of the Fund Facts disclosure document and CRM provisions.

iv) A separate series or class of funds for each purchase option

While the industry does not oppose the creation of separate series for different purchase options, and in fact some companies provide them, we would oppose the introduction of a requirement for manufacturers to introduce such series. In our view, mandating the creation of a separate series or class of funds for each purchase option would create an administrative burden for firms (for example, due to the creation of a separate Fund Facts document for each series), interfere in their commercial decisions regarding product pricing, and increase costs to the investor without commensurate benefits. We believe that rather than focusing on specific details of product design, the work of the regulator should be to ensure that investors have access to a safe, secure and efficient marketplace for financial products and services.

The Discussion Paper asserts that purchasing mutual fund securities under a front-end sales charge option which bears the same management fee as a back-end or DSC option is a form of "cross subsidization". The Paper refers to a Toronto Star article of March 21, 2002 as a source for this position. Unfortunately, the article is flawed and fails to consider a number of relevant facts. First, it is important to note that in today's market, funds with so-called "front-end loads" are almost always sold with the upfront commission waived, so the buyer does not typically pay any commission at purchase. Secondly, the author fails to mention that trailing commissions on front-end load purchases are typically higher than trailing commissions for DSC purchases. On front-end load funds the typical trailing commission is 1% per year. On DSC funds the trailing commission is typically 0.5% per year with an upfront commission of 4% to 5%.[13]

Industry participants have largely recognized that the overall cost of dealer compensation over the entire holding period for the two purchase options is about the same. The fund manager does not have to charge a higher MER on the DSC option because the DSC option would typically have a longer holding period over which to recoup the up-front commission while paying the lower trailing commission. The manager does not have to charge a higher MER on the front-end load option despite its shorter holding period and higher trailing commission, because costs, such as the administration of redemption options, are lower. The rough equivalence of the two options is illustrated in cases where companies have chosen to price them separately – in some cases the DSC series has been priced with the lower MER and in some cases the front-end load series has been priced lower. Because the two options can have roughly equivalent value on average the industry standard has been to price them as purchase options of the same series with the same MER. This has the advantage of providing advisors and their clients with administrative ease (i.e. all options dealt with in one series and one fund facts document) in deciding whether the front-end load or the DSC option is a better fit for the client's needs.

In addition, an element of unequal cost sharing is an inherent element of any collective investment scheme. For example, costs such as the costs of processing small frequent transactions for pre-authorized contribution or withdrawal plans or mailing paper copies of financial statements or different securities regulatory fees depending on the province where a fund is offered, are shared by all investors in the funds and not borne exclusively by those who request those services or live in those provinces. Provided the unequal cost sharing is not unreasonable, it is a fair trade-off for the benefits that a collective investment scheme can offer individuals, such as access to professional investment management services and diversification of holdings.

v) Cap commissions

The industry remains opposed to any regulatory action that would directly intervene in the decision of firms, investors and advisors on the appropriate level of compensation for advisor and dealer services. We believe that implementing a measure to cap commissions is a form of arbitrary price control that would not be the appropriate role of a regulator in a competitive marketplace.

We believe that the Investment Industry Regulatory Organization of Canada ("IIROC") has appropriately dealt with this issue. In August 2012, IIROC issued draft guidance on compensation structures for retail investment products. The draft notice examines and takes into consideration some of the same international developments which are reviewed in the Discussion Paper. The notice takes the view that the promotion of transparency and investor protection with respect to compensation structures in the Canadian market can be achieved within the framework of IIROC rules and identifies specific considerations that should be taken into account by IIROC dealer members and approved persons when they are designing, recommending or supervising the various compensation structures available in the market. We agree with IIROC's assessment and regulatory approach to this issue.

[13] The CSA recognizes this point as it is mentioned on page 11261 of the Discussion Paper.

We believe that the specific measures discussed under this option would be challenging to implement, in particular, a cap that would limit aggregate sales charges through automatic conversion to a series with no ongoing sales commission when the limit has been reached would be costly for the industry to implement. These costs would be borne by investors. A cap could also cause serious economic inefficiencies in the market. It assumes, for example, that dealers and advisors would no longer have ongoing costs for the support and service of their clients beyond a specified number of years. Limiting the level of trailing commissions below the cost of providing current services may require advisors to reduce the level of service they provide to their clients.

Capping commissions also may not have the desired effect, as evidenced from U.S. experience. In 1992, NASD mandated a ceiling on total permissible charges, including point-of-sale commissions, exit/redemption fees, and annual on-going advisor compensation for sales of mutual funds. Strategic Insight notes that, over the years as fewer funds were sold with point-of-sale commissions, redemption fees, or embedded asset-based fees as defined in the Rule, the 1992 NASD Cap rule ceased to be a limiting factor for fees charged to investors. The authors note that "...very few individual funds have, at any time since the introduction of this cap, reached a point when the cap prevented them from charging fees that were embedded in the fund's structure."[14] Such limits encourage the development of other fee structures that are not commission-based - such as fee-for-service, which are less transparent as they are external to the product and paid directly to the advisor, and may result in higher overall cost to investors as suggested in Strategic Insight's study of the U.S.

vi) Implement additional standards or duties for advisors

The question of a fiduciary standard is a complex one. We encourage the CSA to fully understand and fully cost the implications for investors and for the investment industry of any such change. We provided some of the considerations involved in our comment letter of February 22, 2013 on CSA Consultation Paper 33-403.[15] We noted that, before the CSA considers the implementation of a statutory best interest standard for advisors in Canada, it will be necessary to understand: the conditions that prompted the introduction of a version of a best interest standard in other jurisdictions; whether the potential concerns that prompted those initiatives are applicable in the Canadian market; whether any valid concerns are already being, or could easily be, addressed through the current regulatory structure, and whether a legislated best interest standard would offer meaningful investor protection benefits beyond the current rules. We hope that our analysis of this topic will provide the CSA with guidance regarding the issues involved and the questions that remain to be answered.

vii) Discontinue the practice of advisor compensation being set by mutual fund manufacturers

As noted above, we remain opposed to any regulatory action that would directly intervene in the decision of firms, investors and advisors on the appropriate level of compensation for advisor and dealer services. The industry does not support the prohibition of a pricing model as a means to control perceived conflicts.

We also re-emphasize here that it is not the mutual fund manufacturer that sets the compensation of the advisor. The manufacturer pays the dealer a trailing commission that is used by the dealer to pay for its regulatory, supervisory and dealer functions, including the compensation of advisors. We do not agree that the payment of trailing commissions by the manufacturer is properly

[14] Strategic Insight, A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry, November 2012.

[15] The Investment Funds Institute of Canada, letter to the CSA re: *CSA Consultation Paper 33-403: The Standard of Conduct for Advisers and Dealers – Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients,* February 22, 2013.

characterized as setting advisor compensation or, as noted above, that this practice presents a conflict of interest for the manufacturer.

The pros and cons of eliminating embedded fees were first discussed in the OSC's Fair Dealing Model Concept Paper of January 2004.[16] Drawbacks from the elimination of embedded fees were acknowledged at that time to include: costs to the industry; costs to advisors; reduced access to advice for clients with smaller accounts; runs counter to the preference for a free market system and its efficiencies; the unwillingness of consumers to pay for investment and financial planning advice; and loss of convenience of payment. These same drawbacks continue to be relevant today.

The current experience is that trailers are not the source of significant numbers of consumer complaints. If the speculation is that consumers are not sufficiently aware of the existence of trailers to complain about them, then the solution is to improve disclosure, not to conclude that elimination of trailing commissions is the appropriate remedy. We have noted that existing rules for the disclosure and management of conflicts are being strengthened with the introduction of new rules for the Fund Facts disclosure document and the CRM. It is incumbent on regulators to determine whether these new rules are having the desired effect before concluding that stated concerns cannot be addressed within the current system.

Embedded fees provide substantial benefits to Canadian investors. We anticipate that small households and investors will be significantly disadvantaged by any CSA action which mandates the discontinuation of embedded advisor compensation, as the fee-for-service model is not geared towards small investors.

The Discussion Paper refers to major international jurisdictions which have implemented, or proposed, regulatory reforms aimed at addressing conflicts perceived to exist with embedded compensation structures. While still early in the implementation stage of these reforms in the U.K. and Australia, some evidence of the effects are now beginning to emerge. In the U.S. where the move to an unbundled fee structure has been underway for several decades led by market forces, there is a history of experience to examine. It is imperative that the CSA fully understand the effects of these developments on both investors and the industry in these jurisdictions before embarking on any such regulatory change in Canada.

Insights from all three jurisdictions which may have relevance to the current debate in Canada are provided in Appendix A and summarized below.

United States

Research released in November 2012 by Strategic Insight[17] traces the evolution of compensation for financial advisors in the U.S. market over the past two decades from funds being sold one at a time with advisor compensation primarily paid at point of sale to a model whereby advisors are paid directly by the investor based on a percentage of assets invested – the 'fee for advice' model. Strategic Insight suggests that the externalized 'fee-for-advice' model has resulted, at times, in a number of "unintended" consequences within the U.S. marketplace, including – higher shareholder total costs over the lifetime of the investment; higher asset velocity and turnover of mutual fund holdings; potentially reduced diversity of investment strategies and managers over time; reduced transparency of cost information as no mechanism exists to compare the level of fees-for-advice and the services provided across multiple financial advisors or dealers; and potentially in reduced access for small investors to advice.

[16] *The Fair Dealing Model,* Concept Paper of the Ontario Securities Commission, January 2004.

[17] Strategic Insight, *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry,* November 2012.

It will be important to determine whether any of the above consequences could flow from a regulation which would force the elimination of embedded fees in Canada.

United Kingdom

While it is still too early to fully assess the impact of the Retail Distribution Review (RDR) in the U.K. some evidence of concern is already beginning to be released in research studies and commentary. Primary among these are that: (i) small investors are potentially losing access to advisory services because they cannot or will not pay for advice and (ii) pricing structures are becoming more complex, less comparable and less transparent.

In November 2012 Deloitte released a survey result that indicated that 33 percent of UK adults with less than £50,000 in savings, and 32 percent of those with more than £50,000 would cease using advisors for all products if they were charged directly.[18]

While no such survey has been done for Canada, if similar results were to hold here, as many as 4 million Canadian mutual fund investors could decide that they no longer wished to receive advice on their investments. Because the economics of the fee-for-advice model would further limit the provision of advice to those with higher levels of assets, an "advice gap" would most seriously affect new investors and those with lower net worth - arguably the individuals in our society with the greatest need for advice.

Australia

The Future of Financial Advice ("FoFA") reforms, which will ban advisor commissions in Australia, are scheduled to become mandatory on July 1, 2013. Already there are concerns emerging in Australia that the reforms: will require significant adjustments of remuneration arrangements and business models; will increase the overall cost of ownership of funds to investors; and will reduce the transparency of fees.

Again, it is paramount to understand the full impact of these reforms, and the conditions under which they have been imposed in Australia before contemplating similar regulatory reforms in Canada.

Further Research/Analysis

Among the research and analysis we recommend be conducted to inform future discussions are:

- a period of monitoring outcomes in the jurisdictions cited to determine whether the reforms truly work to enhance investor protection, or instead have created unintended negative consequences for the industry and investors;
- after finalizing the new rules for the Fund Facts disclosure document and the CRM, an examination and analysis of the effects of the full implementation of, and transition to, such rules;
- a full and complete cost-benefit analysis, including tax implications for investors, of any major change contemplated.

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[18] Deloitte, *Bridging the Advice Gap: Delivering investment products in a post-RDR world.* November 2012.

Conclusion

Thank you for providing us with an opportunity to comment on this important issue. We look forward to participating in the CSA roundtables on Mutual Fund Fees, scheduled for June 7, 2013, as well as the roundtables which may be held by other Commissions, and would be pleased to discuss our input in greater detail with you. Should you have any questions or wish to discuss these comments, please contact me directly by phone at 416-309-2300 or by email at jdelaurentiis@ific.ca or Jon Cockerline, Director of Policy and Research by telephone at 416-309-2327 or by email at jcockerline@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Joanne De Laurentiis
President & CEO

Addendum : Please find attached a separate submission containing the following research reports by Investor Economics and Strategic Insight which examine the costs of ownership of mutual funds in Canada and the United States:

Investor Economics and Strategic Insight, Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada- U.S. Perspective, November 2012;

Investor Economics, Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives, September 2012;

Strategic Insight, A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry, November 2012.

APPENDIX A

Some Evidence from International Jurisdictions

United States

Research released in November 2012 by Strategic Insight traces the evolution of compensation for financial advisors in the U.S. market over the past two decades. They note that during the 1980s and 1990s most funds were sold one fund at a time with advisor compensation primarily paid at point of sale. This has shifted dramatically in recent years to the point where currently the great majority of advisor compensation for mutual fund new sales is paid directly by the investor to the financial intermediary based on a percentage of assets invested – the 'fee for advice' model. This transition was not driven by regulation. In Strategic Insight's view it was led by the market, as distributors desired to establish more stable revenues model in periods of financial uncertainty.

Regardless of its cause, it is instructive to observe the phenomenon that has taken place in the U.S. as an indicator of what could happen in Canada if advisor compensation were mandated to be paid directly by the investor. Strategic Insight, based on observations of the U.S. market, warns of the possibility for:

- Higher Shareholder Total Costs. Strategic Insight states that the unbundling of fees has resulted in an increase in the total shareholder costs for many mutual fund investors, with such increases amplified due to the loss of tax advantages associated with the payment of fees embedded within the fund.
- Higher Asset Velocity. Strategic Insight has observed a higher-than-average asset velocity within fee-for-advice account structures relative to commission-based accounts, which may be reducing potential investment gains for some investors.
- Reduced Diversity of Investment Strategies. The higher asset velocity for fee-for-advice accounts results in shorter investment holding periods, which translates to lower, less predictable fee revenues for investment managers. This has placed increased strains on investment manager profitability which over time may result in a lower number of investment managers, and a narrower scope of investment strategies participating in the market.
- Reduced Transparency of Cost Information. With distribution costs charged separately and no longer reported in the expense ratio of the mutual fund, costs can no longer be as easily benchmarked. The separation also means a fund's performance is no longer reported net of all expenses, and therefore investors' assessment of their funds' performance will be overstated unless they remember to also deduct the costs paid separately to their advisor. Transparency in the U.S. market has declined.
- Reduced Access to Advice for Small Investors. With unbundled fee-for-advice charges rising as account sizes decrease, many middle income investors in the United States are facing significantly higher ongoing costs for financial advice than they did previously. This may have resulted in reduced access to advice for small and medium-sized accounts in the U.S..

United Kingdom

The Financial Services Authority launched the Retail Distribution Review (RDR) in June 2006 primarily to address the high incidence of mis-selling in the life insurance, pensions and endowment mortgages sectors. For example, the late 1980s saw rampant mis-selling of pension products by the insurance industry, while in the mid-1990s customers were mis-sold endowment mortgages. In the early 2000s, the mis-selling of payment protection insurance is estimated to have overcharged customers by more than £1.4 billion a year. While the RDR was initiated in response to developments in the insurance and mortgage sectors, its scope was extended to cover the sales and distribution of all retail investment products and services.

While it is still too early to assess fully the impact of the RDR, some evidence of concerns is beginning to appear in research studies and commentary. Primary among these are that: (i) small investors are potentially losing access to advisory services because they cannot or will not pay for advice and (ii) pricing structures are becoming more complex, less comparable and less transparent.

Allianz Global Investors reported in February 2013 evidence of an emerging 'Advice Gap', or mismatch between what investors are willing to pay, and what advisors charge under a fee-based model[19]. They report that:

- roughly one in four investors (27%) would be willing to pay up to £50 per hour for advice, whereas only 7% of advisors would work for this rate;
- most advisors (86%) plan to charge between £100 and £200 per hour, but only 7% of investors would be willing to pay this; and
- 32% of investors would not be willing to pay separately and directly for advice.

Deloitte[20] in November 2012 also reports findings that suggest many investors will be reluctant to pay advisor charges under a fee-based model:

- Some 33 percent of UK adults with less than £50,000 in savings, and 32 percent of those with more than £50,000, indicate that they would cease using advisors for all products if they were charged directly.
- Some 56 percent suggested they are likely to reduce the number of times they use advisors if charged a fee of £400-£600, or 3 percent of their investment.

Cass Business School and Fidelity Worldwide Investment released a study in January 2013[21] that reported that the RDR could lead to 43 million Britons falling into a financial 'Guidance Gap' – that is, a gap comprising those people that will be without professional financial advice and that will not have the confidence or knowledge to make their own investment decisions but who, nevertheless, will be in need of financial guidance in order to maintain the health of their personal finances.

There are also concerns about the number of financial advisors that will quit their jobs due to the RDR reforms, leaving consumers underserved – Ernst & Young predicted that the number of independent advisors will fall from 30,000 to 20,000 due to the RDR, a drop of roughly 33 percent.[22]

For those advisors who have remained, there is evidence that they have had difficulty in adjusting to the complexity of the RDR regime – for example, it was recently reported that advisors are often not receiving their fees for advice provided for on-platform investments since they fail to define where funds will come from if clients' cash accounts run low. This reflects the complex nature of the RDR regime and the fact that pre-2013 there was no reason to think about the funding of the fee as it was built into the fund cost.[23]

[19] Allianz Global Investors, February 2013
[20] Deloitte, *Bridging the Advice Gap: Delivering investment products in a post-RDR world.* November 2012.
[21] Cass Business School and Fidelity Worldwide Investment, *The Guidance Gap: An investigation of the UK's post-RDR savings, and investment landscape*, January 2013.
[22] White, Kevin, "24% of advisers are walking RDR tightrope: FSA," *FT Adviser*, November 21, 2012.
[23] O'Loughlin, Donia, "Advisers 'often' not paid due to RDR charging complexity," *FT Adviser, March 14, 2013.*

Merryn Somerset Webb reported in the Financial Times of January 11, 2013[24] that UK banks have been implementing higher and more complicated fee schedules for financial advice in response to the RDR.

The U.K.'s Investment Management Association (IMA) has expressed concerns related to the unintended consequences of the RDR, including increased costs to investors due to unbundling, less transparency, and adverse tax implications[25] for investors.

Australia

The Future of Financial Advice ("FoFA") reforms, which will ban advisor commissions in Australia, will not become mandatory until July 1, 2013.

However, there are already concerns emerging in Australia that the reforms will require significant adjustments of remuneration arrangements and business models. A recent paper states that, "Of all the FoFA changes, the ban on conflicted remuneration is arguably having the biggest impact on the financial services sector in Australia."[26] The ban is leading to a complete transformation of commercial relationships between advisors and licensees, licensees and issuers and platforms and fund managers: "Licensees are struggling to develop compliant models of remuneration which effectively align advisor and licensee interests to incentivize adviser conduct in relation to existing and new clients."

The Financial Services Council estimates that the Australian industry will endure an initial minimum cost of $AUD 700 million in order to comply with the legislative component of FoFA, and an ongoing annual cost of $375 million. These costs will be initially borne by product manufacturers and advisors, and will be subsequently passed on to investors.

It is helpful to understand the background of the ban on advisor commissions in Australia – this originated with concerns in relation to conflicted advice models, notably the Storm Financial model which depended on "one-size-fits-all" recommendations for clients to borrow funds to invest in market-linked investments. The collapse of Storm Financial, in which retirees and small investors lost about $830 million, was a key reason for the introduction of FoFA in Australia.

It is also helpful to understand the context of regulations for advice in Australia, where employed persons are required by law to save 9% (soon to be 12%) of their salaries in superannuation accounts. In a jurisdiction, such as Australia, where there is a ready-made market by law for financial advice, it is incumbent on government to provide strict standards and safeguards so that consumers who are compelled to commit their savings to these plans are protected.

We recognize that a regulatory move to ban commissions may have been justified in Australia to better protect the forced savings of investors against poor industry practices, but we submit that similar conditions do not exist in Canada, and that there has been no evidence of client harm arising from embedded fees on mutual funds that would justify similar regulations here.

[24] Webb, Merryn Somerset, "Banks ignore the spirit of RDR," *The Financial Times,* January 11, 2013.
[25] Roberts, Will, "IMA: Adviser charging will have 'perverse' tax implications," *IFA Online*, May 24, 2011.
[26] Batten, Richard and G. Pearson, *Financial Advice in Australia – Principles to Proscription; Managing to Banning,* St John's Law School Symposium on Revolution in the Regulation of Financial Advice, October 2012.

THE INVESTMENT FUNDS INSTITUTE OF CANADA | L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

IFIC.CA

JOANNE DE LAURENTIIS
President and CEO *Présidente et chef de la direction*
jdelaurentiis@ific.ca 416 309 2300

April 12, 2013

Delivered By Email: comments@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

Attention:

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec) H4Z 1G3

Dear Sirs and Mesdames:

RE: CSA Discussion Paper 81-407: Mutual Fund Fees - Addendum

Attached are two studies and a summary compiled by Strategic Insight ("SI") and Investors Economics ("IE"), on the cost of owning mutual funds in the U.S. and Canada.

The studies were conducted at the request of IFIC to provide evidenced-based data on ownership costs in the two countries. SI and IE were chosen because of their superior knowledge of mutual funds in the respective jurisdictions, their strong brand identity as neutral, independent data analysts, and the depth of their proprietary data bases on mutual fund costs.

The studies illustrate how the retail markets in both jurisdictions work, and provide very detailed cost data which answer a number of outstanding questions, including:

- confirmation that, in Canada, on-going fees for financial advice are generally embedded within a fund's expense structure; whereas, in the U.S. they are unbundled and charged on a fee-for-advice basis;

- when adjusted for HST, the cost of ownership of funds in advised relationships - both commission and fee-based are very comparable - 2.02% in Canada and 2.00% in the U.S.; and
- the unbundling of financial advisor fees from other fund expenses does not result in cost savings for mutual fund investors.

* * * * *

Should you have any questions or wish to discuss these studies, please contact me directly by phone at 416-309-2300 or by email at jdelaurentiis@ific.ca or Jon Cockerline, Director of Policy and Research by telephone at 416-309-2327 or by email at jcockerline@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Joanne De Laurentiis
President & CEO

Attachments:

Investor Economics and Strategic Insight, Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada- U.S. Perspective, November 2012;

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Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios

A Canada – U.S. Perspective

A study by

Investor Economics

and

Strategic Insight

for

The Investment Funds Institute of Canada

November 2012

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Key Takeaways

1. In the past two decades the mutual fund industries in Canada and the U.S. have followed similar development patterns. Some structural differences remain including the large share of U.S. fund industry assets invested through workforce retirement plans.

2. Major mutual fund companies in both countries offer a wide variety of investment product choices and provide access to their funds and fund-based products through a number of distinct distribution channels.

3. The growth of mutual fund assets in both Canada and the U.S. has been reliant on the active participation of a number of advice-based distribution channels. In Canada approximately 80% of mutual assets are under the care of a professional financial advisor. In the U.S., excluding funds held through workforce retirement plans, roughly four in five investors rely on a financial advisor exclusively or for a significant portion of their investments.

4. Over the past two decades, advisor compensation in Canada and the U.S has shifted away from paying for the advisor's services at the time of purchase (transactional costs) and towards paying for such services over the duration of the investment through ongoing fees representing a percentage of clients' invested assets. However, the two countries took different paths.
   - In Canada, ongoing fees for financial advice are generally embedded within a fund's expense structure, alongside fees for investment management, administration and operations, and any applicable taxes.
   - In the U.S., the prevalent approach is the unbundled fee-for-advice model in which investors pay a negotiated ongoing fee directly to the advisor. These fees are in addition to the fees embedded in a fund's total expense ratio.

5. Neither Canada nor the U.S. provides evidence that the unbundling of financial advisor advice and servicing fees from other fund expenses results in cost savings for mutual fund investors. For many U.S. investors, total costs may have increased.

6. Value-added taxes on management fees which are levied in Canada but not in the U.S.; the scale of the business; the manner in which advice fees are charged; different distribution structures; and the level of penetration of mutual funds in the pension system, are among the factors that combine to explain the differences in the level of the cost of ownership of funds in the two countries and to make it difficult to make detailed comparisons between the two jurisdictions.

7. Beyond these differences, the analysis suggests that the cost of ownership of funds in advised relationships in Canada—both commission - and fee-based—is at a comparable level to the average cost of ownership incurred by a typical fee-based investor in the U.S. who has similarly chosen to be helped by a financial adviser.

8. On a tax-adjusted basis, through the elimination of the impact of Canadian value-added taxes, the asset-weighted cost of ownership in Canadian advice channels is estimated to be 2.02% of invested assets compared to the level of approximately 2% in the U.S.

Introduction

In the summer of 2012, *Strategic Insight* (U.S.) and *Investor Economics* (Canada) were engaged by *The Investment Funds Institute of Canada* (IFIC) to undertake parallel studies of the trends in the cost of ownership of mutual funds in the two jurisdictions. This document summarizes the findings of these studies, highlighting those points of similarity and departure between the U.S. and Canadian mutual fund industries that are relevant to comparing investor costs.

The objective of this summary is twofold. First, to propose an analytical framework that will allow comparisons of the total cost of mutual fund ownership by mutual fund investors in the United States and Canada as well as other countries. The framework identifies and highlights the impact of structural differences between the U.S. and Canadian mutual fund industries, including economies of scale in mutual fund distribution and investment management.

Within this framework, and reflecting two decades of evolving market forces, the second goal of the comparison summary is to arrive at a cost of ownership (CoO) metric for use in discussions focused on cross-border comparisons.

The Cost of Ownership Framework

In analyzing the cost of ownership in Canada and the United States, both studies adopted a comprehensive view of costs associated with owning mutual funds, which reflected investor costs included in the reported fund expense ratios—the total expense ratio ("TER") in the U.S. and the management expense ratio ("MER") in Canada—as well as, importantly, costs residing outside of the fund expense formulas.

The holistic nature of the CoO concept stems from the inclusion of the cost elements at each stage of the fund ownership cycle: at the time of purchase (acquisition costs); during the investment period (ongoing costs, both charged to the mutual fund and directly to the investor); and, at the time of redemption of fund units (disposition costs).

The use of the CoO framework enables industry participants and other observers to account for the structural differences between the U.S. fund TERs and the Canadian fund MERs, and to provide a common platform for investor cost comparisons across countries.

Comparing the Two Mutual Fund Markets

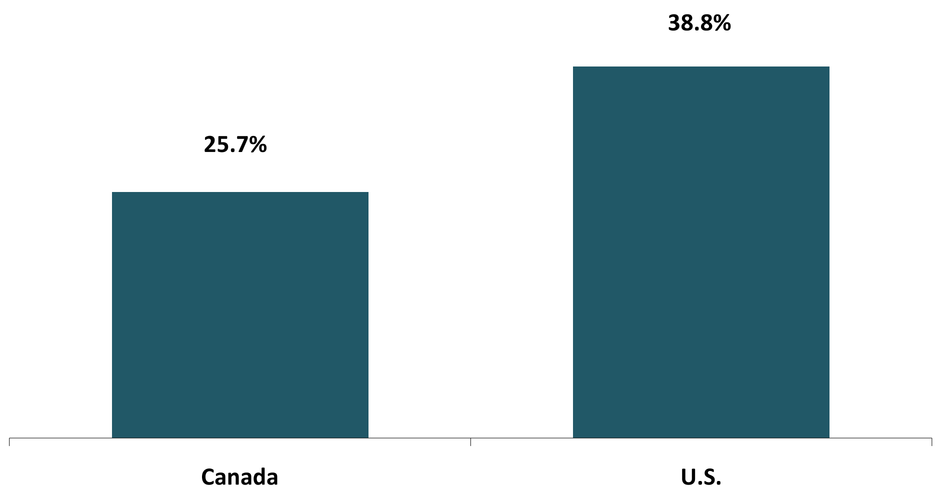
The two studies identify a number of considerations relevant to the discussions of costs incurred by investors in mutual funds.

The Importance of Mutual Funds to Individual Savings

Mutual funds represent a primary avenue for mass market and mass affluent households to access and participate in the fixed income and equity sectors of both domestic and international capital markets.

As suggested by **Figure 1**, mutual funds form a significant part of the total financial holdings of both the Canadian and U.S. households, accounting for 26% and 39% of personal financial wealth (investable assets) in Canada and the U.S., respectively.

Figure 1: Mutual Funds as a Percentage of Financial Wealth
As of December 2011



Source: Investment Company Institute, Investor Economics Insight Database and Household Balance Sheet Report.

In both jurisdictions, mutual funds compete with other financial vehicles, such as fixed and variable rate bank deposits, directly held securities and other retail investment and insurance vehicles for a share of household financial holdings.

Diverse Retirement Market Structures Impact Investor Costs

Although mutual funds are an important retirement savings vehicle in both countries, there are structural differences in the configuration of the retirement markets in the U.S. and Canada.

Approximately one-half of all mutual fund assets in the U.S. are held in dedicated tax-advantaged retirement accounts. Of these retirement savings, about half are held in institutionally-driven, employer-sponsored group retirement and savings vehicles, such as defined contribution 401(K) plans. The other half of tax-advantaged assets are held in individual retirement accounts (IRAs).

Given the size of the defined contribution (DC) plan market in the U.S., a number of mutual fund manufacturers have developed their own record-keeping platforms to service this over $2.5 trillion segment. The magnitude of this institutional distribution channel, and the presence of a number of very large DC plans, have resulted in the development of distinct pricing models for U.S. mutual fund series offered on these platforms. These fund series generally feature lower TERs, particularly for the 40% of DC plan members employed by or retired from major U.S. corporations whose total plan assets each exceed $1 billion. It should be noted that about 90% of DC plans in the U.S. each control under $5 million in assets, and TERs of mutual funds typically used in such plans are higher due to the plan size and the scope of services included in the specific arrangement between the fund provider and the plan sponsor.

The participation of the Canadian fund industry in the retirement market is largely focused on the individually-driven registered retirement savings plans (RRSPs). Assets held in this type of registered account represented 43% of mutual fund industry assets as at December 2011.

While many Canadian mutual fund companies participate in the DC plan segment, their participation is largely as suppliers of mutual fund product to the capital accumulation plan (CAP) platforms operated by the major life insurance companies where they compete with other pooled fund providers, including the proprietary fund arms of the insurers. At the end of 2011, these CAP platforms accounted for approximately 3% of total mutual fund assets in Canada[1]. As a result, fund companies currently have limited influence on the investment costs incurred by CAP plan members.

Range of Investor Choices Reflects Market Forces and Scale

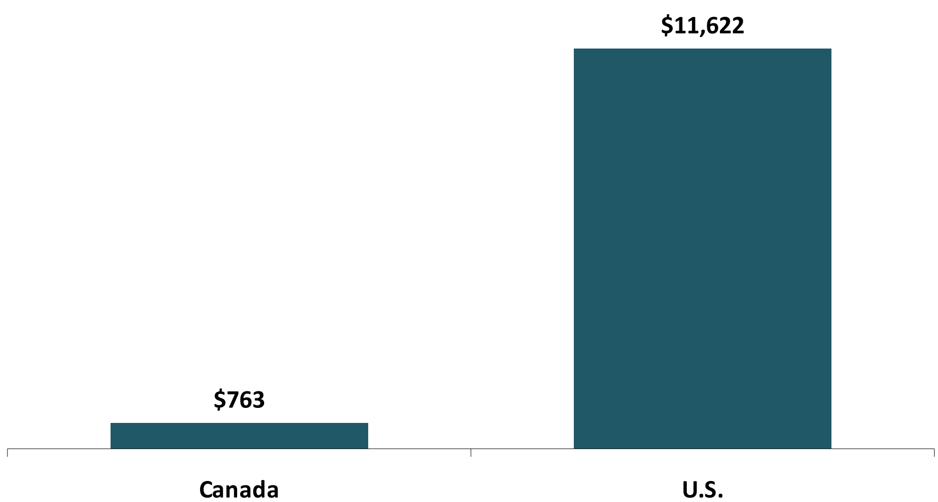
The mutual fund industries in both countries offer investors a wide range of access points, investment strategy mandates, fund features, pricing and advisor

[1] Source: Upcoming Investor Economics *2012 Group Retirement and Savings Report*

compensation options. In both cases, the development of distribution and pricing options reflects the interplay of market rather than regulatory forces.

The more mature and larger U.S. fund marketplace generally offers a broader array of options to investors, particularly in terms of delivery conduits, alternative pricing models that have evolved to reflect client and advisor demand, and investment mandates. The range of investment mandates available to mutual fund investors is one area where the impact of different regulatory frameworks in the two countries has been observed. U.S. regulators have permitted a wider range of investment strategies to be offered by mutual fund manufacturers to retail investors.

Figure 2: Mutual Fund Assets Under Management
In billions of dollars, December 2011



Source: Investment Company Institute, Investor Economics Insight Database and Household Balance Sheet Report. Mutual funds exclude ETFs and closed-end mutual funds.

The difference in the scale of both industries is illustrated in **Figure 2**. The U.S. mutual fund industry is more than ten times larger than its Canadian counterpart. The almost $11 trillion gap between the total assets of the two industries underlines the ability of U.S. mutual fund manufacturers and distributors to take advantage of economies of scale in assets, client numbers, revenue and access to capital to pursue innovation and pricing initiatives at a pace and scale not easily achieved by smaller fund jurisdictions such as Canada. Currently, there are approximately 60 U.S. mutual fund managers each managing over $25 billion, compared to 10 managers in Canada. As the size of the Canadian industry grows so too will the opportunity to pass on economies of scale to investors.

Advice is a Common Link Between Delivery Channels

Figures 3a and 3b provide a comparison of the mutual fund delivery models in the two countries. **Figure 3a** illustrates the distribution of total mutual fund assets under administration in Canada by delivery channel. **Figure 3b** provides an analysis of gross sales of mutual funds in the U.S by delivery channel. (For definitions of each channel, please refer to the *Glossary* at the end of the study.)

Figure 3a: Canada – Long-term Mutual Fund Assets by Channel as a % of Total Long-term Mutual Fund Assets as at December 2011

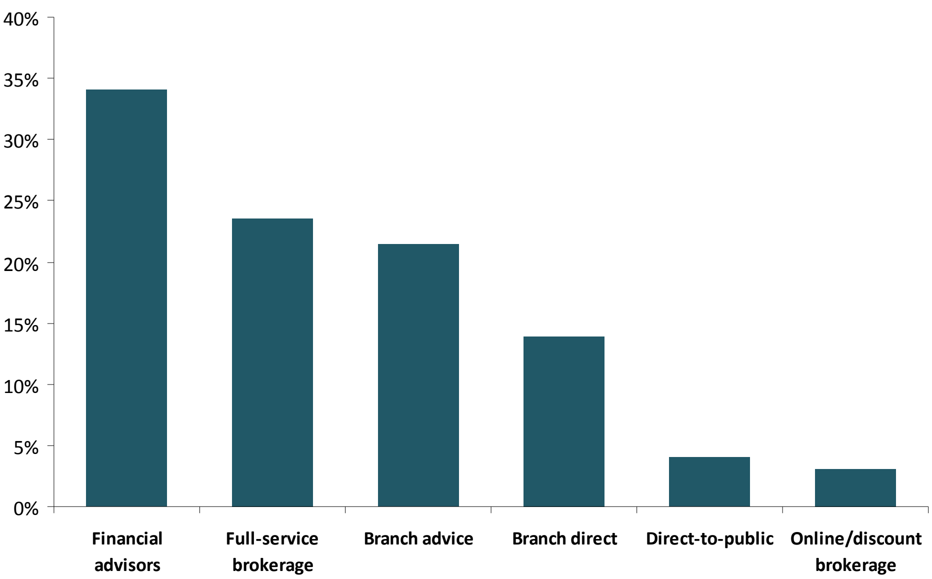
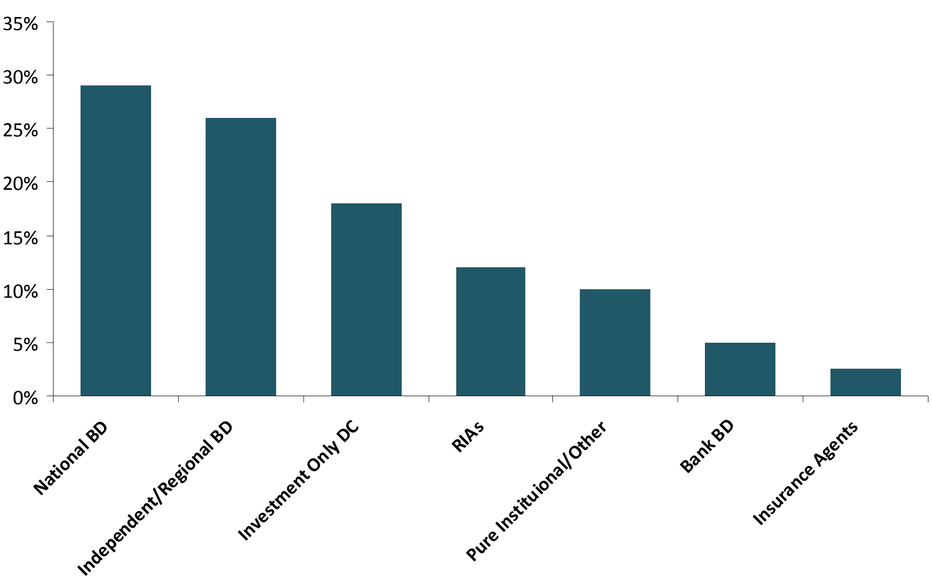


Figure 3b: U.S. – Long-term Fund Sales through Intermediaries: Share of Sales by Distribution Channel 2011



While the two exhibits above use different metrics to provide evidence of distribution channel preferences, the importance of advice channels is a common theme which links the two jurisdictions. In Canada, advice channels account for $79 of every $100 in mutual fund assets. In the U.S., outside of sales that flow through DC plans, an estimated four of five individual fund investors seek advice and investment services from a professional financial advisor for the majority of their invested assets. Furthermore, *Strategic Insight* estimates that in 2011 at least 70% to 80% of sales to individuals being served by financial intermediaries in the U.S. were completed within some form of fee-for-service advisory programs. In such programs, investors pay a fee directly to the financial advisor in addition to the expenses embedded within the mutual funds.

The sheer scale of the U.S. mutual fund industry has enabled it to pioneer innovations in fund delivery such as “fund supermarkets”, several of which administer over $100 billion. This channel format is absent from the Canadian retail investment landscape. The establishment and ongoing maintenance of this delivery framework demand significant capital investment in the technology infrastructure by major industry participants, something that is not easily achieved without the benefit of scale.

In addition to serving the do-it-yourself mutual fund investors directly, these “supermarket” platforms are also used extensively by financial advisors to access a wide range of mutual funds and to provide operational and administrative support related to their client accounts. (For more on this channel, please see pages 17-19 in the *Strategic Insight* study *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Cost in the U.S. Mutual Fund Industry*.)

A further example of a unique U.S. delivery conduit supported by the scale of the market opportunity is the approximately 29,000 independent Registered Investment Advisors (RIAs) who currently manage an estimated $1 trillion in mutual funds, often through the administration of such accounts within the “fund supermarket” structure discussed above. The scale of this growing channel in the U.S. has provided a fertile ground for the noticeable shift towards the unbundled fee-based advice model.

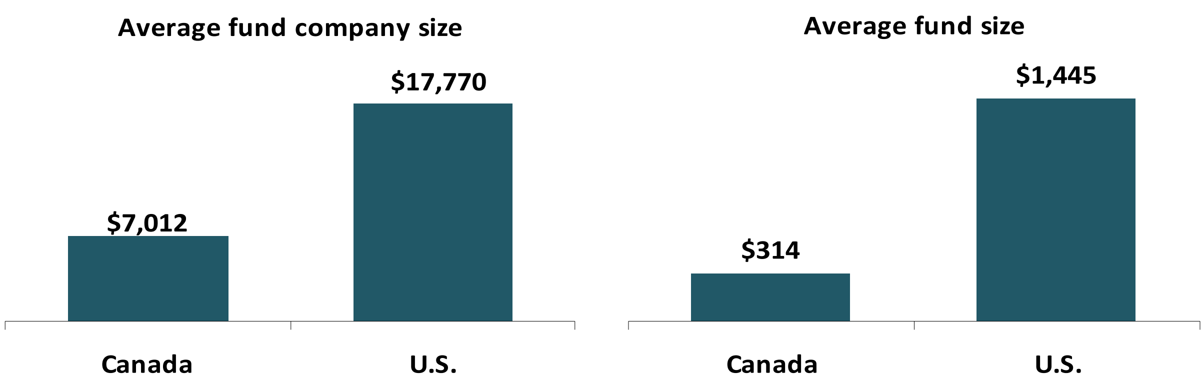
Scale Can Translate into Cost Efficiencies

The scale advantage of the U.S industry is also evident at both the fund company and individual fund levels. For example, the U.S. industry includes three fund companies, among the total of approximately 700, whose managed assets are each larger than the entire Canadian fund industry. In addition, there are 21 U.S. fund companies that each manages over $100 billion. There are 115 active fund companies in Canada, only one of which manages assets in excess of $100 billion.

Both fund industries include a significant number of relatively small fund companies and funds where few economies of scale are available. For example, 29% of Canadian mutual fund managers and 38% of U.S. mutual fund managers each manage less than $100 million.

The average fund company size in the U.S. is about $18 billion, compared to an average of $7 billion in Canada. The corresponding metrics for average mutual fund size are $1.45 billion and $314 million for the U.S. and Canada, respectively **(Figure 4)**.

Figure 4: Average Size of Fund Companies and Individual Funds
In millions of dollars, December 2011



Source: Investment Company Institute and Investor Economics Insight Database

Large financial institutions, such as many of the leading U.S. fund companies, have the ability to realize cost efficiencies in a number of critical areas including investment management, wholesaling, marketing, client servicing, recordkeeping, regulatory filings, and other operations. The competitive nature of the fund industry and the transparency and easy comparison of mutual fund costs are among the market forces encouraging fund companies to pass the financial benefit of their scale efficiencies to fund unitholders in the form of a lower fund management fees.

The same argument can be applied to large funds, where fixed costs can be spread across a large asset base, resulting in potential cost savings at the management fee and operating expense levels.

Evolution of Advisor Compensation Models

The past decade heralded a significant change in the mutual fund distributor and advisor compensation models away from point-of-sale client-paid commissions and fund company-funded advisor commission payouts. The focus of advisor compensation in both Canada and the U.S has shifted towards the charging of ongoing fees-for-advisor-service based on a percentage of client assets.

While the two countries have taken different routes to a largely similar result, forces behind the shift were common to both jurisdictions. These drivers of change, which did not include regulatory intervention, included the evolution of demand (repeat, more mature and better-informed clients); a shift from stand-alone fund sales towards fund-based asset allocation solutions (such as fund wraps); and competition from other investment instruments (such as ETFs) among advice-giving distributors.

In 2011, 98% of mutual fund assets in Canada did not attract upfront charges and did not incur disposition costs (for more on this measurement, please see pp 22-23 of the *Investor Economics* study *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*). This reflects the prevalence of load-waived front-end load (zero point-of-sales commissions) fund sales in Canada. No load and unbundled fund series (F-series) sales are also on the rise. As a result, advisor compensation is now largely dependent on ongoing fund trailing commissions which are embedded in the fund's MER, or separate fees associated with a fee-based account (the unbundled pricing model). Of the two models, the fund-embedded trailer compensation is currently the dominant one in the financial advisor channel. It is the case, however, that fee-based accounts are emerging as the business model of choice in the full-service brokerage channel, in which mutual funds are but one of multiple product options.

Similarly in the U.S., transactional mutual fund investor costs—where investors pay a fee at point-of-sales or upon redemptions—currently account for fewer than 10% of mutual fund sales. The unbundled fee-for-advice models—where investors pay an ongoing fee directly to the financial advisor and where such a fee is paid in addition to the fees embedded in funds' TERs—is the prevalent method for nearly all mutual funds purchased with the help of a financial intermediary. This fee-for-advice culture extends across both independent advisors (i.e. RIAs), as well as those employed by national or regional U.S. broker-dealers. As a result, cost of ownership comparisons between mutual fund investors in both countries must take into account the impact of this unbundled investor cost which is not captured in the U.S. fund TER.

No Evidence of Meaningful Investor Cost Savings in Unbundled Fee Models

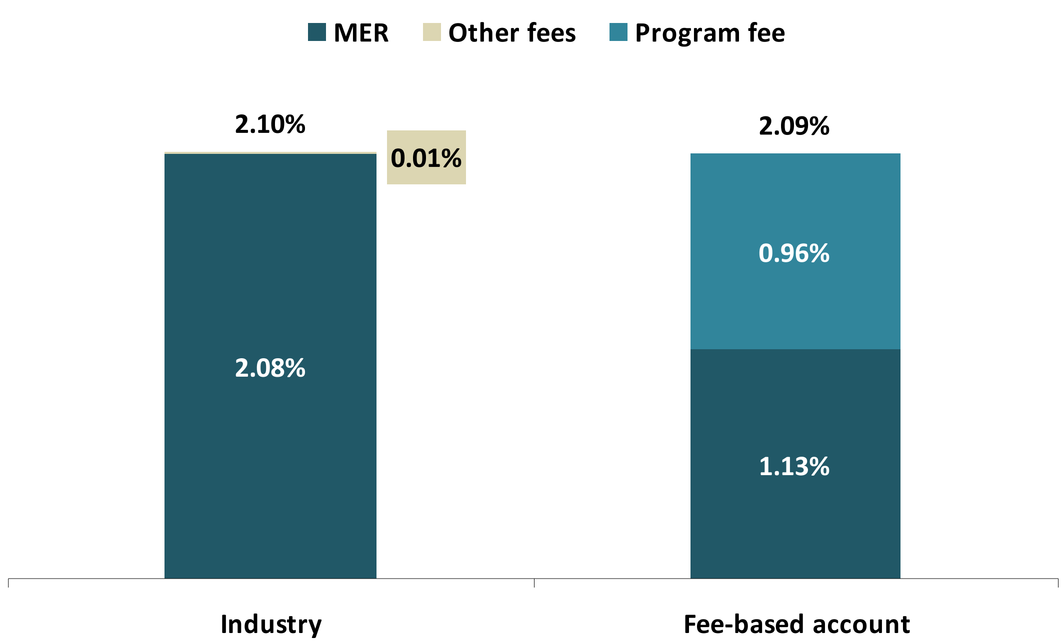
Neither Canada nor the U.S. provides evidence that the unbundling of distributor advice fees from fund expenses results in cost savings for mutual fund investors.

Strategic Insight suggests that an opposite effect took place in the U.S., where fee-for-advice fees range between 1.0% and 1.5%, with the first fee reduction tier occurring at a relatively significant asset level, such as $200,000 for a mutual fund wrap program offered by a full service brokerage firm. In other channels, the fee reduction level is set in some instances at $500,000.

The *Strategic Insight* report states that "for many 'buy-and-hold' U.S. mutual fund investors, total shareholder costs over the lifetime of an investment have increased as a result of the transition to a fee-for-advice model." It further suggests that "In total, the unbundling of fees has resulted in an increase in the total shareholder costs for many investors, with such an increase amplified due to tax considerations at times." (For more information, see pp 5 of the *Strategic Insight* study *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Cost in the U.S. Mutual Fund Industry*.)

Canadian fee-based account fees generally fall at or below U.S. levels. **Figure 5** below illustrates the Canadian experience by identifying the average cost of owning mutual funds in an unbundled fee-based account and comparing it to the industry aggregate cost of ownership metric developed for the purposes of this study. The investor cost savings are modest, and likely reflect the higher-end nature of the account clientele. The average account size for a non-discretionary fee-based brokerage account in Canada is $225,000 and $360,000 for a discretionary fee-based account.

Figure 5: CoO of Mutual Funds in Canada



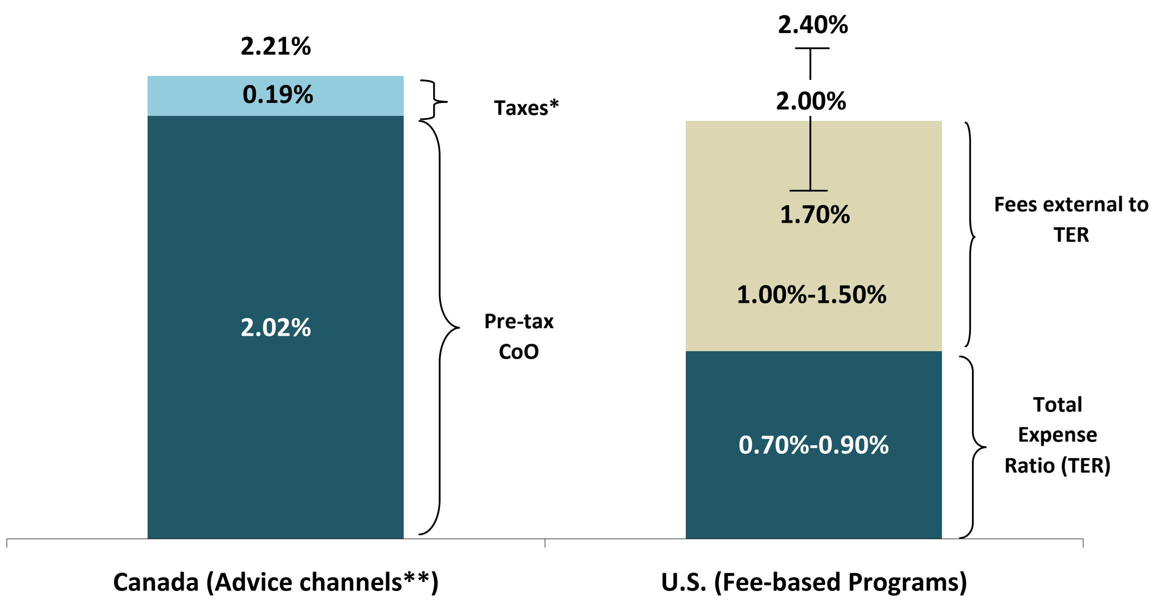
Cross-country Comparison of Mutual Fund Investor Costs

The comparable CoO metrics for clients in advice channels in the U.S. and Canada are shown in **Figure 6.**

The depicted U.S. cost reflects the dominant fee-for-advice model, and includes a range for external fees. These fees can range from up to 1.5% of managed assets charged annually for smaller investments (i.e. $100,000), down to approximately 1.0% for larger investments (i.e. over $1 million) as shown in **Figure 6** (for additional details, please refer to the *Appendix*). These external fees are charged to investors along with the underlying average fund TERs estimated at 0.85% (which does not include any distributor fees).

Adding these two costs components, *Strategic Insight* estimates the average CoO for U.S. mutual fund relationships guided by a financial intermediary to be approximately 2% (see pp 45 of the *Strategic Insight* study *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Cost in the U.S. Mutual Fund Industry*). This cost may range depending on the size of the relationship, family of funds, and the portfolio asset mix. For U.S. investors with accounts under $250,000, the CoO may be at the higher end of this range, reaching 2.25% or higher due to increased external fee levels.

Figure 6: Comparing Cost of Mutual Fund Ownership



**Note: This reflects an industry aggregate and is not specific to advice channels*

***For all account types*

The Canadian measure has been assembled as an asset-weighted average representing all types of accounts sold through advice-giving distribution channels. This average CoO accounts for the impact of transactional charges and fund-embedded fees (MER) and unbundled fees levied at the account level.

Canada is unique among mutual fund markets in that both federal and provincial value-added taxes are required to be embedded in the MER. On an industry aggregate basis, the impact of these taxes is to increase the asset-weighted CoO by approximately 19 basis points (For information on the methodology used to determine the tax component, please refer to page 59 of the *Investor Economics* study *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives*). If no value-added taxes were imposed on various components within the MER, the CoO in Canada would be almost directly comparable to that in the U.S. (For more on the components comprising the Canadian CoO and measures by channel and advice model, please see the *Investor Economics* study *Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives.*)

The analysis renders similar overall pre-value-added tax CoO results for both countries. On an after-tax basis, the Canadian average CoO is 21 basis points higher than the comparable U.S. measure. This gap expands to 51 basis points for large investors who qualify for fees at the low end of the U.S. fee range but disappears for smaller investors whose advice fees in the U.S. might fall in the higher end of the specified fee range (see *Appendix* below for further details). These differences can be largely explained by economies of scale and the sales taxes levied on virtually all components of the Canadian MERs. No such taxes are imposed in the U.S..

On average, the Canadian mutual fund CoO in advice channels can be lower than the U.S. for more modest account levels, as a result of the potentially higher fee-based account fee ranges for U.S. investors. However, the emerging competitive pressures in the U.S. are pushing the fee-for-advice fee levels towards the lower end of the fee range.

In Canada, similar pressures have resulted in an overall decline in fee levels charged to clients using fee-based brokerage and advisor managed accounts, as well as declining fund management fee levels, particularly in the unbundled F-series and the HNW-series, both of which target the high end of the fund investor spectrum.

Appendix

The commentary below has been developed by *Strategic Insight* to provide additional information on charges incurred by investors in the U.S. that hold mutual fund units in a fee-based account. There is no comparable data available for Canada as the use of similar fee-based structures for holding mutual fund units is extremely limited and, in any event, only available to investors with accounts in excess of $100,000. Additional information on this topic is contained in the reports developed by *Strategic Insight* and *Investor Economics*.

Fees Charged to U.S. Mutual Fund Investors within Fee-for-Service Accounts in Addition to Mutual Fund Embedded Fees

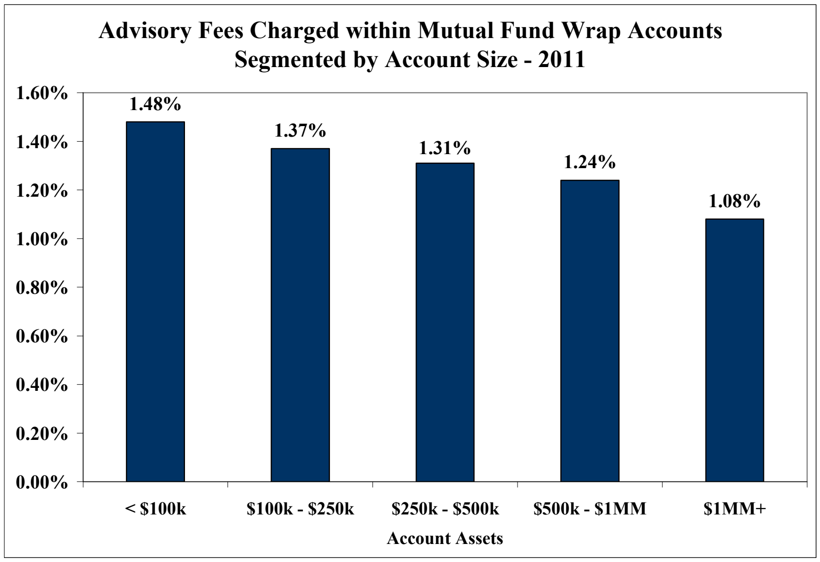
The table below indicates advisory fees charged directly by financial advisors to their clients across various account sizes. These advisory fees are in addition to mutual fund TERs. For example, the top row shows that among investors with $100,000 accounts, only 1% of financial advisors charge less than 0.75% annually, while 65% of such advisors charge their $10 million dollar client accounts less than 0.75%.

US Fee-Based Advisory Programs Frequency of Advisory Fee Charged by Client Asset Size - 2011						
Fee Range	**$100K**	**$300K**	**$750K**	**$1.5m**	**$5m**	**$10m**
Less than 0.75%	1%	1%	2%	7%	30%	65%
0.75% to 1.00%	6%	9%	22%	36%	45%	26%
1.00% to 1.25%	22%	35%	44%	36%	19%	6%
1.25% to 1.50%	39%	30%	16%	12%	3%	1%
1.50% to 1.75%	10%	12%	8%	6%	2%	1%
1.75% to 2.00%	10%	9%	6%	3%	1%	1%
2.00% to 2.50%	9%	3%	1%	0%	0%	0%
More than 2.50%	2%	0%	0%	0%	0%	0%

Sources: Cerulli Associates, in partnerships with the Financial Planning Association, the Investment Management Consultants Association, Advisor Perspectives, and Morningstar

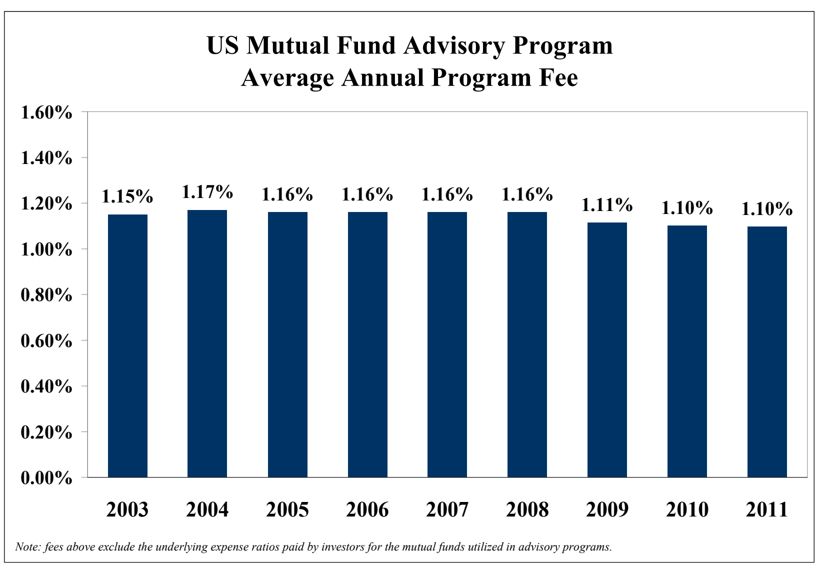
As captured above, approximately 70% of U.S. investors with account sizes of $100,000 are charged advisory fees higher than 1.25% and 31% are charged over 1.50%. This suggests that the external fees for an average mutual fund investor could exceed 1.25%.

The chart below – based on data and research from PriceMetrix – details the average overlay fee charged to investors of varying asset sizes across 11,000 mutual fund wrap accounts in the U.S.



*Source: PriceMetrix, Inc *Note: Advisory Fees expressed as RoA (Return on Assets)*

In measuring the fee paid on the average dollar (as opposed to the average investor) within fee-based accounts in the U.S., the influence of larger investor accounts is significant with a relatively low number of accounts holding a high proportion of actual dollars. The graph below, based on research from Cerulli Associates, shows the dollar-weighted-average annual program fee paid by U.S. investors in aggregate, within mutual fund-centric fee-based advisory programs. This data excludes underlying fund expenses and additional charges that are levied in some programs.



Source: Cerulli Associates

Glossary

Canadian Distribution Channels

1. Branch advice (BA)

The branch advice channel is a creation of the major banks and credit unions and accounts for $314 billion in client assets. 13,500 in-branch advisors are engaged primarily in financial planning and investment product distribution. Advisors are predominantly registered to the MFDA arm of deposit-takers, although some BA advisors are registered through IIROC.

2. Branch direct (BD)

This channel is made up of personal banking officers and employees with similar responsibilities. They initiate mutual fund transactions at the request of customers and provide limited advice. Individuals in the branch direct channel may move into the firms' branch advice channel.

3. Direct-to-public

The direct-to-public channel is represented by a small group of firms that include private investment counsellors and specialist firms. The share of the mutual fund market represented by this channel is modest.

4. Financial advisor (FA)

The FA channel is the most varied of the channels. It is made up of a wide range of firms including registered dealer firms; unregistered, fee-only planning firms; and life insurance distributors. These business models have varying degrees of independence and different product shelf capabilities. In the dealer category, models range from those with dedicated sales forces to firms with a high degree of product independence.

The FA channel also includes insurance distribution firms through which licensed insurance agents distribute life insurance products and segregated funds. The majority of these insurance distributor firms (approximately 300) are managing general agencies.

5. Full-service brokerage (FSB)

In terms of assets, FSB is the largest intermediated channel. The channel includes those IIROC member firms that have client-facing advisors with a retail offering of directly-held securities and fee-based managed asset solutions, including discretionary management. The open architecture and investment dealer registration allow these firms to distribute the widest range of investment products and wealth management solutions of any channel. Over 10,000 advisors operate in the full-service channel, though the number of firms operating in the channel continues to be reduced by consolidation.

6. Online/discount brokerage (ODB) and direct-to-public

This channel delivers products and its value proposition largely through centrally-managed technology platforms. The channel is dominated by bank-owned firms although some small firms operate in the deep discount and specialized sectors. This channel is growing rapidly in terms of both assets under administration and the number of users.

U.S. Distribution Channels

1. National Broker-Dealers

The National Broker-Dealer channel encompasses a number of the largest wealth management firms in the U.S. These firms, which distribute both individual securities, unitized investment and other fee-based solutions, account for more than 50,000 financial advisors nationwide and represent a very substantive proportion of overall U.S. mutual fund industry sales. From an asset perspective, National Broker-Dealers account for in aggregate over $1 trillion in total U.S. mutual fund assets.

2. Independent/Regional Broker-Dealers

Independent and Regional Broker-Dealers are comprised mainly of broker-dealer firms whose financial advisors operate as independent contractors (as opposed to National BD advisors who are employees of their firms). The Independent/Regional BD marketplace is made up of a majority of small firms but also several large and growing players. This channel, which offers similar products to National Broker-Dealers, represents an important advisor-sold mutual fund distribution avenue in the U.S.

3. Registered Investment Advisors (RIAs)

The RIA channel encompasses independent and largely fee-only advisors whose primary means of accessing mutual funds is via supermarket platforms such as those offered by Schwab, Fidelity, etc. While the RIA channel has been an emerging area of focus for many of the large, traditionally broker-dealer sold fund firms in the U.S., much of the established mutual fund presence within the RIA community has been concentrated largely among no load boutique and specialized fund managers.

4. Investment-Only Defined Contribution

The Investment-Only Defined Contribution channel includes mutual fund sales within defined contribution retirement plans in which the fund manager acts in an investment capacity only (through the offering of its mutual funds to plan participants) and does not also serve as the retirement plan's recordkeeper.

5. Bank Broker-Dealers

The Bank Broker Dealer channel includes mutual fund sales through bank-affiliated financial advisor networks. These Bank BD advisors often operate and sell products out of branches of affiliated bank locations.

6. Insurance Agents

The Insurance Agent channel represents sales through the agent networks of insurance companies. For purposes of the data included in this report, Insurance Agent sales include mutual funds only and exclude sales of variable annuity or other insurance-related products (which may be more prevalent within this channel).

7. Pure Institutional / Other

The Pure Institutional / Other channel captures mutual fund sales through pure institutional investors such as pension funds, endowments, etc. Such sales may often be made directly by a fund company to an institution, without the assistance of a financial advisor.

MUTUAL FUND MERs AND COST TO CUSTOMER IN CANADA:
Measurement, Trends and Changing Perspectives

A study by

Investor Economics

for

The Investment Funds Institute of Canada

September 2012

iNVESTOR ECONOMiCS

Table of Contents

SECTION 1: Introduction

At the end of 1960 there were 65 different mutual funds in Canada with total assets of approximately $608 million. These funds were reported to have "administrative" expenses ranging from 0.23% to 2.30% and "acquisition charges" ranging from zero to 8.5% of the "offering price".[1]

As the size and relative importance of the mutual funds industry in Canada has changed significantly in the past 50 years[2], so too has the manner in which investors are charged for, and pay for, participating in the mutual funds marketplace. As such, it is now appropriate for an objective and detailed study to be undertaken of the cost of ownership (CoO) of retail mutual funds in Canada.

To this end, and to ensure that investors, advisors, policymakers and regulators have a knowledge base upon which to hold discussions centred on the issue of the cost of ownership, the Investment Funds Institute of Canada (IFIC) has engaged Investor Economics to examine the historic and current cost of acquiring, maintaining and liquidating investments in retail mutual funds. At the same time, and in order to facilitate a proper comparison between costs incurred by investors in the United States and Canada, Strategic Insight has been engaged by IFIC to document the cost of ownership in the United States.

1.1 Report Outline

The analysis is organized as follows. *Section 2* is the *Executive Summary* which is provided to enable readers to develop a clear appreciation for the major elements of the CoO and the associated issues. *Section 3* introduces the concept of the cost of ownership and provides brief background information to provide some context for the analysis. *Section 4-8* monitors the cost of mutual fund ownership, its key components and the drivers of change. *Section 9* adds the distribution channel perspective. *Section 10* contains the list of survey participants and outlines the analytical processes used to generate the data presented in this report. A *Glossary of Terms* used in the study concludes the report.

1.2 Methodology

In order to arrive at an accurate and reliable measurement of the Canadian cost of fund ownership, Investor Economics has constructed a specialized model to measure the following determinants of the aggregated measure:

- Investor acquisition costs

- Ongoing costs
  - Embedded MER

[1] E.P. Neufeld. *The Financial System of Canada (Toronto, Macmillan 1972) pp 370 – 372.*
[2] At the end of July 2012, total mutual fund assets (including ETFs) were $844 billion. *Investor Economics Insight, August 2012, pp 4.*

- Unbundled (additional advice fees)

- Disposition costs

- The analysis also considered the following key factors affecting the realized investor cost:
  - Fund asset classes
  - Distribution channels
  - Advice model
  - Product structure
  - Fund series
  - Load structure
  - Holding period

All fund ownership cost measures used in the report have been calculated on an asset-weighted average basis. For details on the construction of the database for this analysis, please refer to the *Methodology* section in the Appendix.

1.3 Resources

In the process of developing the analysis and commentary, extensive use has been made of Investor Economics' proprietary databases and inventory of industry information. These internal sources include product databases dedicated to stand-alone mutual funds, fund wraps, segregated funds, fund series, trailer fees and fund loads.

During the course of the study, we also made use of proprietary distribution databases that cover full-service brokerage, online/discount brokerage and various other financial distribution channels.

Proprietary data has been supplemented with statistical information by a sample of mutual fund companies active in the Canadian marketplace. Specifically, these firms have provided us with information covering the past five calendar years on the following:

- Redemption fees paid, amounts redeemed and assets at the time of redemption for different load options.
- Front-end fees (paid and waived) and gross sales associated with those fees.

Investor Economics also accessed publicly available information regarding various fund companies, including published annual reports, investment analysts' reports, corporate websites and fund documents, as well as information obtained from other reliable industry sources.

SECTION 2: Executive Summary

2.1 The Position of Investment Funds in Canadian Financial Wealth

Over the past two decades, Canadian households have shifted their savings focus from one concentrated on bank deposits to one that embraces investment funds that provide access to equity and fixed income markets. By the end of 2011, long-term mutual funds and fund wraps moved their share from 6% at the end of 1990 to 29% in December 2011, with the majority of that share growth taking place in the first ten years of the period. In absolute terms, over the last decade, long-term funds and fund wraps grew from $496 billion in 2001 to $877 billion at the end of 2011.

This period of significant development also witnessed the introduction of a number of competing investment and deposit-based products, as well as new fund-based products, such as mutual fund wraps, which had an impact on the growth of traditional, stand-alone mutual funds. Twenty years ago, stand-alone investment funds accounted for all fee-based assets held by retail investors; the share held by stand-alone funds has since declined to less than one half.

2.2 The Cost of Ownership

The cost of ownership (CoO) of mutual funds is the sum of three distinct elements: acquisition costs, such as front-end load commissions; ongoing costs, both embedded and negotiated; and disposition costs, such as redemption fees. The adoption of the cost of ownership, rather than the management expense ratio (MER), as the most effective way to measure total investment expenses incurred by an investor over the life of an investment permits comparisons to be made between not only investment funds but across a wide range of competing vehicles.

The overall Canadian mutual fund CoO has been relatively stable in recent years although the elements within the CoO have changed significantly. The change in commission, or load, structures and the manner in which commissions are applied, that has taken place in the last two decades and the trend towards embedding the majority of investor costs within the fund MER are two of the major influences on the cost of ownership equation.

In 2011, 98% of mutual fund assets did not attract upfront charges and did not incur disposition costs.

In the 1990s, it is estimated that between 75% and 85% of all fund sales were made up of back-end load units. In recent years (2007 – 2011), there has been a noticeable return to funds carrying a front-end charge, with 71% of all load fund sales being represented by units of this type. Of those sales, however, 98% were effectively sold on a no load basis as no commission was charged at the time of purchase. It is also worth noting that no load funds claimed 69% of total industry gross sales in the same five year period.

2.3 Management Expense Ratio

As a result of the trend towards embedding most costs within the MER, the rate at which the MER is charged to the fund is a fair, albeit not comprehensive, representation of the overall CoO incurred by an investor. Despite the development of approaches to the separation of the cost of investment services from the costs of advice (such as F-series funds), a majority of funds sold in Canada are those in which almost all costs are embedded in the MER.

At the end of 2011, the overall asset-weighted CoO for Canadian mutual funds was 2.10%, a level slightly lower than the 2.14% recorded in 2006. It is the case, however, that increasing use of non-core fund series, such as F-series and D-series, and the overall shift to fee-based services by Canadian investors will lessen the importance of the MER as a cost measurement metric, and emphasize the applicability of the more complete CoO model.

The CoO of mutual funds is not constant across the various product types (including asset class, fund series and fund wraps) and distribution channels that are available to Canadian investors. For example, the average asset-weighted MER for a Canadian bond fund in 2011 was 1.36% compared to that for an international equity fund of 2.44%.

The introduction of unique series of funds, such as F-series and HNW-series, which are becoming more widely used as advisors move away from traditional business models, point to an industry that is aware of, and reacting to, competition from a wide range of financial institutions and instruments. Each unique series is designed to enable advisors to meet the evolving needs of various investor segments. For example, F-series funds are specifically designed to be held in a fee-based account at either a full-service brokerage firm or mutual fund dealer for which a separate charge will be made for advice and planning services. HNW-series, on the other hand, have largely a traditional MER in terms of structure although the client benefits from a discounted fee to reflect the size of the account.

Account size and access to planning and investment advice have a material influence on the MER. Understandably, when the cost of advice is uncoupled from the provision of investment management services, the MER will be lower. This is the case with F-series funds although, to date, it is generally the case that the combination of the MER and the advice fee negotiated between the advisor and the investor has not resulted in discernable savings to the investor.

2.4 Mutual Fund Distribution

The cost of distribution is largely built into the MER, and it is noticeable that during a period when the various major cost components of the MER, such as management fees and operating costs, were trending down, distribution costs represented by trailer fees paid to dealers remained unchanged. In 2011, the average trailer fee paid by long-term funds was 78 basis points, virtually unchanged from the 77 basis points recorded in 2006.

Since 2007, estimated fund company gross revenues, as defined by the asset-weighted MERs and average monthly fund industry assets, have grown at a compound average annual growth rate of 0.95%. Over the same period, the estimated distribution compensation component has expanded at a rate of 2.45%.

Retail investors access mutual funds through a range of distribution channels and the average cost of ownership varies from channel to channel. Canadian investors have the ability to choose between direct channels, such as purchasing directly from the fund manager, and advice channels, such as full-service brokerage. The channels where the average cost of ownership is above the benchmark rate of 2.10%, are the full-service brokerage channel (2.27%) and the financial advisor channel (2.38%). By comparison, the average cost of ownership for funds purchased through a branch-based advisor is 1.89%.

The lowest cost of ownership is achieved by investors who purchase directly from the fund manufacturer. The average cost of ownership for these investors is 86 basis points below the benchmark, although it is the case that the advice provided by the direct-to-public fund manufacturers is not comprehensive and is frequently limited to suitability and other issues required by regulation.

2.5 Conclusions

Up until the mid-1990s, Canadian retail investors had limited product choices and, as such, had only a moderate ability to shape the total costs that they would incur over the life of an investment. Over the past twenty years, there have been significant changes within the three primary participant areas within the mutual fund industry – governments and regulators, manufacturing and distribution.

Changes that have been introduced in recent years, generally as the direct result of a high level of competition rather than regulation, have provided retail investors with the opportunity to better manage and lower their investment costs. The decision by the majority of fund investors to use traditional advice channels in order to benefit from other services, or the need to qualify for certain products through meeting minimum investment guidelines, may have limited the extent to which some cost-saving measures and features have been adopted. The proliferation of no load funds, the growing use of online/discount brokerage firms for fund investments, and the emerging popularity of fee-based accounts, where the cost of advice and account maintenance is separated from the investment management costs, are three examples of options available to investors which may result in lower costs.

Unlike other sectors within the financial services industry, such as retail banking and life insurance, the mutual fund industry has not matured to the point where the marketplace is dominated by a few, very large participants, and where barriers to entry have been raised to limiting heights. Competition, if judged by the number of managers, the number of individual funds and the number of advisors able to sell mutual funds, has remained intense. By enabling this business environment, regulators have allowed the forces of competition to positively influence the cost of investment to the extent that, despite the increased sophistication of the product, total investment costs have seen a modest decline.

2.6 Outlook

There is no current evidence that points to any future increases in the cost of ownership of mutual funds, other than those cost increases which may be caused through a shift to higher risk investments or investor preference for complex structures, such as those that include performance-driven compensation for fund managers.

As such, as has been the case in other countries, it is likely that economies of scale and competitive pressure will continue to move the costs in favour of the investor.

SECTION 3: Background

3.1 Historical Perspective on Fund Industry Growth

Over the past two decades, the composition of financial assets reported on the Canadian household balance sheet has been transformed through the influence of a number of factors including an aging population needing to supplement conventional pension income with high levels of personal savings. A further influence has been a greater willingness by savers to assume a degree of volatility in the value of their long-term savings. In addition to these demand-driven changes, various regulatory initiatives encouraging the banks and other deposit-takers to enter the retail investment business have had a material impact on the structure and availability of savings and long-term investment instruments.

One result of these changes has been a marked reduction in the use of deposit instruments as the primary vehicles for personal savings. As indicated in **Figure 1** (below), despite an absolute increase of $700 billion, the share of personal financial wealth represented by both variable and fixed rate deposits has fallen from 68% in 1990 to 39% in 2011. The leading role in terms of long-term savings has now been taken by individual securities and investments funds which, when combined, have recorded a share increase from 29% in 1990 to 48% in 2011.

The shift to market-sensitive investments, away from those with an administered rate of return, reflects not only regulatory changes but also a period which has been highlighted by declining and persistently low interest rates and a generally positive investment climate. The trend also reflects the impact of the large cohort of the baby-boomers, who entered the accumulation phase of their household financial lifecycle at the beginning of the 1990s.

It is reasonable to suggest that the investment funds industry has been the main beneficiary of these trends, with the industry's share of financial wealth moving from 6% at the beginning of the period to almost one-third at the end of 2011. In the process, investment funds also became a core savings vehicle within Canadian individual retirement savings. At the end of 2011, investment funds accounted for 42% of assets held in Registered Retirement Savings Plans (RRSPs), up from 31% in 1996.

Figure 1: Composition of Canadian Financial Wallet
Assets in billions of dollars

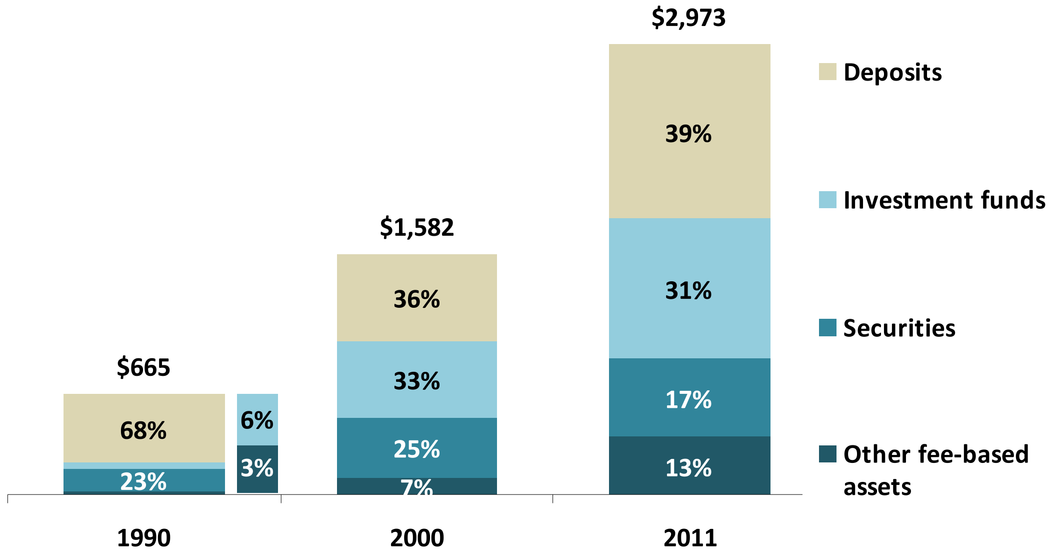
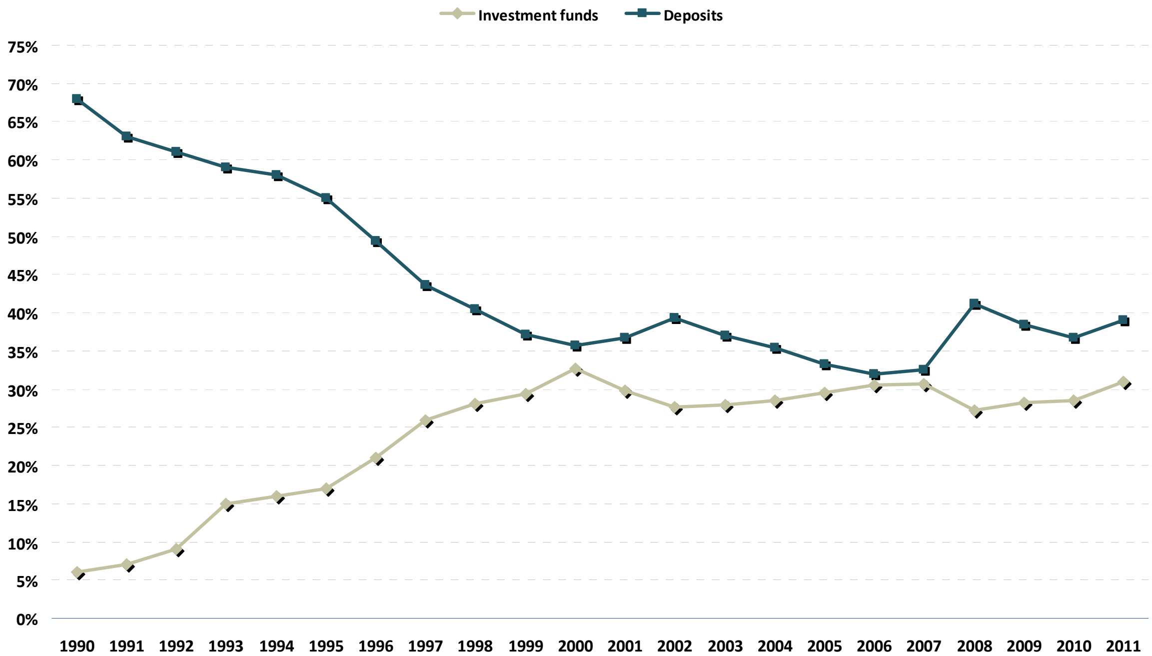


Figure 2 (below) illustrates the restructuring of the Canadian household financial wallet by monitoring the share of investment funds and deposits since 1990. The main thrust of the shift occurred in the 1990s, with the 2000s decade—and its two bear markets—delivering a slight rebound in the importance of deposits but no further meaningful gains for the share held by investment funds. Since the 2008-2009 market downturn the share of deposits has drifted up, highlighting the risk-averse stance of Canadian households and supporting the idea of an ongoing potential for substitution between the core components of the household financial wealth.

Figure 2: Share of Financial Wealth Held in Deposits and Investment Funds
Assets in billions of dollars



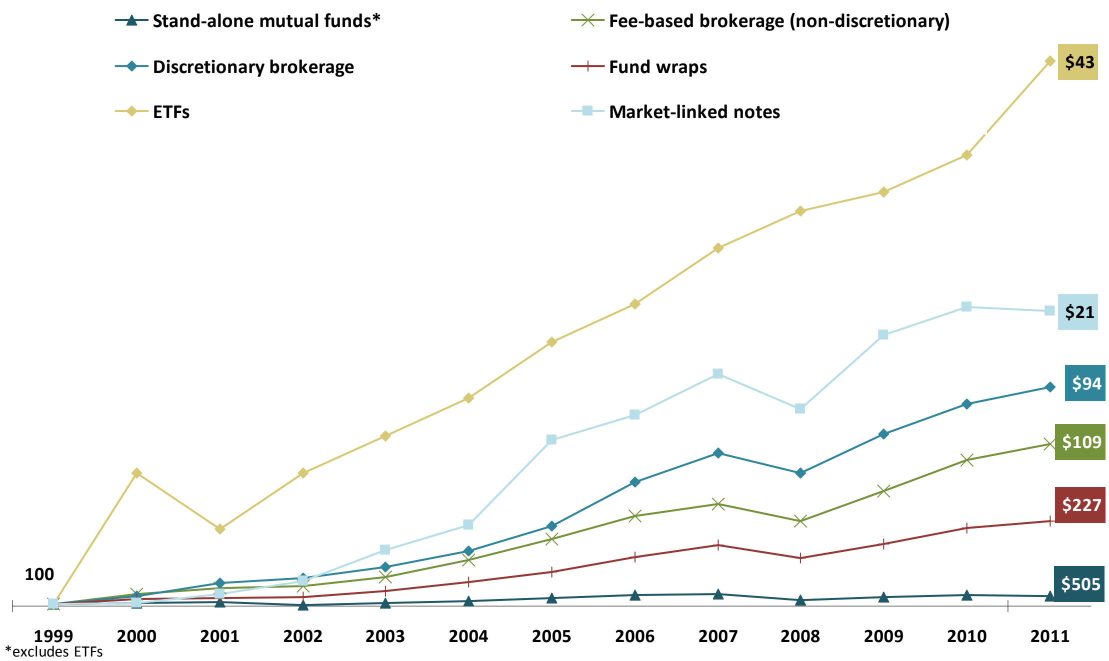
	1990	2000	2011
Financial wealth	$ 665	$ 1,582	$ 2,973
Investment funds	$ 40	$ 516	$ 925
Deposits	$ 452	$ 564	$ 1,148

3.2 Expanding Competitive Landscape

The end result of the balance sheet restructuring is that the past 11 years have failed to deliver any significant increase in the penetration of the Canadian wealth portfolio by mutual funds. Since the beginning of the last decade, mutual funds have faced increasing competition from an expanding array of financial products vying for a share of the Canadian household wallet.

Figure 3 (below) expands the competitive view by tracing the relative growth of selected investment products that compete with mutual funds.

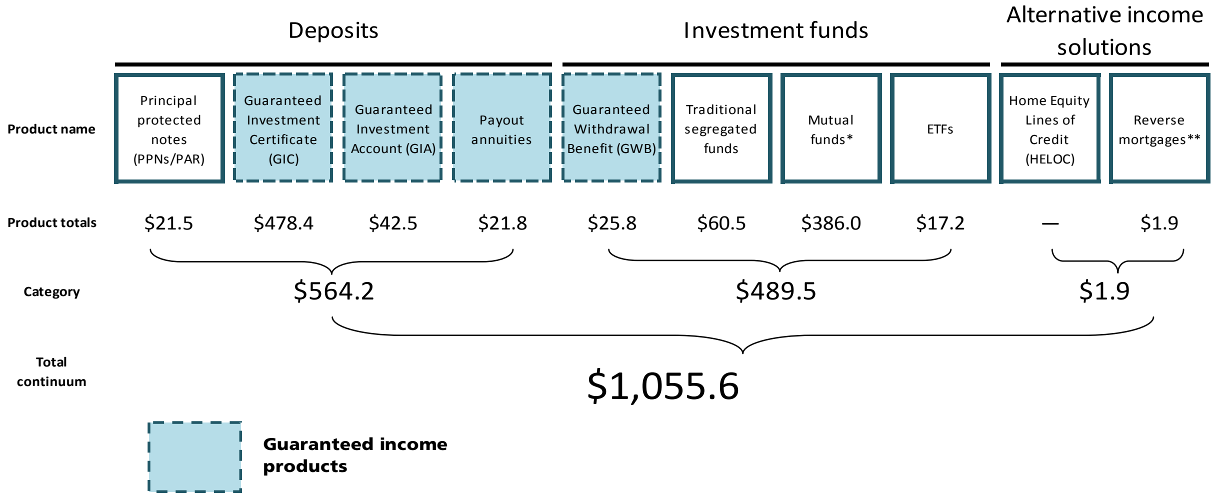
Figure 3: Comparing the Growth of Key Investment Products and Services
Indexed to 1999 = 100, assets in billions of dollars



The chart highlights the inroads made by other investment alternatives, such as exchange-traded funds (ETFs) and managed asset solutions, such as fund wraps, during the last decade. Notably, the majority of these offerings were not part of the financial wealth landscape 20 years ago. Having formed the centre of the fee-based asset universe, accounting for 100% of it in 1990, stand-alone funds—those not sold as part of managed asset solutions in which the advisor is not required to construct individual portfolios—have stagnated and their share has eroded to the point that they now account for less than half of fee-based assets.

Figure 4 (below) provides an additional perspective on the competitive environment for mutual funds by identifying the main product categories occupying the Canadian retirement income continuum. The exhibit reveals a still-evolving range of products and solutions targeting the retirement market opportunity.

Figure 4: Retirement Solutions Continuum—2011
Assets in billions of dollars



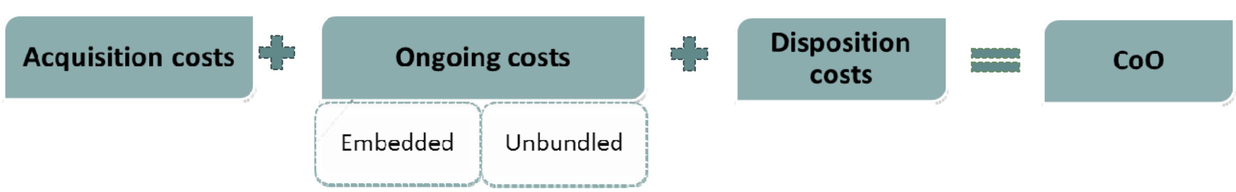
*Mutual funds and exchange traded funds consist of fixed income, income balanced and equity income funds.
**Source: CHIP Home Income Plan.

3.3 Cost of Ownership

This growing competition for the savings dollars of Canadian households highlights the importance of developing a cost of ownership (CoO) framework capable of housing the variant cost elements of a broad range of financial products and solutions.

In the past, the analysis of the CoO of mutual funds in Canada focused almost exclusively on the level of fund management expense ratios (MERs). While this approach has proved useful in assembling *cross-fund* comparisons, it does not permit a complete and consistent measurement of the costs incurred by Canadian households through the ownership of various financial instruments, including deposits. The reasons include the lack of comparable expense information for some products, the absence of updated/ongoing information regarding their various cost components, the limited transparency of their distributor compensation formulas and the potentially meaningful transaction costs associated with their acquisition and disposition.

Figure 5: Cost of Ownership Framework

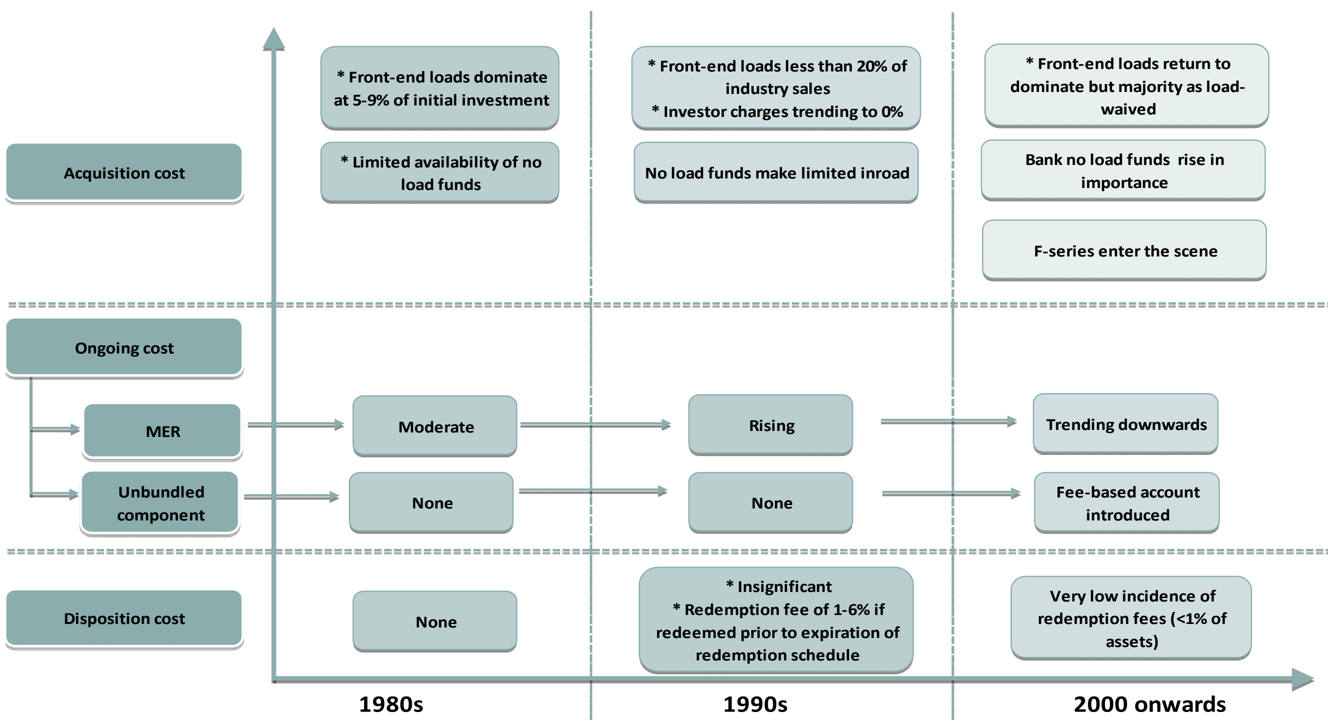


The proposed CoO framework outlined in **Figure 5** is designed to serve as the basis for informed decisions concerning investor expenses, including those related to public policy and *cross-product* and *cross-border* comparisons. The CoO measure takes a holistic view of the customer cost experience by accounting for the transaction costs associated with the acquisition and the disposition of the product as well as the ongoing costs represented by internal product expenses (embedded costs) as well as any other investor charges levied outside the product itself (unbundled costs). In this way, the CoO model levels the playing field in solving the cost-to-customer equation across a continuum of investment offerings available to savers and investors through a multiplicity of platforms and delivery channels. The CoO approach that is outlined above deals effectively with the majority of investment products where costs to investors (and, consequently, revenue to either manufacturers or distributors) are required to be fully disclosed. It is, however, more difficult to make comparisons between the CoO of mutual funds and deposit instruments where the major revenue component of deposits (the spread between the cost and use of the funds, or net interest margin) is not disclosed by the institution

3.4 Trends in the Cost of Mutual Fund Ownership

In addition to being a period of rapid growth, the 1990s saw mutual funds progressively transformed from a predominantly commission-based product into a fee-based product. **Figure 6** (below) traces the key milestones in the development of costs of mutual fund ownership and confirms the reduction in importance of the transactional fees over the course of the decade.

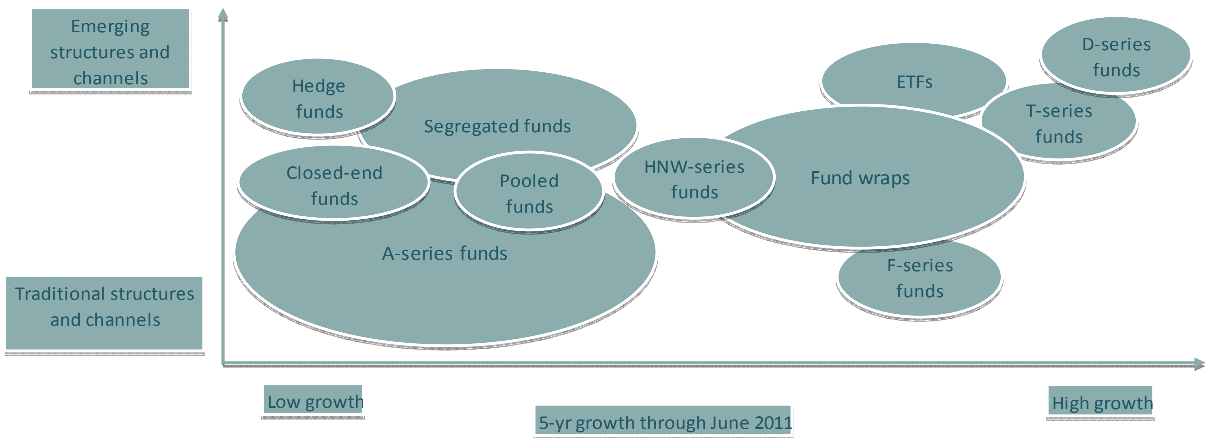
Figure 6: Evolution of Mutual Fund Cost-to-Customer



In addition to being a period of rapid growth, the 1990s saw mutual funds progressively transformed from a predominantly commission-based product into a fee-based product. **Figure 6** (above) traces the key milestones in the development of costs of mutual fund ownership and confirms the reduction in importance of the transactional fees over the course of the decade. Recent years have witnessed further changes to the mutual fund pricing models, as the industry adapted its pricing and product structures to fit the new competitive paradigm.

Figure 7 (below) illustrates the changing environment by indicating the range of currently available fund product types, series and structures, targeting diverse client segments and distribution opportunities. Here, as well, the field is made up of offerings and fund structures that did not exist 20 years ago.

Figure 7: The Proliferation of Fund Product and Series Structures



** Bubble size = product's relative asset size*

Over the past three decades, the investment fund industry in Canada has witnessed an unprecedented number of changes to what is being offered to retail investors and how those investors access a widening range of investment options. These changes have been driven by a combination of innovation, changes in demand and regulatory and government action. These three drivers are dynamic not static and they will continue to influence the overall direction taken by the industry as well as the various costs incurred by those Canadian savers and investors who use investment funds.

Key Takeaways — Section 3

- The share of personal financial wealth held by deposits fell from 68% in 1990 to 39% in 2011.
- Over the same period, the share of investment funds increased from 6% to 31%, establishing them as core savings vehicles and the primary conduit to capital markets for the mass market and mass affluent households.
- Mutual funds face increasing competition from an expanding array of financial products. As a result, the share of personal financial wealth held by mutual funds has not shown a significant increase in recent years.
- The intense competition for the savings of Canadian households highlights the need to develop a comprehensive cost of ownership (CoO) framework able to house the cost elements of a broad range of financial products and solutions to facilitate cross-product and cross-border comparisons.
- The mutual funds industry offers a range of fund products, fund series and fund-based solutions, which reflect the needs of a various client segments and distribution channels.

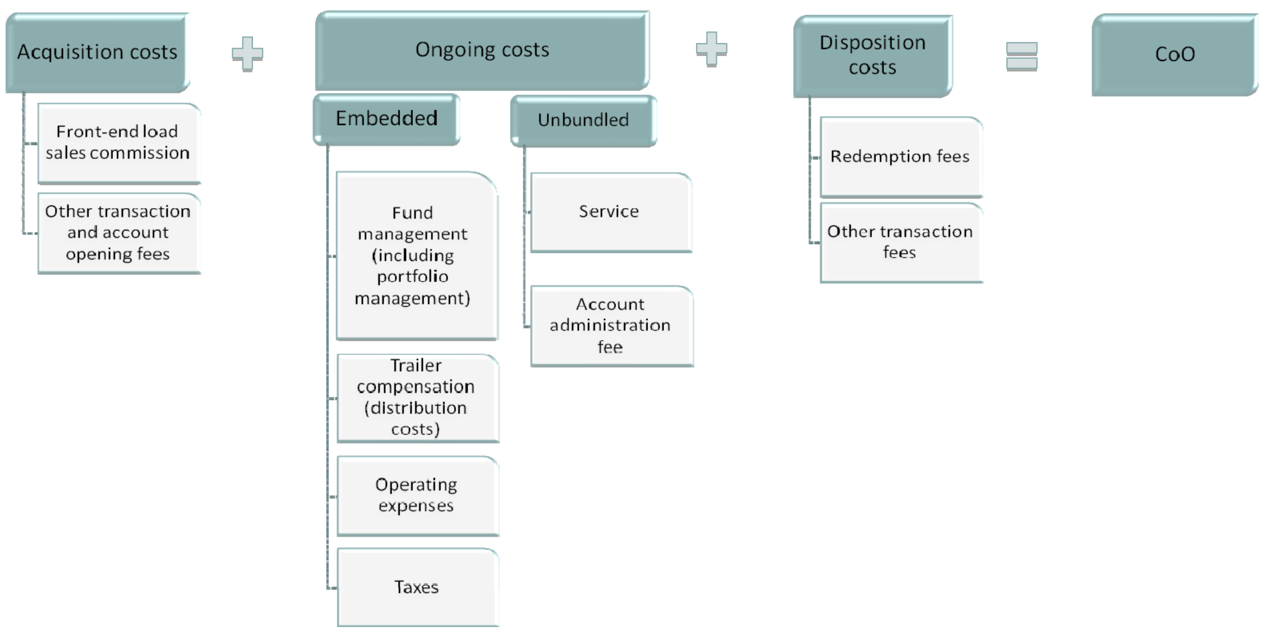
SECTION 4: Measuring the Mutual Fund Cost of Ownership (CoO) in Canada

Having established the importance of creating and maintaining a comprehensive CoO measurement for the purpose of cross-product and cross-border comparisons, this section presents the results of our ongoing analysis of the cost-to-customer of Canadian mutual funds. The commentary focuses on key forces impacting the composition and the level of the mutual fund CoO in Canada.

Together with the U.S. metrics developed by Strategic Insight, the analytical outputs in *Section 4-7* and *Section 9*, which outlines the cost of mutual fund ownership in key distribution channels, will act as inputs into the comparative analysis of the Canadian and the U.S. mutual fund cost of ownership.

Following the structure of the analytical framework outlined above, **Figure 8** identifies the key components of the CoO equation from the perspective of the Canadian mutual fund investor.

Figure 8: Drivers of the Mutual Fund CoO



The costs associated with owning a mutual fund fall into two broad categories: transaction-related costs and ongoing costs. Transaction-related costs represent commission costs associated with the purchase and the disposition of mutual fund units. Fund-specific acquisition costs are front-end load sales commissions, which reflect the point-of-sale charges levied on investors. Disposition costs refer to the fees paid by investors redeeming their back-end load fund holdings prior to the expiry of the redemption schedule. (For detailed definitions, please refer to the *Glossary of Terms* in Section 10 of this report commencing on page 61)

Over the past 20 years, the importance of transaction-related costs to the overall CoO of mutual funds has declined in line with the significant decrease in the incidence of investors paying upfront sales commissions when purchasing a mutual fund. At the end of 2011, 98% of the mutual fund book of business was held by investors who did not incur any acquisition or disposition costs. As such, the majority of Canadian mutual fund investors do not face any financial penalty should they chose to sell their fund holdings. This is in contrast to other investment vehicles, such as equities or ETFs, which will likely attract acquisition and disposition costs if they are held in commission-based accounts. It is also the case that GICs redeemed prior to maturity attract early redemption penalties.

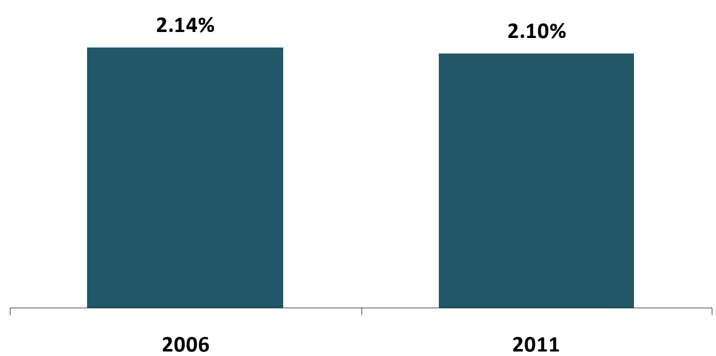
Ongoing costs include fund-specific embedded costs captured in the fund MER and ongoing service fees levied at the client account level. Other one-time fees may be incurred by investors at the time of purchase and redemption of the fund units as well as during the holding period. Examples of these fees include distributor-defined account opening fees and annual RRSP plan account fees. These fees are generally negligible, with their application being contingent on a number of factors related to the specific circumstances of individual investors, such as their choice of distribution channel, plan provider, advisor business model, type of plan, investment size and investor purchasing power.

Additional cost-to-customer considerations, such as trading expense ratios (TERs) and performance fees are discussed in *Section 8*.

4.1 Benchmarking the Industry-aggregate CoO

The aggregate benchmark for the CoO of mutual funds in Canada at the end of 2011, expressed as percentage of assets under management, was at 2.10%, a level almost unchanged from the aggregate CoO in 2006 (see **Figure 9**).

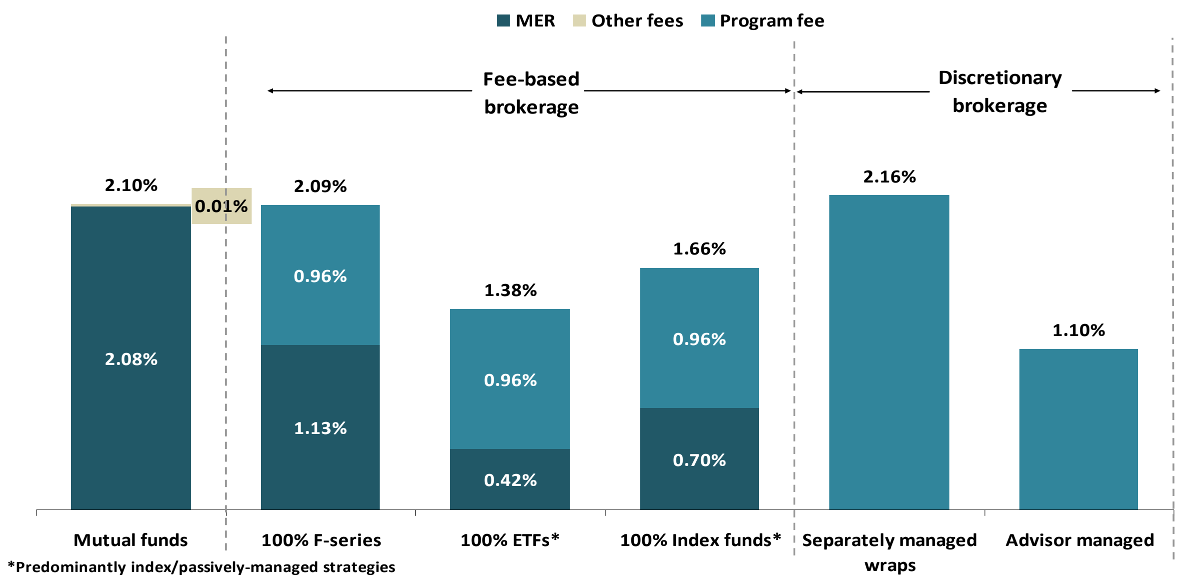
Figure 9: Overall Cost of Mutual Fund Ownership in Canada
Asset-weighted, expressed as a percentage of assets under management



A comparison of CoO across a range of investment alternatives in **Figure 10** reflects a variety of potential cost outcomes. In keeping with our CoO model, the exhibit presents three types of investor expenses:

– The product-embedded expenses, such as MERs.
– Fees levied at the client account level that are not part of the product or solution's internal expenses.
– Transaction costs associated with owning selected investments.

Figure 10: CoO across Selected Fee-based Products and Managed Asset Solutions



Alongside the mutual fund cost of ownership, **Figure 10** provides estimates of the cost-to-customer by using an exclusively fund- or exchange-traded fee-based brokerage account. In both cases, the composition of the investor costs is altered by the extraction of the distribution cost component from the fund MER and the replacement of that fee by a negotiated fee levied at the account level. This process (also known as unbundling) does not necessarily translate into significant investor cost efficiencies.

More meaningful investor cost savings are realized when the fee-based brokerage account is populated by low-cost vehicles, such as ETFs or index funds, both of which represent passively-managed strategies as opposed to actively managed. In this case, the account service fees represent two-thirds of the cost-to-customer, while ETF-embedded costs (in the form of the expense ratio) represent one-third of the cost-to-customer.

The two columns on the far right of **Figure 10** above outline the range of costs for investors who use two types of discretionary services offered by qualified full-service brokerage advisors, which are typically targeted at the mass affluent and upscale clientele. The all-inclusive fees shown in the exhibit represent the industry averages for the sample of full-service brokerage firms in the Investor Economics' database. (For more on our methodology and assumptions, please refer to the *Methodology* section in the Appendix).

Importantly, the mutual fund CoO reflects the average transactional costs as measured for the entire industry. Meanwhile, the remaining examples featured in the exhibit reflect exclusively fee-based account types, in which investors typically do not incur transactional fees. However, transactional accounts remain a dominant account structure at online/discount brokerage firms and roughly 45% of the assets administered by full-service brokerage advisors sit in commission-based accounts.

When profiling the cost-to-customer of investments held within transactional-type accounts, the length of the investment holding period and the extent of portfolio turnover are levers affecting individual client cost outcomes. This is particularly true for those investment vehicles that incur transaction fees at the point of entry and exit, such as equities or ETFs held in transaction-based accounts. This consideration is of particular relevance to active traders. For these types of investors, the CoO of a particular investment is driven by the transactional costs associated with the purchase and the disposition of individual securities, as well as the number of transactions occurring in a given period.

Key Takeaways — Section 4

- The cost of ownership can be divided into three specific areas: acquisition costs, ongoing costs and disposition costs.
- The aggregate cost of ownership of mutual funds in Canada in 2011 was 2.10% compared to 2.14% five years earlier.
- In fee-based brokerage accounts, the process of unbundling – extraction of the distribution cost component from the fund MER and the replacement of that fee by a negotiated fee levied at the account level – does not necessarily translate into significant investor cost efficiencies.
- For equities and/or ETFs held in transaction-based accounts, the length of the investment holding period and the extent of portfolio turnover impact individual client cost outcomes significantly.

SECTION 5: Acquisition and Disposition Costs

5.1 Mutual Fund Transaction Costs

The marginal change in the Canadian aggregate CoO over the five-year period between 2006 and 2011 belies the longer-term changes in the relative importance of its various components. Our review of the individual cost components begins with an examination of acquisition and disposition costs.

5.2 History of Loads in Canada

The past two decades have witnessed a decline in the importance of the transaction cost component for mutual fund owners.

The limited impact of the sales commissions and redemption fees on the cost-to-customer was not always the norm in the Canadian funds industry. In the 1980s, fund sales were dominated by the front-end load option, which could reach up to 9% of the initial investment.

The back-end, or deferred sales charge (DSC) load option, was introduced in the late 1980s and quickly gained popularity among advisors. The DSC structure replaced the investor-paid sales commission with a fund company-funded advisor payout in the 4% - 5% range and an ongoing trailer fee to the advisor at half the rate of the front-end load funds. Investors faced a redemption charge for withdrawals in the first seven or eight years. According to data collected by Investor Economics in the second half of the 1990s, and supported by anecdotal evidence obtained from conversations with industry sales executives over the past two decades, the back-end load fund option accounted for between 75-85% of load fund sales throughout the 1990s.

The shift towards back-end loads exerted a suppressing effect on the level and importance of transactional costs for investors. However, in terms of the overall cost-to-customer, the trend was counteracted by the rise in fund management fees for load funds. The increase in load fund management fees reflected the higher distribution costs associated with the fund companies' financing of the upfront sales payout to the advisors and the ongoing costs of the trailer compensation. In other words, in the course of the 1990s, the costs associated with compensation of distributors became increasingly internalized—or embedded—within the fund management fees. The impact of the rising costs of distribution on the management fees is difficult to quantify, as the majority of Canadian fund manufacturers opted for a single unit class—and a single management fee—for all load options.

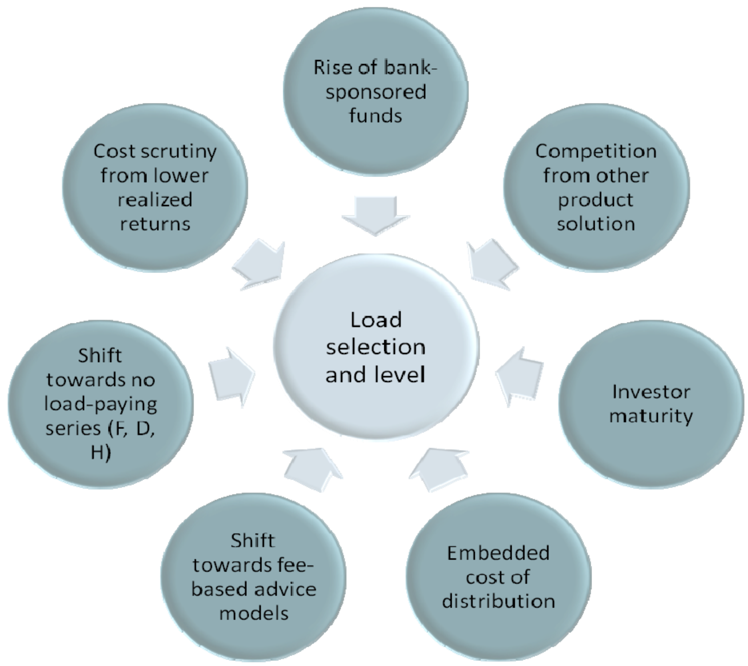
In 1999, the load options expanded with the introduction of a low load option, also known as a short-term deferred sales charge (where the fund company pays the advisor a sales commission ranging from 1%-3%, but the load structure follows an abbreviated redemption schedule).

Completing the Canadian load landscape are no load funds. The emergence of the banks as major participants in the Canadian mutual fund industry has led to a higher industry weighting of no load funds. In the past five years (2007 through 2011), no load funds accounted for 69% of industry gross sales. No load funds are sold without an initial sales charge and carry no redemption fees other than those fees paid if they are redeemed within 90 days from the date of the initial purchase (similar to funds purchased in the front-end load option).

5.2.1 Evolution of Load Structure Post-2000

Since 2000, a number of the factors listed in **Figure 11** have weakened the appeal for back-end load funds. Against the backdrop of sluggish fund sales in the first half of the decade, the intensified competition for savings dollars resulted in advisors increasingly employing the zero front-end load approach (also known as the load-waived approach).

Figure 11: Key Factors Impacting Load Structures



5.2.2 Acquisition Costs

The load-waived approach to new sales is in line with the overarching trend towards greater emphasis by distributors on recurring, fee-based—as opposed to transaction-based—revenues. In this context, the zero front-end load option represents a type of fee-based solution, as it bases the advisor's and distributor's compensation on the recurring asset-based compensation in the form of front-end load fund trailers.

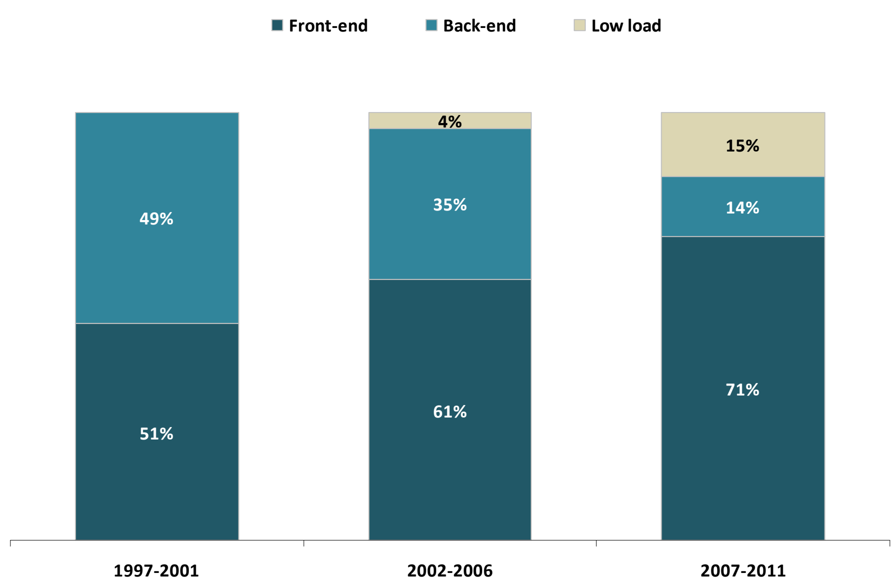
The zero front-end load model is now firmly entrenched. Based on sample of data received from eight companies representing 45% of front-end load fund gross sales in 2011, our analysis suggests that the majority of sales into front-end load options are now load-waived. In 2011, 98% of sales of front-end load funds did not incur sales commissions. Of the remaining 2%, investors accounting for 1% of front-end load fund assets paid less than 1% at the point-of-sale, with an average commission of

0.82%. The remaining 1% of assets incurred a sales commission in excess of 1%, with an average of 2.11%. In aggregate, the average commission paid for front-end load purchases that incurred an acquisition cost was 1.42%. This represents an annualized acquisition cost of 0.31% based on our assumed average holding period of 4.5 years (see **Figure 13** on page 22).

5.2.3 Disposition Costs

Between 2007 and 2011, front-end load funds accounted for approximately 71% of load fund gross sales (see **Figure 12**). The traditional back-end load option accounted for 14% and low load funds for the remaining 15%. The low load option has gained sales momentum in recent years, largely at the expense of the traditional back-end load funds. (For explanations of the various load options, please refer to the *Glossary of Terms*.)

Figure 12: Percentage of Gross Sales by Load Type



The impact of the redemption fees for fund unitholders in the back-end or low load options has been constrained by the lower redemption rates for these load options relative to front-end and no load funds. Also contributing to the low incidence of redemption fees being charged to investors, which is confirmed by the data collected from a sample of 11 load fund manufacturers for the purposes of this project, is the waning importance of back-end load sales and the related mature profile of the existing back-end load fund book of business. This means that a growing share of the asset base is *de facto* "off schedule", i.e. has been held past the expiry of the fund redemption schedule.

In 2011, 95.3% of back-end load assets did not incur redemption charges either because they were not redeemed at all or were redeemed after their redemption schedule had expired. For the 4.7% of assets that incurred a redemption fee, the aggregate charge was 1.87%. Recalibrating this average to reflect the various maturities (and the resultant levels of redemption fees paid) of the redeemed back-end load fund holdings and the associated relative redemption fee levels produces an effective average redemption charge of 0.93% (see **Figure 13**). This fee becomes the input into our mutual fund CoO model. (For more details please refer to the *Methodology* section in the Appendix).

The effective disposition fees differ for traditional back-end and low load funds; 4.6% of the assets in the traditional DSC funds incurred, on average, redemption fees of 1.95%. Once adjusted for the holding period, the effective disposition fee was 0.93%. Also, 5.2% of assets held in the low load option redeemed prior to the expiry of the redemption schedule incurred average redemption fees of 1.05%, or 0.86% after the holding period adjustment.

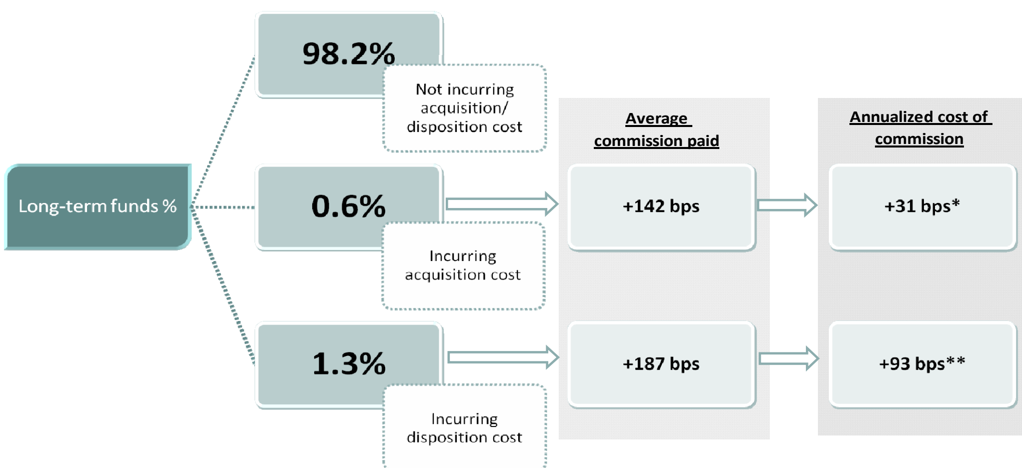
5.2.4 Impact of Acquisition/Disposition Costs on CoO

To arrive at a fully costed *annualized* CoO measurement, the transactional costs must be considered in the context of the mutual fund holding period. In the case of mutual fund holders who pay either a one-time sales commission at the time of purchase of front-end load mutual fund units or a one-time deferred sales charge on the redemption of back-end load mutual fund units, we have conservatively assumed an average holding period of 4.5 years. This assumption is validated by our long-term tracking of redemption rates for back-end load funds.

Figure 13 summarizes the results of our analysis of the acquisition and disposition components for mutual fund investors in 2011.

Figure 13: Percentage of Industry Assets that Pay Acquisition/Disposition Cost-2011

Fees reported on an asset-weighted basis



**Based on a 4.5-year holding period.*
***Based on actual holding period data from 12 fund company surveys.*

The exhibit traces funds purchased and redeemed under the various load options. The analysis suggests that more than 98% of fund assets in 2011 did not incur an acquisition cost in the form of a front-end load sales commission paid by the client to the advisor, and were not charged a disposition cost in the form of a redemption fee. The "no acquisition/no disposition costs" pool captures assets held in no load funds, F-series funds, front-end load funds sold with a 0% upfront commission (also known as load-waived sales) and back-end load funds (of both the traditional and low load varieties) whose redemption schedules have expired or those back-end load funds still on redemption schedule but not redeemed during 2011, thereby not incurring redemption fees.

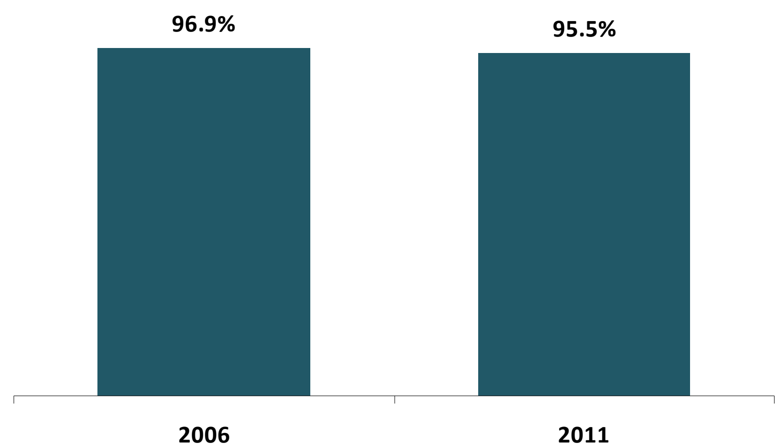
Key Takeaways — Section 5

- Over the past 20 years, the importance of transaction-related costs to the overall CoO of mutual funds has declined.
- Costs associated with compensation paid to distributors have become increasingly embedded within fund management fees.
- In the past five years (2007 through 2011), no load funds accounted for 52% of industry gross sales.
- The low load option has gained sales momentum in recent years, largely at the expense of the traditional back-end load funds.
- During the course of 2011, 98% of mutual fund assets held by individual investors did not incur either acquisition or disposition costs.
- To arrive at a fully costed *annualized* CoO measurement, the transactional costs must be considered in the context of the mutual fund holding period.

SECTION 6: Management Expense Ratios (MERs)

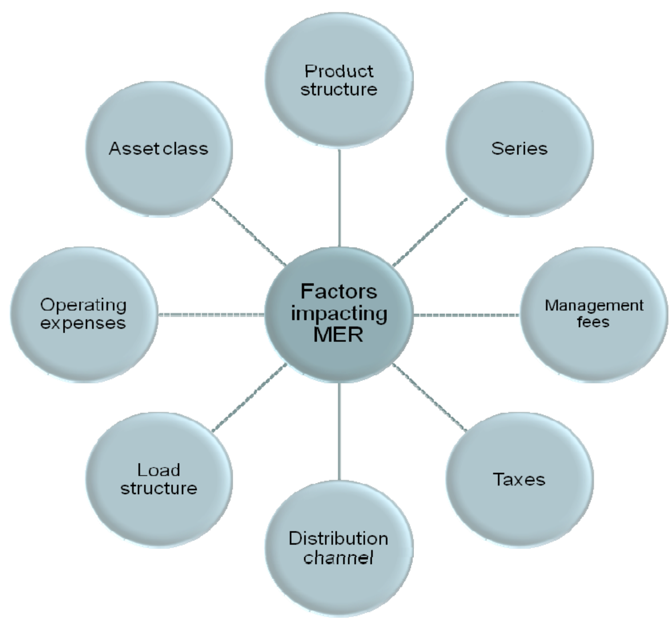
MERs—the ongoing expenses charged to the fund—represented 95.5% of the cost of mutual fund ownership in 2011 (see **Figure 14**). As discussed earlier, in the 1990s the MER formula became a more relevant indicator of the ultimate cost-to-customer as a result of the lessening importance of mutual fund transaction costs and the practice of incorporating the distributor compensation within the fund management fees. In recent years, the rising importance in the unbundled fund series (F and HNW, and their combinations) for use in fee-based advice models has once again begun to slowly erode the value of MER as a measure of mutual fund cost-to-customer. This trend has been counteracted by the rise in the bank-sponsored no load funds where no transaction fees are charged and where the MER represents the investor CoO.

Figure 14: Percentage of Long-term Mutual Fund Assets for which CoO = MER



6.1 Key Factors Affecting MER Levels

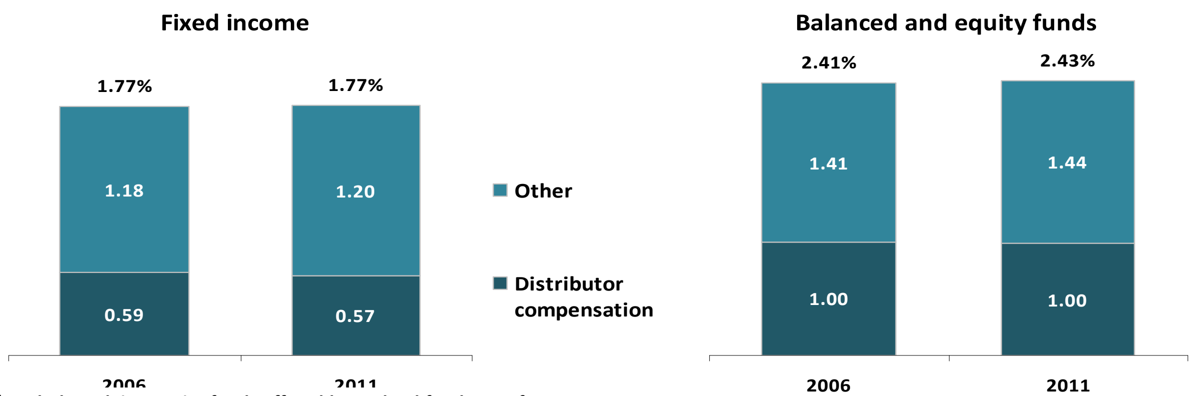
Figure 15: Determinants of MER



Of the factors affecting the level of fund MER identified in **Figure 15**, the selection of the distribution channel through which mutual funds will be purchased—a decision that reflects the individual client's desire and/or need for advice—represents a key determinant in the cost of ownership.

Figure 16 analyses the importance of the distribution cost component of the MER for two major asset classes. The analysis focuses on A-series load funds as data on distribution expenses is not readily available for no load funds. (For an explanation of the analytical model used to estimate the distribution component of the MER, please refer to the *Methodology* section in the Appendix.)

Figure 16: Estimated Cost of Distribution Embedded within MER of A-series Load Funds*
Asset-weighted MER



* Excludes Advisor-series funds offered by no load fund manufacturers

Our analysis of distribution costs, which include an allocation for the trailer fee and the financing of the advisor payout for the back-end and low load fund options, put their share of the average 2011 MER at 31.7% for fixed income funds and 40.9% for balanced and equity. In 2011, the average asset-weighted trailer paid by long-term load funds was approximately 72 basis points, unchanged from 2006.

Stated trailer fee levels have remained virtually unchanged for the past two decades. For front-end load option assets, most equity and balanced funds pay a 1% annual trailer fee to advisors. Fixed income trailers lie in the range of 0.50% to 0.75%, depending on the specific asset class. The trailer fee levels are halved for back-end load purchases (see **Figure 17**).

Figure 17: Typical Trailer Fees by Load Structure

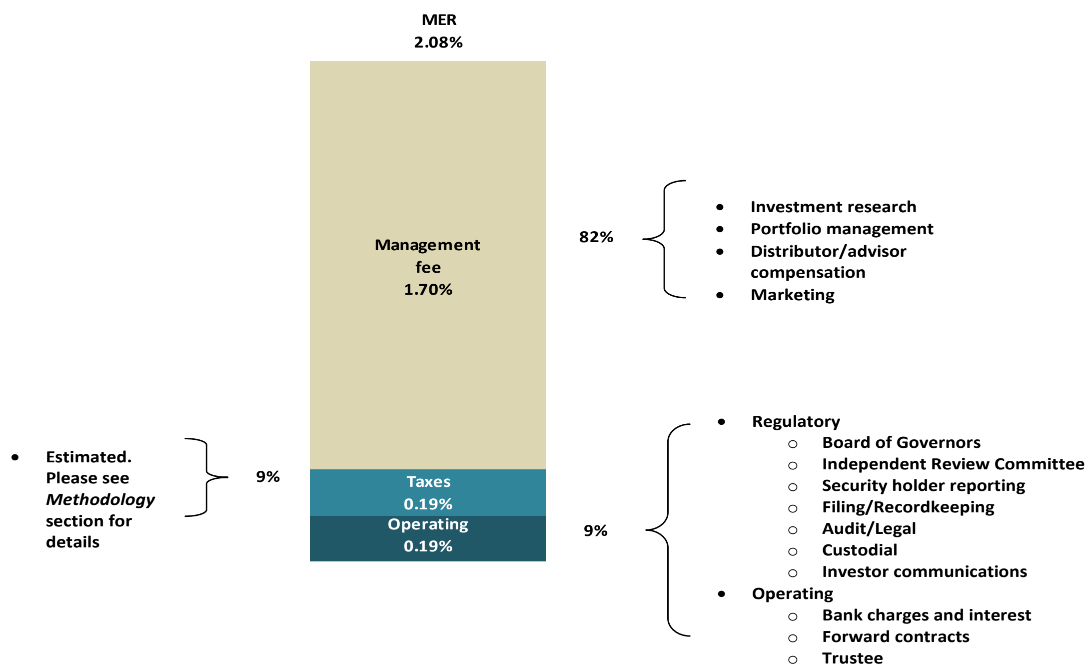
Asset class	Front-end	Back-end	Low load
Canadian bond	0.50%	0.25%	0.25%
High yield bond	0.75%	0.25%	0.35%
Canadian balanced	1.00%	0.50%	0.50%
Equity income	1.00%	0.50%	0.50%
Canadian equity	1.00%	0.50%	0.50%
International equity	1.00%	0.50%	0.50%
U.S. equity	1.00%	0.50%	0.50%

Since 2007, fund company gross revenues as defined by the MERs and fund industry assets have grown at a compound average annual growth rate of 0.95%. Over the same period, the estimated distribution compensation component has expanded at a rate of 2.45%.

6.2 Key Components of Canadian MER

Figure 18 identifies the key components of the Canadian fund MER (for an explanation of the analytical model used to measure the key components of the MER, please refer to the *Methodology* section in the Appendix.) On average, management fees, which include the distribution component, account for more than three-quarters of the industry-aggregate fund MER. While other components of the CoO have moderated over time, the distribution component of fund management fees has remained virtually unchanged. Beyond compensation for distributors, the fund's management fees cover portfolio management expenses (which may be outsourced to external sub-advisors), direct and allocated costs associated with marketing and manufacturing of the fund and the fund company profit margin.

Figure 18: Composition of MER—2011



Fund operating expenses and sales taxes on management fees paid by the fund complete the MER model. Operating expenses shown in this exhibit represent the overall average of stand-alone funds and mutual funds of funds.

Figure 19: Operating Expenses by Asset Class

Asset class	Operating expenses 2006	2011
Stand-alone funds	**0.23%**	**0.20%**
Fixed income funds	**0.13%**	**0.11%**
Mortgage	0.25%	0.12%
Canadian bond	0.10%	0.09%
Foreign bond	0.14%	0.17%
High yield bond	0.23%	0.16%
Balanced funds	**0.19%**	**0.18%**
Income balanced	0.15%	0.16%
Canadian balanced	0.22%	0.20%
International balanced	0.28%	0.27%
Equity funds	**0.25%**	**0.23%**
Equity income	0.24%	0.20%
Canadian equity	0.23%	0.20%
International equity	0.29%	0.31%
U.S. equity	0.22%	0.21%
Mutual funds of funds	**0.16%**	**0.17%**

As indicated above, operating expenses account for the costs associated with running the fund, including—but not limited to—unitholder reporting, regulatory filings, recordkeeping, audit, legal and custodial fees, and other charges and costs incurred by the fund.

On average, in 2011 operating expenses contributed 19 basis points (0.19%) to the asset-weighted MERs, accounting for 9% of the 2011 MER metric. With few exceptions, operating expenses, which currently range between 9 basis points (Canadian bond) and 31 basis points (international equity) have recorded a modest decline over the past five years (see **Figure 19** above).

In recent years, a number of fund sponsors have fixed the fund administration fees in terms of percentage points to be charged on the fund's assets. Currently, companies using the fixed administration fee approach account for $400 billion and more than 1,000 funds.

Fixing the administration fee has the potential to achieve greater transparency of fees and their predictability for the retail investor. In exchange for a fixed administration fee, the fund company typically agrees to pay all of the operating expenses of the fund except for expenses related to the independent review committee, regulatory requirements, taxes, borrowing costs and portfolio transaction costs. However, as the fund's asset base increases, the fixed fee practice may prevent the investor from benefiting from economies of scale realized by the fund manager.

6.3 Key Forces Impacting Change in Level of MER

Figure 20 expands on the conceptual view of the MER drivers with a five-year tracking of asset-weighted average MERs for the various asset classes and product structures. The asset-weighted MER decreased by 4.3 basis points (0.043%) during the period.

Figure 20: Asset-weighted MER by Asset Class

	2006	2011
Long-term funds	**2.12%**	**2.08%**
Asset class		
Stand-alone funds	**2.10%**	**2.06%**
Fixed income funds	**1.48%**	**1.46%**
Mortgage	1.77%	1.70%
Canadian bond	1.39%	1.36%
Foreign bond	1.77%	1.74%
High yield bond	1.73%	1.74%
Balanced funds	**2.01%**	**2.03%**
Income balanced	1.77%	1.86%
Canadian balanced	2.25%	2.24%
International balanced	2.40%	2.22%
Equity funds	**2.23%**	**2.26%**
Equity income	2.07%	2.12%
Canadian equity	2.24%	2.28%
International equity	2.38%	2.44%
U.S. equity	2.06%	2.14%
Mutual funds of funds	**2.27%**	**2.16%**

The changes in MERs were the result of both deliberate action by fund managers as well as a change in the share within the asset class between load and no load funds.

The six sub-sections that follow address the impact of the changes in key factors on the industry-aggregate MER.

6.3.1 Asset mix: shift to fixed income

Of all the MER change drivers, the change in asset mix has had the greatest impact on the industry-aggregate MER. The more risk-averse stance by Canadian households has translated into a greater allocation to fixed income and balanced funds over the last five years. The preference for Canadian funds over those holding non-Canadian assets has also had an impact. Collectively, the asset mix shifts have contributed approximately 10 basis points to the decrease in the asset-weighted MER of long-term funds.

The level of MER varies depending on the fund's asset class. For example, at year-end 2011, the average asset-weighted MER for fixed income funds was 1.46% compared to 2.03% for balanced and 2.26% for equity funds (**see Figure 20**). Beyond the prevailing management fee levels, the broad asset class MERs also reflect the changes in the detailed asset class composition of their asset base.

The asset-weighted average MER metrics belie the wide range of individual fund MERs within each asset class, suggesting a range of options – e.g. no load vs. load, actively- vs. passively-managed mandates etc. **Figures 21a** and **21b** below show the dispersion of MERs for A-series funds in the Canadian bond fund and Canadian equity multi-cap categories.

Figure 21a: Canadian Bond Funds MER Dispersion
A-series load and no load, number of funds

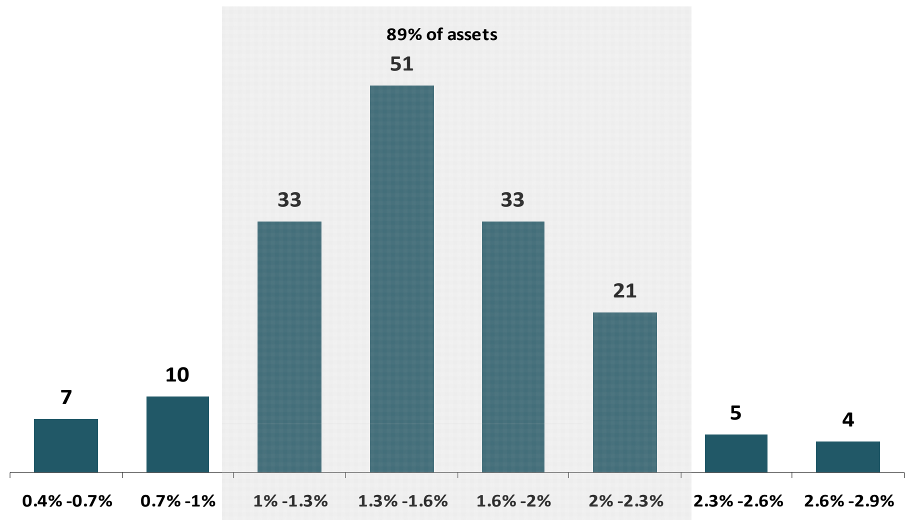
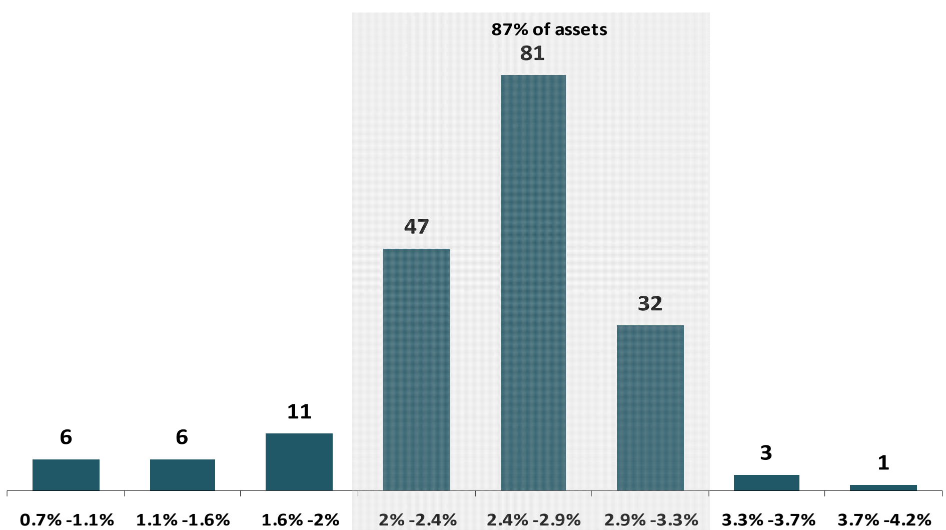


Figure 21b: Canadian Equity Multi-Cap Funds MER Dispersion
A-series load and no load, number of funds



Common themes among low MER outliers in **Figures 21a and 21b** are fund companies absorbing fees and large funds investing in lower-cost mandates, such as government bonds. Funds included in the high MER outlier group, on the right side of the figures, suffered from significant net redemptions that have caused a significant shrinkage of a given fund's asset base and the related increase in the expense ratio.

6.3.2 Management Fees

In the past five years, the asset-weighted management fees for 23 detailed asset classes tracked by Investor Economics have declined, while management fees for seven asset classes have increased (see **Figure 22** below). At 2011 year-end, the asset-weighted management fees for Canadian bond funds sat at 1.14%, down from 1.20% in 2006; management fees for Canadian balanced funds were 1.84%, down from 1.90%. International equity global funds recorded a decline of 5 basis points.

During the period, 26 fund manufacturers lowered the fund management fees of their funds.

Figure 22: Management Fees for Selected Asset Classes

	Asset-weighted management fee	
Asset class	2006	2011
Stand-alone funds	**1.75%**	**1.68%**
Fixed income funds	**1.26%**	**1.22%**
Mortgage	1.41%	1.43%
Canadian bond	1.20%	1.14%
Foreign bond	1.52%	1.41%
High yield bond	1.39%	1.42%
Balanced funds	**1.70%**	**1.66%**
Income balanced	1.51%	1.53%
Canadian balanced	1.90%	1.84%
International balanced	1.98%	1.74%
Equity funds	**1.84%**	**1.82%**
Equity income	1.71%	1.72%
Canadian equity	1.88%	1.87%
International equity	1.94%	1.90%
U.S. equity	1.72%	1.74%
Mutual funds of funds	**1.98%**	**1.80%**

6.3.3 Load Structure

Figure 23: Asset-weighted MER by Load Structure

	2006	2011
Long-term funds	**2.12%**	**2.08%**
Asset class		
Load	2.32%	2.24%
No load	1.90%	1.91%

Another factor impacting the industry-aggregate is the industry's load structure. MERs for no load funds are typically below those reported by the comparable investment mandates for load funds. Beyond the major Canadian banks, whose funds industry share advanced by 17% between January 2000 and June 2012, other no load fund sponsors include associations and direct sellers. Non-core fund series, such as F-, D- and HNW-series, are also typically distributed in no load format.

6.3.4 Taxes

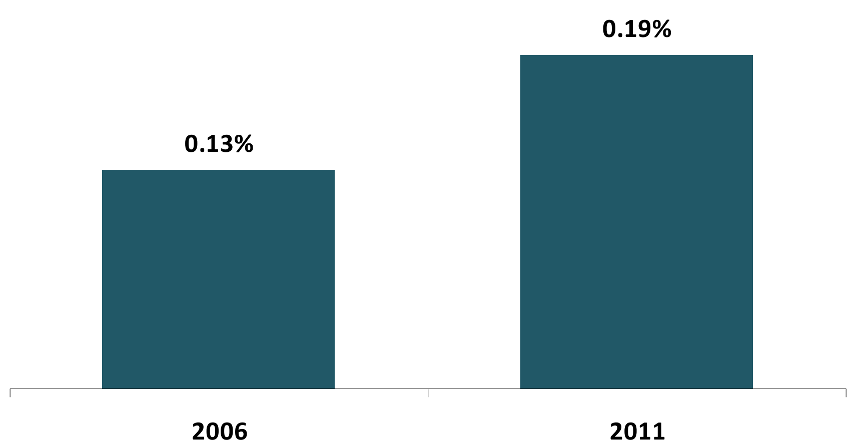
Canadian mutual fund MERs ratios include taxes that are paid on most of the components of the MER, including management fees and nearly all operating expenses (see **Figure 24**). Since 1991, the taxes levied on the MER are the federally regulated Goods and Services Tax (GST) as well as provincial sales taxes at varying rates.

The Canadian sales tax landscape as it pertains to mutual funds has undergone changes in the past decade. GST rates declined from the original 7% to 6% in 2006 to 5% in 2008, contributing to a 4 basis point decline in the industry-aggregate MER between 2005 and 2008.

In 2010, British Columbia and Ontario introduced the Harmonized Sales Tax (HST), at rates of 12% and 13%, respectively. The HST is also in place in Newfoundland, Nova Scotia and New Brunswick. This has resulted in raising the effective tax rate on mutual fund management fees to 10%. (The effective tax is an asset-weighted rate based on the geographical distribution of mutual fund assets).

A number of fund companies introduced a separate non-HST series of their funds for unitholders outside of those jurisdictions. However, the majority of fund sponsors employ a blended tax rate (by taking into account the assets held within and outside HST jurisdictions), which is applied all unitholders.

Figure 24: Estimated Tax Component of MER



On average, it is estimated that taxes accounted for one-tenth of the industry-aggregate MER, contributing 0.19% to the mutual fund average asset-weighted MER in 2011, up from 0.13% in 2006.

Key Takeaways — Section 6

- In 2011, the MER represented 95.5% of the cost of mutual fund ownership, down from 96.9% in 2006, reflecting the rise in importance of the unbundled fund series (F and HNW, and their combinations).
- This trend has been offset by the rise in bank-sponsored no load funds where no transaction fees are charged and where the MER represents the CoO.
- The overall asset-weighted MER declined from 2.12% in 2006 to 2.08% in 2011.
- The distribution channel through which funds are purchased—which reflects the need for advice—the asset class, the fund series and the size of the investment are key CoC determinants.
- Trailer fees have been almost unchanged in the past two decades. In 2011, the average asset-weighted trailer fee paid by long-term funds was approximately 78 basis points.
- Fund sponsors representing $400 billion in assets have fixed administration fees in terms of percentage points to be charged on the fund's assets.
- Factors contributing to a decline in the asset-weighted MER include a shift to fixed income funds, a decline in management fees and increased market share held by no load funds.
- Higher taxes counteracted the decline in asset-weighted MERs.

SECTION 7: Other Factors Affecting the Cost of Ownership of Mutual Funds

Other major factors that have contributed to the change in the overall asset-weighted MER include the expansion of non-core series and the shift to fund wrap solutions.

7.1 Fund Series

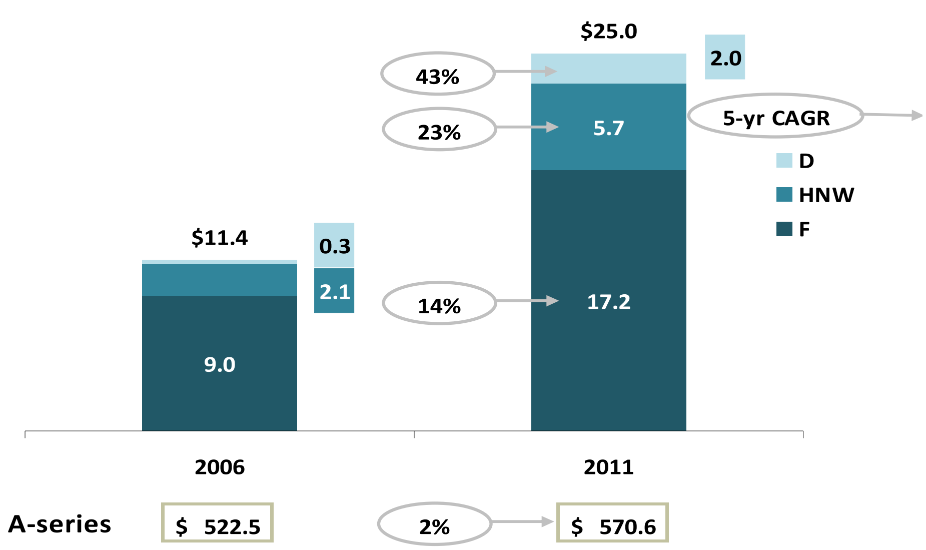
The expansion in non-core series which generally feature lower MERs (**Figure 25**) is also contributing to a reduction in the industry-aggregate MER. The development of multiple fund series has introduced a greater degree of flexibility with respect to investor pricing and advisor compensation options. Series F-, D- and HNW have grown consistently faster than A-series over both the medium- and short-term, yet the overall pool of money in the multi-series structures remains modest at just over 4% of industry assets.

Despite the rapid pace of expansion in the non-core series assets in recent years, A-series funds still make up 95.6% of the industry long-term fund assets which limits the impact of the non-core series on the industry-aggregate MER. **Figure 26** monitors the asset base in F-, D-series and HNW-series.

Figure 25: Asset-weighted MER by Series

	2006	2011
Long-term funds	**2.12%**	**2.08%**
Asset class		
A	2.14%	2.13%
D (Online)	0.42%	0.91%
F	1.21%	1.13%
HNW	1.34%	1.29%

Figure 26: Mutual Fund Assets in Non-core Series
Long-term mutual fund assets, in billions of dollars



The original concept of multi-series design was pioneered in Canada in the early 1990s, but attracted limited attention at the time. The concept was re-introduced to the market in an expanded version in 1999. Today, virtually all mutual fund companies offer multiple series of fund units in order to assist advisors to more accurately customize the financial solutions developed for their clients. The availability of various fund series also enables advisors to retain traditional supplier relationships while, at the same time, changing their business model.

A-series represent the original series of funds and target all distribution channels and types of investors. The non-core series target different types of investors and specific distribution opportunities.

Figure 27 provides a side-by-side comparison of asset-weighted MERs for F-, D- and HNW-series, with the no load and load versions of A-series.

Figure 27: MERs by Funds Series for Selected Asset Classes

	Asset-weighted MER (2011)			A-series Asset-weighted MER (2011)	
Asset class	F	D	HNW	Load	No load
Stand-alone funds	**1.09%**	**0.91%**	**1.15%**	**2.36%**	**1.75%**
Canadian bond	0.79%	1.11%	1.04%	1.67%	1.27%
Income balanced	1.09%	1.73%	1.21%	2.22%	1.53%
Canadian balanced	1.17%	2.98%	0.80%	2.39%	2.19%
Equity income	1.20%	2.27%	0.88%	2.38%	1.81%
Canadian equity	1.18%	1.00%	1.20%	2.46%	2.02%
International equity	1.37%	1.57%	1.78%	2.59%	2.31%
U.S. equity	0.96%	0.58%	2.16%	2.53%	1.80%
Mutual funds of funds	**1.39%**	**1.33%**	**1.68%**	**2.38%**	**2.05%**

The series capsules below summarize the key characteristics of each series and their cost-to-customer parameters. Additional series, which are excluded from this analysis, address institutional opportunities. For detailed definitions of each series, please refer to the *Glossary of Terms)*

7.1.1 F-series

F-series are designed for use in fee-based programs and do not offer ongoing trailer compensation. The F-series pricing formula represents the "unbundled" version of the traditional A-series, which features embedded advisor compensation. A total of 1,530 fund products are offered in F-series, 56% more than five years ago. F-series represent approximately 3% of industry assets.

In the 2000s, the F-series funds faced growth challenges, as their original major price concession—or the F-series management fee discount versus the A-series—was not considered a sufficient incentive for advisors to use them in fee-based accounts targeting higher-end clients. In recent years, fund manufacturers have started to reduce F-series management fees, a trend likely accelerated by the growing use of ETFs in fee-based brokerage accounts. At the end of 2011, the asset-weighted MER of F-series was 1.13%, down from 1.21% in 2006 (see **Figure 25**).

As indicated in **Figure 28a**, F-series growth has accelerated in the past five years, supported by the rapid expansion of fee-based advice models, such as fee-based brokerage (FBB) and discretionary advisor managed (AM) programs. **Figure 28b** highlights the higher-end nature of investors using these managed account platforms.

Figure 28a: F-Series Assets Held in Fee-based Programs
Assets in billions of dollars

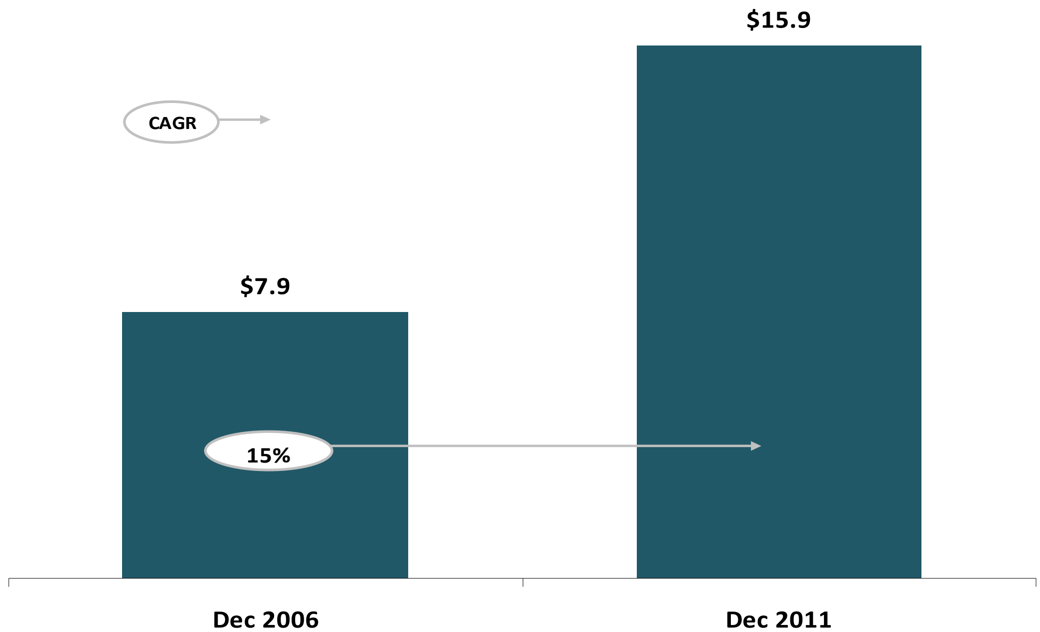
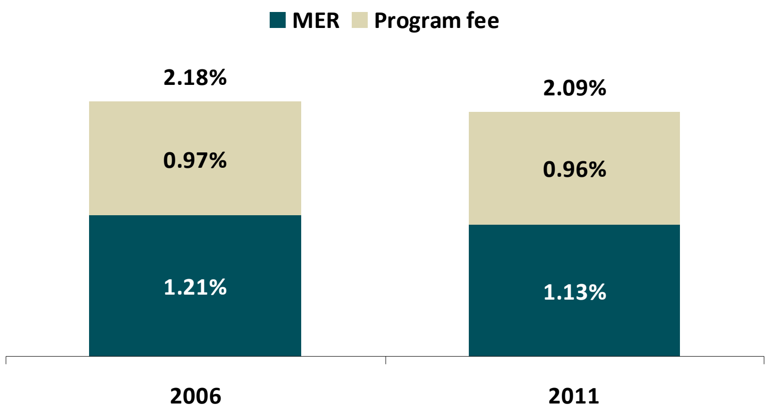


Figure28b: Average Account Size
In thousands of dollars

	2006	2011	Average account minimum
Fee-based brokerage	$275	$225	$100
Advisor-managed	$400	$360	$200

The overall average CoO for investors holding mutual funds in FBB and AM accounts is estimated at 2.09% in 2011 (see **Figure 29 below**). Given that the overall mutual fund cost-to-customer in 2011 was 2.10%, and the industry-aggregate MER stood at 2.08%, the analysis provides an empirical foundation for a view that the unbundled fee models have not generally translated into lower investor costs. (For more analysis of unbundled fee models, please see page 50 in *Section 9*.)

Figure 29: Mutual Fund Cost of Ownership for Investors Using Fee-based Programs



7.1.2 HNW-series

HNW-series target high-end investors and feature a relatively high investment minimum (typically $100,000 or higher) and a discounted management fee. A total of 346 fund products are offered in HNW-series, double the number five years ago. Assets in HNW-series accounted for 1% of the industry total at the end of 2011 and have grown at a 23% CAGR during the past five years.

At 1.29%, the MER of HNW-series is at a marked discount to A-series (see **Figure 27** on MERs above) and has exhibited a downtrend since 2006 across most asset classes, likely reflecting the impact of the inroads made by competitive product alternatives, such as ETFs.

7.1.3 D-series

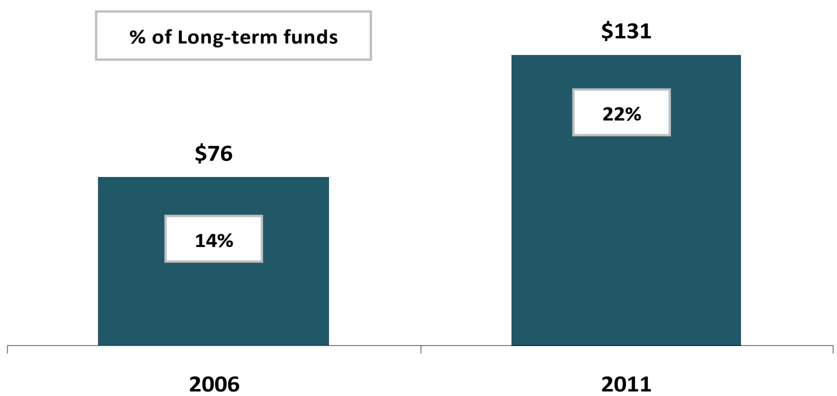
D-series funds are designed for “do-it-yourself investors” operating through online/discount brokerage or *e*banking platforms and feature a discounted management fee relative to the A-series version of the same fund. In certain cases, an investment minimum is set significantly higher than for A-series (e.g., at $10,000). A total of 62 fund products are offered in D-series, four times as many as were available five years ago. The series finished 2011 with approximately $2 billion in assets, or 0.3% of the industry total, growing at a compound annual growth rate (CAGR) of 43% in the past five years.

The pricing approach of D-series can be gleaned from the MER discount relative to the corresponding original series (see **Figure 27** above). The asset-weighted MER for all D-series funds was 0.91% at December 2011, compared to 1.76% for the A-series for the same group of funds. This lower management fee level is evident across all asset classes in which D-series is offered, with the MER discount ranging from 35% to well over 40%.

7.2 Product Structure: Shift to Pre-assembled Advice Solutions (Fund Wraps)

Reflecting the growing importance of pre-assembled solutions, fund wraps have captured nearly 80 cents of each dollar flowing into the mutual funds industry between 2007 and 2011. **Figure 30** monitors the growing importance of fund wraps to the fund industry's book of business.

Figure 30: Impact of Shift to Fund Wraps
Assets in billions of dollars



Asset-weighted MER of Fund Wraps	
2.27%	2.16%

As demonstrated by the MER of 2.16%, pre-assembled fund wraps carry an MER premium relative to stand-alone funds. This is a reflection of the distinct fund wrap asset class mix (equities are present in all but the most conservative of portfolio risk profiles) and the expanded value proposition which includes a client risk profiling process, overlay management, portfolio rebalancing and enhanced client and advisor reporting and support. The asset-weighted MER of the fund wrap programs measured in this study (those based on mutual funds) has declined by 0.11% in the past five years.

The MER for an increasing number of fund wraps has been approaching the asset-weighted MER of their underlying fund building blocks. This has resulted in a decrease in fund wrap MERs in the past five years.

Key Takeaways — Section 7

- The development of multiple fund series has introduced a greater degree of flexibility with respect to investor pricing and advisor compensation options.
- F-series growth has accelerated in the past five years in concert with the expansion of fee-based advice models, such as fee-based brokerage and advisor managed programs, and further supported by the reduction of F-series management fees by a number of fund manufacturers.
- Impact of the expansion of non-core series on the industry-aggregate MER is still limited due to the dominating presence of A-series funds
- Fund wraps have captured nearly 80 cents of each dollar flowing into the mutual funds industry between 2007 and 2011.
- The MER for an increasing number of fund wraps has been approaching the asset-weighted MER of their underlying fund building blocks.
- The increased importance of fund wraps which carry a MER premium relative to stand-alone funds (reflecting a higher equity weighting and expanded value proposition) counteracted the decline in industry asset-weighted MERs.

SECTION 8: Other Investor Cost Considerations

This section addresses two specific cost factors that may impact the overall CoO. One of the factors–performance fees–only impacts investors who hold a position in a relatively small group of funds while the other has universal application to funds with any equity content.

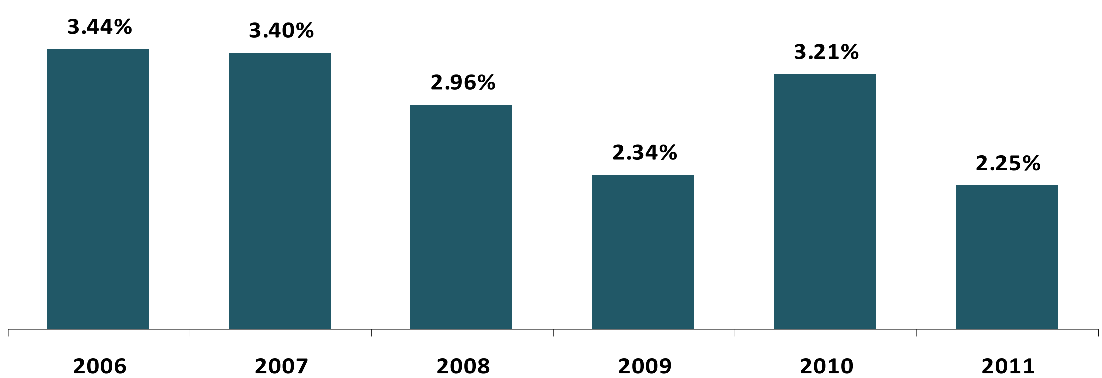
8.1 Performance Fees

Funds that charge performance fees generally seek absolute returns and use hedge fund-like strategies. Strategies commonly employed include short-selling, the use of derivatives (not only as hedging instruments, but also to gain exposure to certain asset classes or investment strategies) and securities lending. Most of these strategies are not available to investment managers of a typical long-only mutual fund.

Because of their distinctive fee structure and limited universe, funds with performance-based fees were not included in our calculation of the industry aggregate MER. At the end of 2011, the 92 funds that charged performance fees collectively held $18.5 billion in assets.

Performance fees permit the investment manager's compensation to be aligned with fund performance when outperforming a given benchmark, commonly referred to as the hurdle rate. If the fund has beaten the benchmark, the typical performance fee is 10% of the fund's excess return over the benchmark. This fee is paid directly by the fund and is included in the MER, resulting in a higher expense ratio.

Figure 31a: MER for Funds with Performance Fees



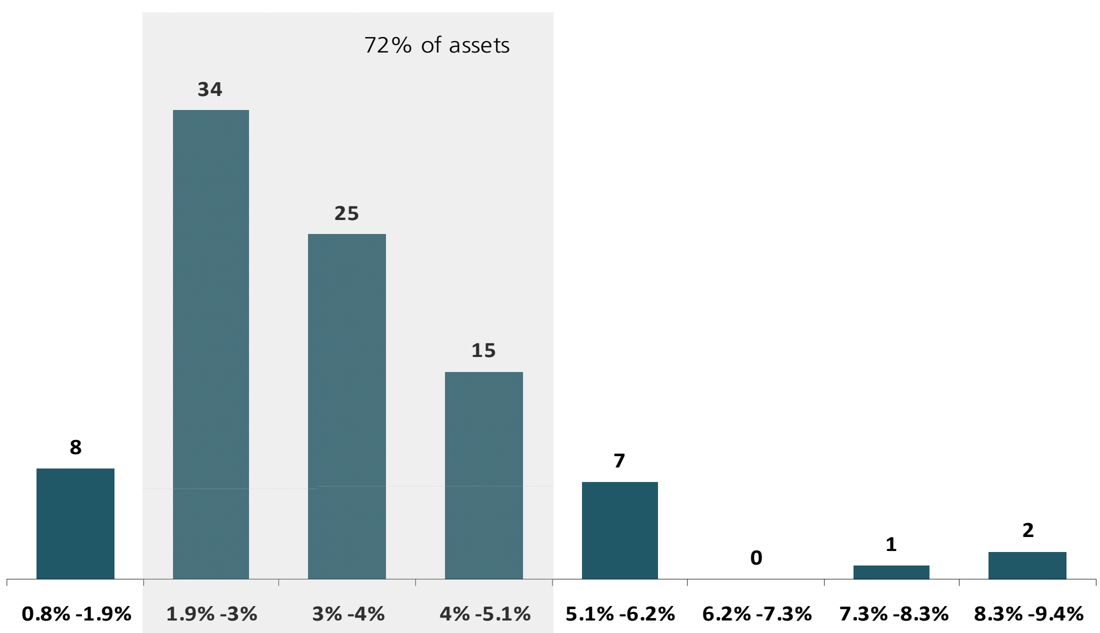
Funds with performance fees may also have a high-water mark (which represents the highest peak in value of the fund) that must be exceeded before performance compensation is available to the manager. There are no downward adjustments in compensation for below-benchmark performance.

The majority of these funds are equity-centric. The asset-weighted MERs of funds that charge performance fees were elevated during the bull market years and during the 2010 market rebound, when managers were able to capitalize on market opportunities. Conversely, the MERs of funds charging a performance fee were largely aligned with their comparative broad asset class MERs (i.e., non-performance-fee funds) during the 2008-2009 and 2011 market downturns.

Figure 31b: MER of Funds that Charge Performance Fees by Asset Class

Asset class	Number of funds (2011)	Asset-weighted MER 2006	Asset-weighted MER 2011	Change (2006-2011)
Stand-alone funds	**91**	**3.44%**	**2.25%**	**-1.19%**
Fixed income funds	**8**	**–**	**1.13%**	**1.13%**
Mortgage	–	–	–	–
Canadian bond	4	–	1.07%	N/A
Foreign bond	–	–	–	–
High yield bond	4	–	1.13%	N/A
Balanced funds	**11**	**3.00%**	**1.85%**	**-1.14%**
Income balanced	7	3.40%	2.78%	-0.62%
Canadian balanced	2	2.63%	1.59%	-1.04%
International balanced	2	–	3.36%	N/A
Equity funds	**70**	**3.50%**	**2.64%**	**-0.87%**
Equity income	5	2.42%	2.61%	0.18%
Canadian equity	43	3.66%	2.71%	-0.95%
International equity	18	3.35%	2.12%	-1.23%
U.S. equity	4	3.03%	2.76%	-0.28%
Mutual funds of funds	**1**	**–**	**2.34%**	**N/A**

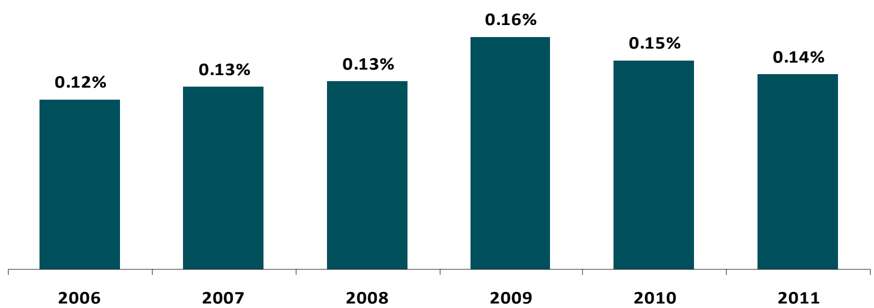
Figure 31c: MER Dispersion of Funds that Charge Performance Fees
Total number of funds at 2011



8.2 Trading Expense Ratios

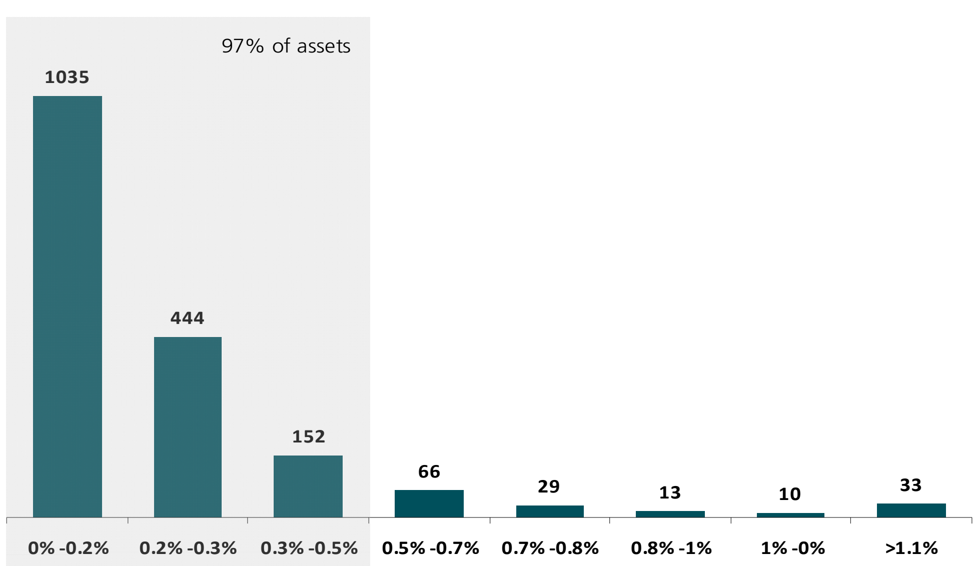
Brokerage fees and commissions charged to the fund as a result of trading activity within the portfolio are part of a separate metric known as the trading expense ratio (TER). The TER largely reflects the costs associated with commissions paid for the purchase and sales of equity securities. Fixed income securities are not represented in the TER as the commissions paid to the broker/dealer on the trading of fixed income securities are embedded in the price of the security. (For an explanation of the methodology used to calculate TER, please refer to the *Methodology* section in the Appendix).

Figure 32a: TER by Year



As illustrated in Figure 32a above, the aggregate industry level TERs ranged from a low of 0.12% in 2006 to a high of 0.16% in 2009, likely a reflection of the bear market and the subsequent volatility. Since then, industry-aggregate TERs have decreased although they have remained above 2006-2007 levels. While each fund employs unique trading tactics, the majority of funds report a TER of less than 30 basis points.

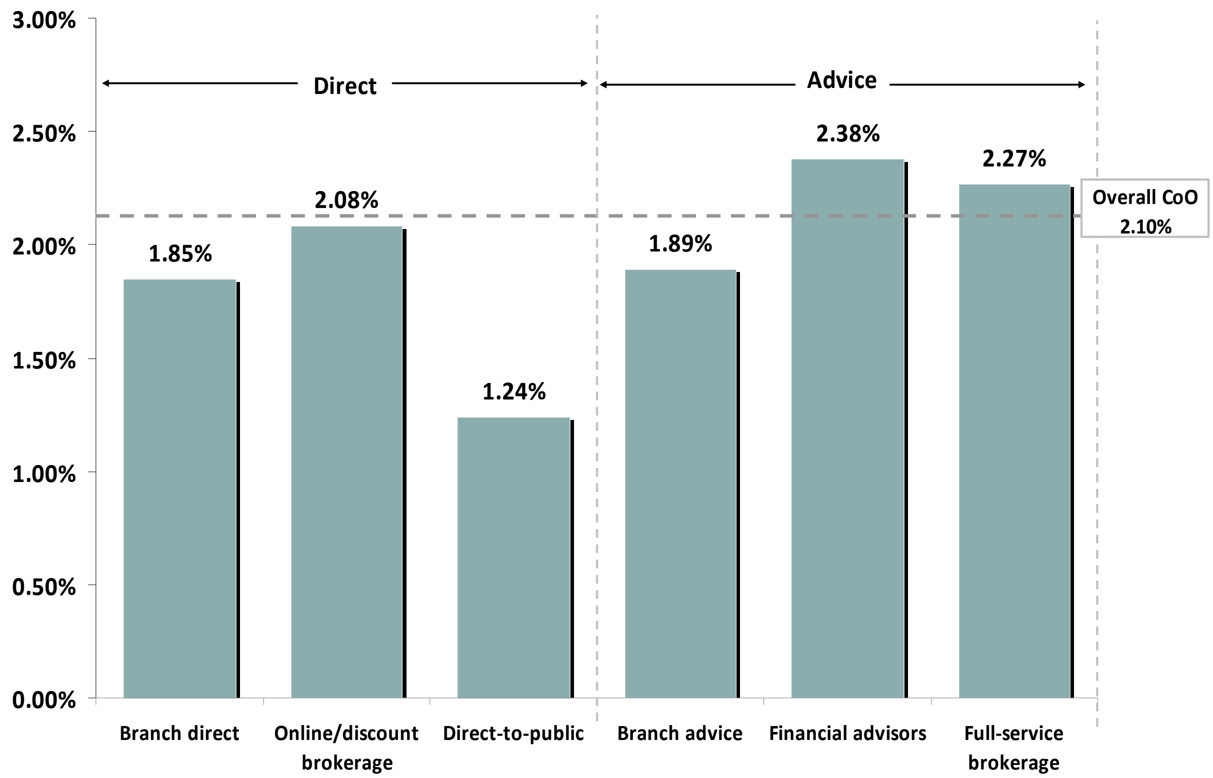
Figure 32b: Industry TER Dispersion
Total number of funds



SECTION 9: Comparison of Mutual Fund CoO by Distribution Channel

Figure 33 highlights our estimates of the cost of mutual fund ownership by distribution channel and advice model. The narrative provides an in-depth look at our methodology, data sources and assumptions used to arrive at the channel-aggregate measures.

Figure 33: Mutual Fund CoO by Distribution Channel

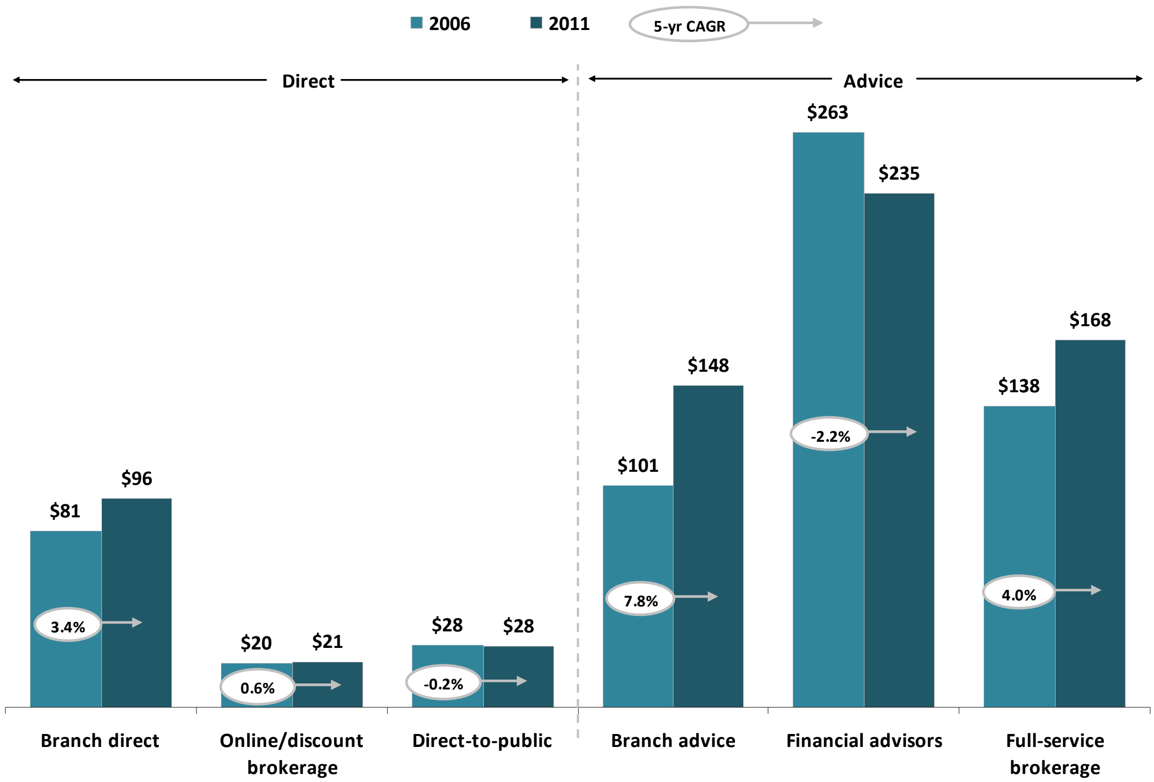


9.1 Overview of Mutual Fund Distribution

Retail investors access mutual funds through a wide array of distribution channels. **Figure 34** charts the absolute dollar magnitude and recent growth of long-term mutual funds in each retail distribution channel. (For a detailed description of each channel, please refer to the *Glossary of Terms.*) The advice channels are responsible for the majority of mutual fund assets in Canada. However, it is the case that access to certain advice channels, such as full-service brokerage, and/or specific products offered may be limited through minimum account size requirements.

Figure 34 (below) also provides an additional perspective by tracing the relative importance of mutual funds to each channel. The financial advisor channel is the largest single conduit for the delivery of mutual funds, and also the one in which mutual funds constitute the highest weighting in the book of business.

Figure 34: Long-term Mutual Fund Asset Trend by Distribution Channel
Assets in billions of dollars



Share of mutual fund assets of total AUA within each channel (2006-2011)					
12%	12%	87%	45%	69%	20%
11%	9%	78%	47%	61%	21%

In the full-service and online/discount brokerage channels, mutual funds are but one component of an open architecture shelf that includes a broad array of investment products and services. These include individual equities and bonds, cash and deposits, alternative fund products (such as ETFs) and, in the case of the full-service brokerage channel, insurance products and non-discretionary and discretionary managed asset programs.

In the deposit-takers' branch-based channels (branch direct and branch advice), mutual funds and mutual fund wraps co-exist with deposits issued by the parent deposit-taker. In the branch advice channel, mutual funds comprise nearly half of the total client assets under administration (AUA). In the branch direct channel, 11% of the assets are held in mutual funds.

At the end of 2011, total mutual fund assets purchased through branch direct and branch advice sales forces totalled $244 billion, an amount greater than assets held through financial advisors ($235 billion), and considerably more than fund assets held in accounts at full-service brokers ($168 billion). It is evident that the major banks will exert increasing influence over all aspects of the CoO of mutual funds in Canada. It is also worth noting that several banks have begun to build a presence in the mutual fund advice channels outside their branch networks, which could result in their influence extending beyond the confines of their proprietary networks.

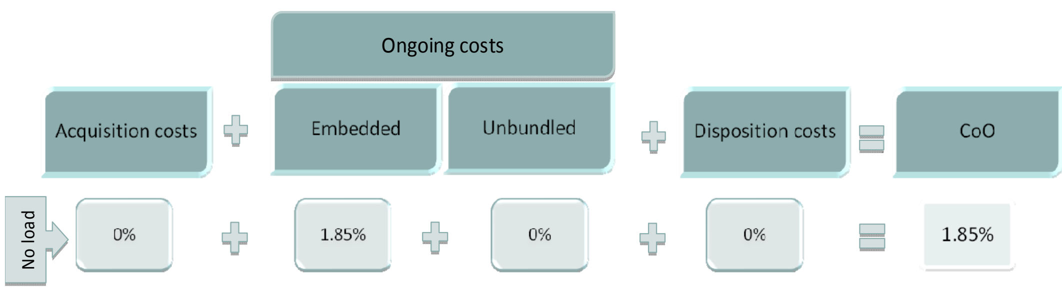
9.2 Channel Analysis

The overall mutual fund CoO for a specific channel is a reflection of the mix of load structures, the asset class mix of fund holdings and the availability of alternatively priced account structures. The channel capsules below summarize our analysis and identify the key factors impacting the cost of owning mutual funds in each channel.

9.2.1 Branch-based Channels: Mutual Fund CoO in Branch Direct Channel

The branch direct channel is made up of personal banking officers and other employees with similar responsibilities. If appropriately registered, they initiate mutual fund transactions at the request of customers and provide limited advice. The channel's share of mutual fund assets was 14% at the end of 2011.

Figure 35: Mutual Fund CoO in Branch Direct Channel

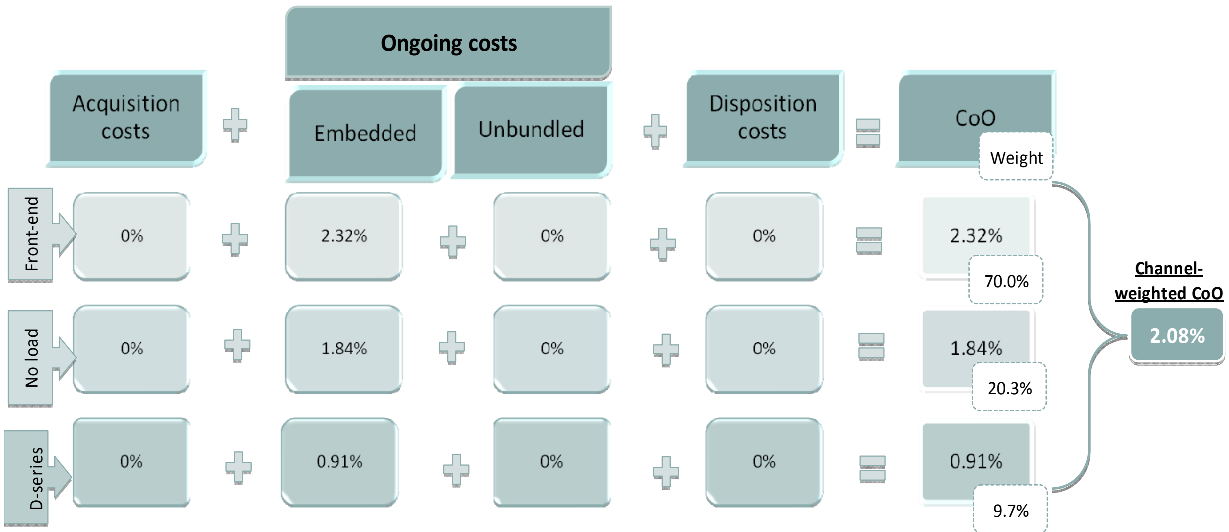


The branch direct channel is exclusively focused on proprietary mutual funds. Additionally, it differs from the branch advice channel in that the share of total mutual funds held in mutual fund wraps, while still relatively high, is lower than that of the branch advice channel (33% versus 50%). This difference in mix is evident in the slightly lower cost of ownership. However, the relative importance of funds through this channel is heavily diluted by the channel's primary focus on deposits.

9.2.2 Mutual Fund CoO in Online/Discount Brokerage Channel

The online/discount brokerage channel delivers investment products and associated services through centrally managed technology platforms. The channel's share of mutual fund assets was 3% at the end of 2011.

Figure 36: Mutual Fund CoO in Online/Discount Brokerage Channel



While the online/discount brokerage firms offer fewer avenues to hold mutual funds than the full-service brokerage channel, there are a number of options that impact the CoO. Front-end load, back-end load and no load mutual funds can all be held or transferred into and purchased within an online/discount brokerage account. Most online/discount brokerages have allowed the purchase of front-end load mutual funds with a zero front-end load since the late 1990s. As a result, the load-waived FEL sales option has become the dominant load structure in the channel. Bank-sponsored and independent investment counselor no load funds are also available in the channel.

Online Mutual Funds

Most major online/discount brokerage firms offer mutual funds without trading commissions. However, there are some exceptions. Some distributors charge a trading commission on certain fund families (generally no load.) Online/discount brokerages also apply distributor-based, short-term trading fees, which are defined at the end of this section.

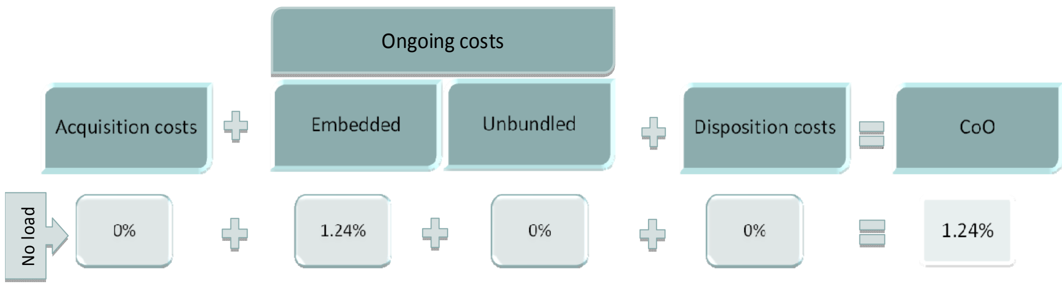
Exclusive Series

Three online/discount brokerages offer a special series of mutual funds (E- or D-series of bank-sponsored mutual funds) featuring a lower MER relative to the A-series versions of the same funds. These special series—designated D-series in our nomenclature (please see the *Glossary of Terms* for the full definition and description in Section 5)—currently make up one-tenth of total mutual fund assets in the online/discount brokerage channel.

9.2.3 Mutual Fund Cost of Ownership in Direct-to-public Channel

The direct-to-public channel is represented by a small group of firms that includes private investment counsellors and other specialist firms. The channel's share of mutual fund assets was 4% at the end of 2011.

Figure 37: Mutual Fund Cost of Ownership in Direct-to-public Channel



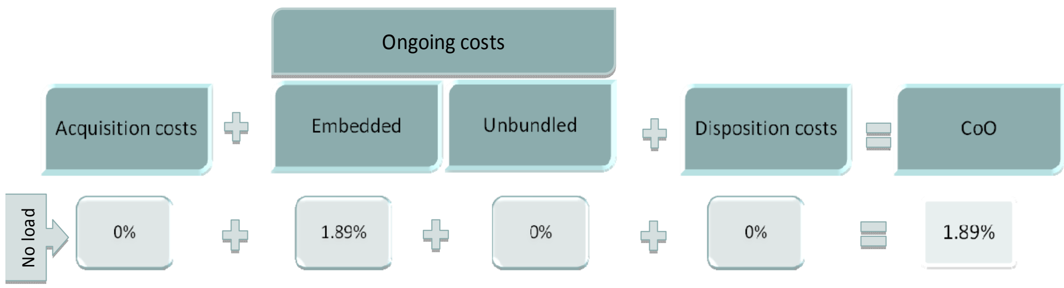
The direct-to-public channel is, by definition, exclusively focused on proprietary funds. The distinction with the proprietary mutual fund focus of the branch direct channel is that these proprietary funds are generally distributed solely through the manufacturers' direct-to-public sales process. With no acquisition or disposition costs, the CoO is simply the MER that these funds carry. The singular distribution focus helps contain the MER levels. However, as in other distribution channels, MERs are variable on a manufacturer-by-manufacturer basis.

The largest fund complexes in this channel also charge the lowest MERs among participants and serve to keep the channel's asset-weighted MER low. Additionally, in aggregate, the direct-to-public channel has a significantly higher fixed income weighting than the mutual fund business of other channels, which also reduces the overall level of the asset-weighted average MER.

9.2.4 Branch-based Channels: Mutual Fund CoO in Branch Advice Channel

The branch advice channel is a creation of the major banks and credit unions where 13,500 in-branch advisors are engaged primarily in the provision of investment and financial planning and activities associated with the implementation of those plans. The channel's share of mutual fund assets was 21% at the end of 2011.

Figure 38: Mutual Fund CoO in Branch Advice Channel



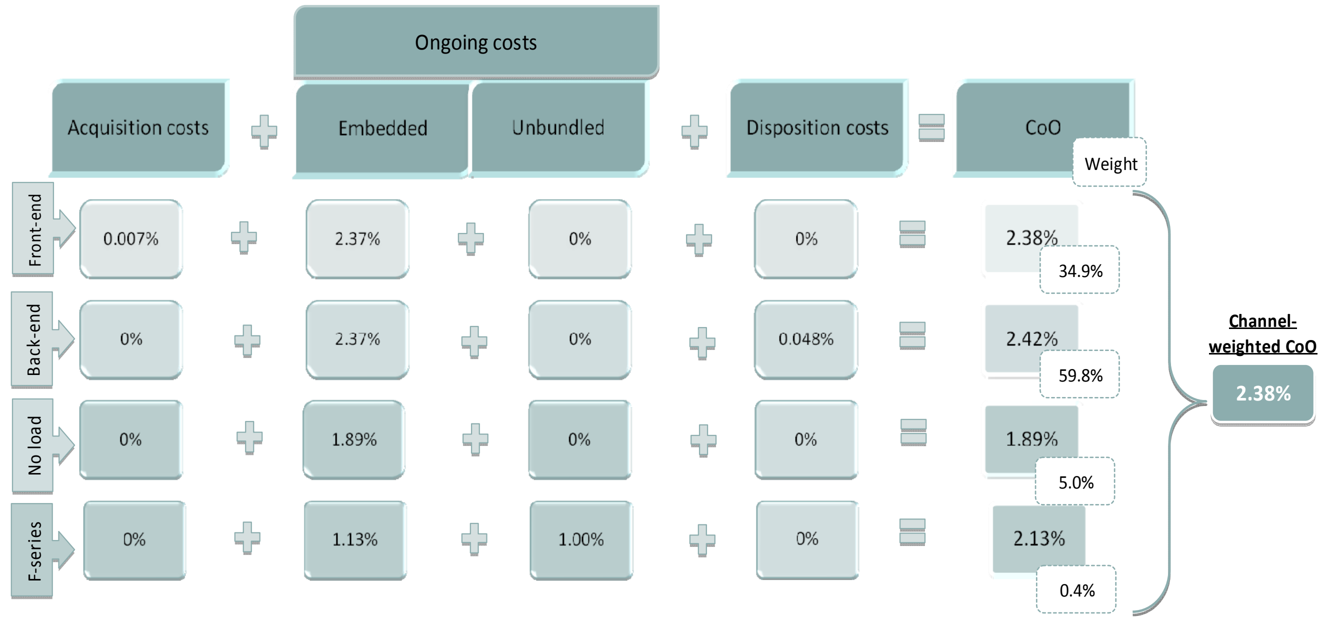
The branch advice channels of the deposit-takers are varied in their regulatory approach. The presence of IIROC platforms in the channel allows for a broader mix of investments including third-party mutual funds. A number of branch advice organizations have allowed third-party funds on their shelf. However, the channel remains primarily focused on no load proprietary mutual funds and deposits. The relatively significant weighting in deposits represents the biggest departure from the full-service brokerage and financial advisor channels. The branch advice channel is also a significant distributor of packaged mutual fund solutions, i.e. fund wraps.

For the majority of no load mutual fund holdings (apart from those firms that may have some third-party funds on the platform), the CoO is represented by the fund MER. As with other channels, this is an asset class-driven cost weighted by the mix of asset classes in the channel. The channel's focus on mutual fund wraps is germane to the weighting exercise and has been reflected in the weighted cost for the channel.

9.2.5 Mutual Fund CoO in Financial Advisor Channel

The financial advisor channel consists of commission- or fee-based advisors that offer financial planning, third-party/proprietary investment funds and insurance services. The channel's share of mutual fund assets was 34% at the end of 2011.

Figure 39: Mutual Fund CoO in Financial Advisor Channel

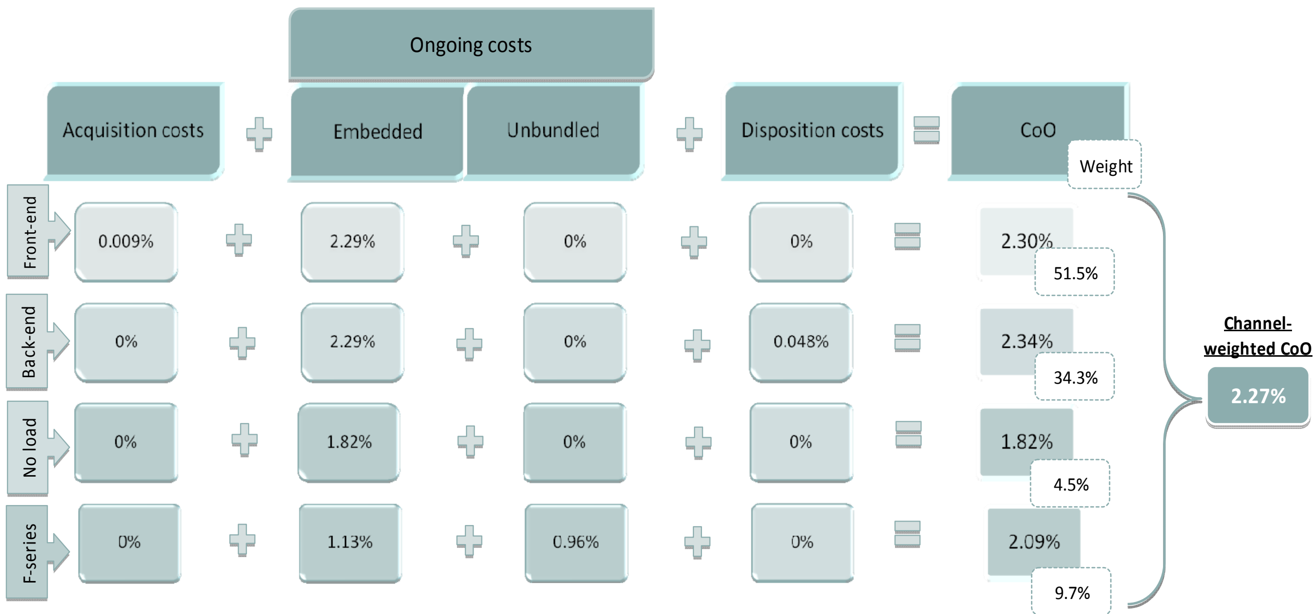


The cost of mutual fund ownership in the financial advisor channel closely resembles the stand-alone component of mutual funds in the full-service brokerage channel. The cost elements are the same. One of the key differences of the channel, and the practices of its advisors, is that it is largely aimed at the mass market and the mass affluent client segments, in contrast to the higher-end focus of the full-service brokerage channel. Unbundled pricing models, such as fee-based accounts, are generally less frequently offered. This is evident in the mix of load structures within the financial advisor channel, which shows a higher share of assets under the DSC structure than in the full-service brokerage channel. Additionally, the financial advisor channel has a higher weighting of equity mutual funds than the full-service brokerage channel.

9.2.6 Mutual Fund CoO in Full-service Brokerage Channel

The full-service brokerage channel is made up of IIROC member firms that have client-facing advisors with a retail offering of directly-held securities and fee-based managed asset solutions, including discretionary management. The channel's share of mutual fund assets was 24% at the end of 2011.

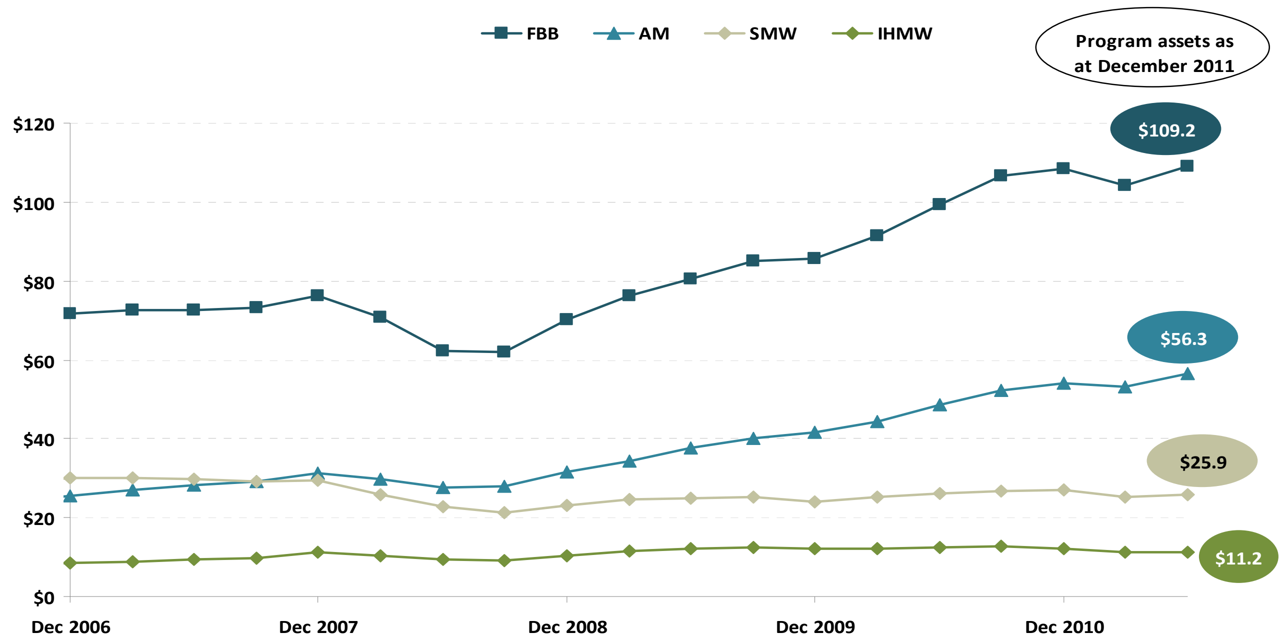
Figure 40: Mutual Fund CoO in Full-service Brokerage Channel



As indicated in **Figure 40**, mutual funds can be held within the full-service brokerage channel in several ways, reflecting both the choice of the investor and the practice model of the advisor. Mutual funds can be held within a transaction account in which all the previously described load structures are available, or as a component within a fee-based program in which the client pays a fee based on the average of all assets held in the program.

Figure 41 highlights the growing importance of fee-based solutions by tracking the current asset levels and recent growth rates for the fee-based programs that can hold individual securities and mutual funds. These programs are the non-discretionary fee-based brokerage (FBB), discretionary advisor managed (AM), separately managed wraps (accounts) (SMW) and in-house managed wraps (IHMW). The investment minimums for these programs range from $100,000 to $500,000.

Figure 41: Growth of Fee-based Programs
In billions of dollars



	FBB	AM	SMW	IHMW
1-yr growth	10.5%	19.8%	0.3%	-6.9%
3-yr CAGR	13.5%	21.2%	-1.0%	2.6%
5-yr CAGR	11.6%	23.0%	1.5%	11.9%

Mutual Funds in Fee-based Brokerage Accounts

Mutual funds held in an FBB or AM program are subject to an asset-based fee. The preferred distributor option is to use F-series mutual funds. A number of full-service brokerage firms permit A-series holdings of load mutual funds to be transferred into an FBB or AM program as part of the process of converting transactional holdings into a fee-based program. In such cases, the A-series series mutual fund holding are treated as non-billable assets. As a result, they do not incur the program fee.

With respect to new sales, generally only F-series mutual funds are allowed to be held in the program account unless a given fund is not available in this series. Conversion of A-series load fund assets to F-series is encouraged and in several programs this conversion must take place within a specified period. (For more discussion on series of mutual funds, please refer to page 33 in *Section* 7.)

Fee-based Pricing Structures

Fee-based brokerage fee structures fall into two broad categories: blended pricing and asset class-based pricing.

The blended model, increasingly the pricing model of choice, applies a tiered approach to fee determination regardless of the specific asset and product allocation within the account. **Figure 42** presents the asset tiers and the corresponding range of fees across the full-service brokerage firms for FBB programs. This approach allows the advisor to negotiate the pricing of the fee-based relationship and separate it from the asset mix recommendation. All assets except those designated as non-billable are treated equally from a fee perspective.

Figure 42: Fee Schedules

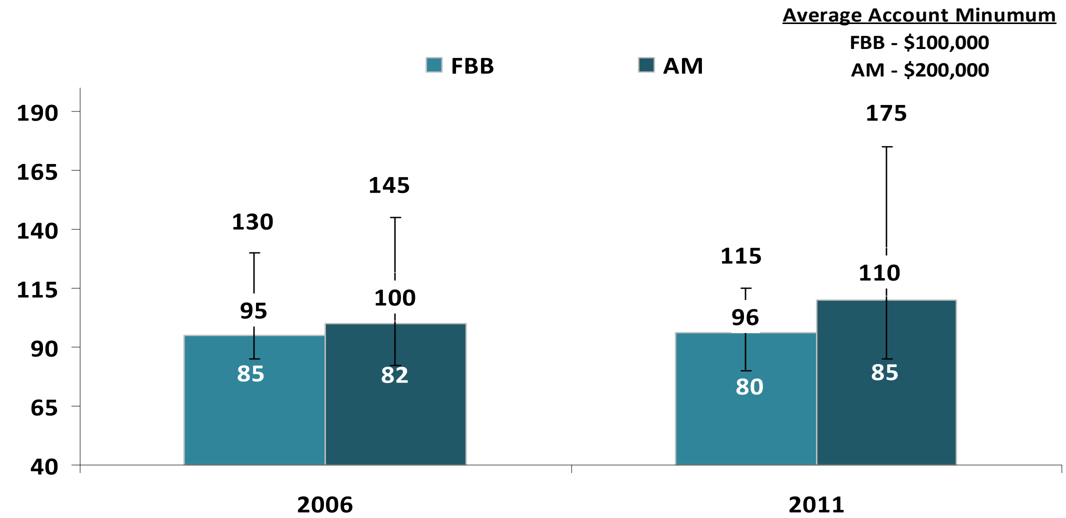
Flat-Tiered Pricing				
Portfolio size ($ thousands)	**Minimum**	**Maximum**	**Mid-point**	**Trades***
$100 to $250	1.50% - 2.25%	2.00% - 2.75%	1.75% - 2.50%	15 to 100
Average	1.72%	2.44%	2.08%	35
$250 to $500	1.00% - 1.75%	1.50% - 2.25%	1.38% - 2.00%	35 to 100
Average	1.33%	2.03%	1.68%	50
$500 to $1,000	0.75% - 1.25%	1.50% - 2.00%	1.25% - 1.63%	45 to 100
Average	1.05%	1.88%	1.46%	75
$1,000 to $2,000	0.50% - 1.00%	1.25% - 2.00%	1.00% - 1.50%	65 to 225
Average	0.89%	1.64%	1.27%	140
$2,000 to $5,000	0.50% - 0.85%	1.25% - 2.00%	1.00% - 1.38%	Negotiable
Average	0.73%	1.56%	1.14%	

**Trades reflect the range and median trade ceiling level for each balance range and excludes programs with no limits.*

By contrast, the asset class-based models vary in terms of the number of specific asset classes that can be priced separately. The most prevalent models distinguish equity and fixed income, although others distinguish cash, fixed income, equities and mutual funds. ETF distinction is available, though it is rare. If the asset-class based approach is selected, the individual asset class prices are still determined based on the overall value of the portfolio. For example, $10,000 F-series mutual funds in a $300,000 FBB account would be charged a lower fee than $100,000 F-series mutual funds held in a $150,000 FBB account on the same asset class-based pricing platform.

Figure 43 (below) presents the overall FBB and AM fees computed for the programs belonging to the Big Six bank-owned, full-service brokerage firms and six other firms. The annualized rates are asset-weighted and are derived from detailed revenue and asset reporting by managed asset products for each of the 12 firms.

Figure 43: Average Fee-based Program Fees
Asset-weighted fees in basis points (maximum, minimum and average)



Role of Discounting

Brokerage firms generally provide a minimum/maximum fee range for each asset tier. Advisors are often free to price an account within that range. If pricing occurs at the minimum, firms do not view this as discounting. There appears to be near-universal pricing movement towards or at the scheduled minimums for a given asset tier.

Discounting below the minimum for a specific asset level requires various levels of approval (branch manger, regional, national sales) and will result in a range of payout treatments on the discounted fee. This treatment could see the advisor and the firm share the discount via the grid mechanism or could see the advisor absorb the entire cost of the discount in terms of payout.

Excess Trading Commission

FBB programs typically specify trade ceilings, with the trades in excess of the ceiling incurring a commission. Excess trading commissions typically range from just under $100 per excess trade to $150 per trade, but can be higher. FBB accounts hitting the trade ceiling are rare and the overall impact on cost is immaterial. Excess trading commissions are included in the computation of the overall FBB and AM fees presented in **Figure 43.**

The number of free trades increases with account size (see **Figure 42**). However, FBB program sponsors do not consider that a large volume of free trades to be an important value proposition of the program. Mutual fund trades within the FBB program are usually counted as a full trade and as such, if that trade crosses the threshold, there is an excess trading commission charged.

All FBB programs with trade ceilings have a generous allotment of time-limited, set-up trades that do not count towards the threshold and do not add to the cost of conversion from transactional to fee-based accounts.

9.3 Other Cost Considerations

Beyond the four key cost drivers, other costs—primarily one-time costs or annual fees—may be applied to mutual fund holdings and transactions across distribution channels. These fees fall into two broad categories: Administration and transaction fees.

9.3.1 Account administration fees

These fees are associated with the custodial and administrative costs related to registered accounts. Mutual fund registered accounts, which are set up within the various registered specimen plans of the fund's manufacturer, rarely charge an administration fee. However, on full-service or online/discount platforms or on third-party self-directed platforms which are used in the financial advisor channel, annual administration fees may apply. The fees are incurred at the account level and do not apply specifically to mutual funds. The fees range from $50-$75 per annum for a typical self-directed TFSA or RESP to $125 to $150 per annum for a self-directed RRSP, RIF, LIRA, LIF, LRIF, LRSP etc. Fees for multiple registered accounts, e.g. an RRSP or a LIRA, are usually discounted by 50% for additional accounts. Fees may also be waived depending on the assets under administration, particularly in the online and full-service brokerage channels.

9.3.2 Account transaction fees

These include fees for closing an account and deregistering a self-directed plan by withdrawing all the assets in a plan or transferring all the assets to a competing institution's plan (either in-kind or proceeds). These fees are typically between $100 and $135, with transfer to a competing institution more costly than de-registration. Fees for partial withdrawals from a registered plan are typically $25.

9.3.3 Mutual fund transaction fees

Short-term trading fees established by the manufacturer (STTF) come into play on all mutual funds (excluding money market) on trades made within a specified time frame after purchase. Periods vary from seven to 90 days. The STTF is determined as a percentage of the trade and ranges from 1% to 2% of the redemption value.

Short-term trading fees are also charged by distributors in the online/discount brokerage channel when mutual funds are traded within 30 to 90 days of the original purchase. These are in addition to any STTFs charged by the fund company, and are generally in the range of 1% of the redemption value or $45 per trade, whichever is greater. Fees can also be charged on the purchase of no load funds by distributors in the full-service brokerage or the financial advisor channels at up to $75 per purchase.

The application of these administration fees occurs at the broad self-directed account level rather than the individual product level. Additionally, the application of the fees at a fixed annual amount can be waived depending on the size of the account or the relationship. Similarly, the short-term trading activity targeted by STTFs and the no load purchase of mutual funds in intermediated advice channels are not behaviours representative of the majority of mutual fund investors.

Key Takeaways — Section 9

- Canadian investors can access mutual funds through a variety of direct and advice channels.
- The CoO varies between the various distribution channels reflecting the differences in the value proposition and extent of advice.
- The cost of owning a mutual fund through either a financial advisor or full-service broker is above the average CoO.
- Mutual funds can be held in a transaction-based account or within a fee-based program.
- Fee-based programs are increasingly popular within the brokerage channel but have attracted little attention in the financial advisor channel.
- Access to most fee-based programs is limited to individuals with minimum investments of $100,000.
- Most online/discount brokerages have allowed the purchase of front-end load mutual funds with a zero front-end load since the late 1990s.
- Special series of funds structured for the online/discount channel are available at some online/discount brokerage firms (D-series). The MER of these funds is lower than the original series of the funds.

SECTION 10: Conclusion

An increasing number of Canadian households rely on mutual funds to provide a safe haven for their savings, be they for some future purchase or, more importantly, for the funding of their retirement. As individuals become increasingly responsible for the accumulation and management of retirement assets, it is expected that mutual funds and fund-based solutions will play a critical role in both individual and institutional pension programs. As a result, the issue of obtaining value for the cost of investment has become increasingly important to investors, partly as a reflection of the low interest rates and the low and uncertain rates of return which have been experienced in recent years

Opportunities to lower costs

Up until the mid-1990s, Canadian retail investors had limited product choices and, as such, had only a moderate ability to shape the total costs that they would incur over the life of an investment. Over the past twenty years, there has been significant change in the three primary participant areas within the mutual fund industry – government, through regulation and taxation; manufacturing, through the development and management of products; and, distribution, through the expansion of both direct and advice channels.

The changes that have been introduced, as the result of competition rather than regulation, have provided retail investors with the opportunity to better manage and lower their investment costs. However, the decision to use advice channels by a high percentage of investors has limited the extent to which various cost-saving measures have been adopted. The proliferation of no load funds, the growing use of online/discount brokerage firms and the growing popularity of fee-based accounts, where the cost of advice and account maintenance is separated from the investment management costs, are examples of the choices available to investors which can lead to a lower cost of ownership.

A competitive business environment

Unlike other sectors within the financial services industry, such as retail banking and life insurance, the mutual fund industry has not matured to the point where the marketplace is dominated by a few, very large participants, and where barriers to entry have been raised to limiting heights. Competition, if judged by the number of managers, the number of individual funds and the number of advisors able to sell mutual funds, has remained intense and there is no immediate prospect that this situation will change.

By enabling this open business environment, those responsible for the maintenance of an orderly market for retail investment services have allowed competition to positively influence the cost of investment to the extent that, despite the increased sophistication of the product, total investment costs have seen a modest decline. It is also apparent that, unlike in the United States, distribution costs, in the form of trailer fees paid to advisors by fund companies and fees negotiated directly between investor and advisor, have not been as overtly influenced by competition as have manufacturing costs.

Lower costs have led to gain in share

Distribution channels that provide access to mutual funds at lower than industry average cost are gaining share over channels that have been slower to adapt to the changing demands of the investor. At the same time, manufacturers that have failed to offer investors the opportunity to lower their CoO, other than through the size of their portfolio, have been challenged to retain the interests of advisors and investors alike.

There is no evidence that points to any future increases in the Cost of Ownership other than that generated through a shift to higher risk investments. As such, it is likely that economies of scale and competitive pressure will continue to move the costs in favour of the investor.

SECTION 11: Appendix

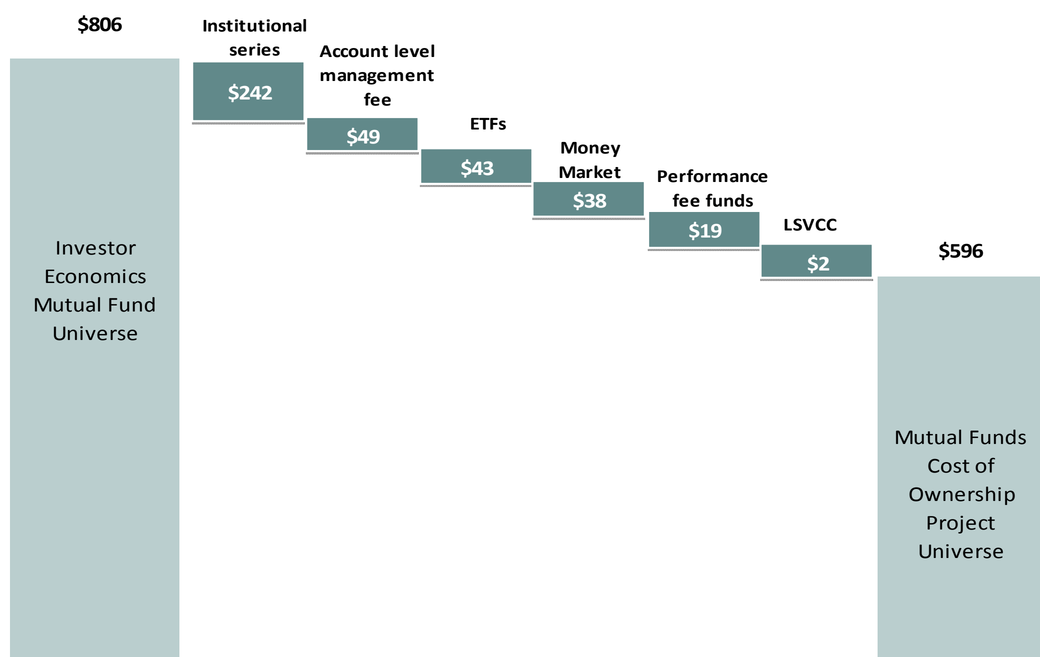
11.1 List of Survey Participants

AGF Investments Inc.
Brandes Investment Partners & Co.
Dynamic Funds
Fidelity Investments Canada ULC
Franklin Templeton Investments Corp.
IA Clarington Investments Inc.
Investors Group Inc.
Invesco Canada Ltd.
Mackenzie Financial Corporation
Manulife Financial Corporation
PFSL Investments Canada Ltd.
Russell Investments Canada Limited

11.2 Notes on the Methodology

11.2.1 CoO Project Database Construction and Exclusions

Figure 44: Exclusions to Investor Economics Mutual Funds Universe
Assets in billions



Note: The above mentioned criteria are not mutually exclusive. Some series of funds excluded from the analysis belong to more than one grouping.

The primary database used in the Mutual Fund Cost of Ownership project is the Investor Economics Multiclass Database which sources data from each fund's Management Report of Fund Performance filings. Data gathered includes mutual fund assets under management; MERs, TERs, and management fees.

The data included in the Multiclass Database universe is broken down by each fund series, or class of shares, according to the naming convention of the issuer. Investor Economics employs a proprietary nomenclature whereby all series of funds have been categorized into distinct groupings based on the objectives of the series or class of share in question.

Certain funds captured in the database have been excluded. The overarching objective behind the exclusions was to make the dataset as homogeneous as possible in terms of the pricing mechanism and to target audience and distribution channels utilized by the funds included in the database. To achieve this, the following products or series have been excluded from the analysis.

Institutional series of funds: Mutual funds used as the underlying investment for segregated funds, fund wraps, principal protected notes and by institutional investors are issued in institutional series (or classes of shares). Management fees are typically discounted, reflecting the nature and size of the relationship and the fact that no advisor compensation is embedded in the MER. Institutional series of mutual funds accounted for $242 billion in assets at December 2011 and 1,521 funds.

Series of funds charging management fees at the account level*:* For these funds, the MER reflects only operating expenses, while management fees and advisor compensation are charged at the account or fund wrap level. Funds that charge the management fee at the account level represented $49 billion in assets and 570 funds at December 2011.

Exchange-traded funds (ETFs): Open-ended investment funds that typically track a benchmark index and are listed on an exchange. Unlike regular mutual funds, the net asset value (NAV) of an ETF unit is not calculated daily and fund units can be traded at a discount or premium to the NAV throughout the trading day. The expense ratios of ETFs are lower than that of regular mutual funds, as ETF are generally passive investments and the majority do not include any embedded compensation. ETFs accounted for $43 billion in assets and 229 funds at the end of 2011.

Money market funds: Funds that invest in short-term securities maturing in one year or less. The objective of such a fund is to act as a low-risk, cash-equivalent vehicle. Money market funds are not typically held by investors with a long-term horizon. Money market funds accounted for $38 billion in assets and 129 funds at December 2011.

Mutual funds subject to performance fees: These funds pay a fee to the investment manager when a determined benchmark is exceeded. During the years in which a fund achieves an excess return, the performance fee may have a material impact on the level of the MER. Performance fee funds accounted for $19 billion in assets and 92 funds at December 2011.

Labour-Sponsored venture capital corporations (LSVCC): Corporations created to provide venture capital financing. Units of the underlying investments of these corporations (Labour-Sponsored Investment Funds or LSIF) are not actively traded and, as a result, may be subject to liquidity restrictions. MERs charged to these funds are often well above the level of regular mutual funds. LSVCCs accounted for approximately $2 billion in assets and 82 funds at December 2011.

11.2.2 CoO in Fee-based Accounts Offered through Full-service Brokerage

The comparative cost of holding only F-series mutual funds in a fee-based brokerage account (FBB) is the MER of the F-series funds and the average annual fee attached to account. The average fee of 96 basis points that has been used in this analysis is based on the blended rate that arises from all assets held in FBB accounts. The average account size is approximately $275,000. When added to the 113 basis points MER of the mutual funds, the cost of holding F-series mutual funds in FBB accounts is 209 basis points.

The calculation for a FBB account holding only ETFs is similar; the average ETF MER of 42 basis points plus the 96 basis points average annual fee across all FBB assets results in an overall cost of 138 basis points.

11.2.3 Redemption Charges

To determine the holding period of DSC or low load sales options, data was collected from 11 companies, representing $135.1 billion in DSC and low load assets at December 2011. This amount is equal to approximately 74% of the market. The aggregate redemption charge was calculated by dividing back-end and low load redemption fees by the assets redeemed. An aggregate rate of 1.9% represents the typical fee charged upon redemption.

In order to make this redemption charge comparable on an annual basis, the fee was adjusted to account for the period during which the funds were held. Our survey data classified DSC and low load assets, redemptions and redemption fees by maturity (number of years remaining until the fund units were no longer subject to a redemption charge). This approach enabled redemption charges to be adjusted by the holding period at various points in the schedule. The aggregated effective annual disposition fee was asset-weighted to arrive at 0.93%.

11.2.4 Decomposing the Canadian MER

The weight of the components of the industry MER were determined through the utilization of data from Investor Economics' Multiclass Database. The asset-weighted management fee of 1.70% was calculated using data from 3,889 funds or 95% of the series of funds in our database.

Using the provincial distribution of mutual fund assets, the effective tax rate was determined by multiplying the tax rate in each jurisdiction by their share of AUM. An effective tax rate of 10% was applied to represent the tax component of the MER. The residual component of the MER was attributed to operating expenses.

11.2.5 Determining the Distribution Component

The initial step in calculating the distributor compensation component of the MER was the determination of the asset mix in terms of various load structures including front-end, back-end on-schedule, back-end off-schedule, low load on-schedule and low load off-schedule.

Once determined this mix was applied to the fixed income, balanced and equity categories. It was assumed that, other than for some back-end and low load assets, full trailer fees of 50 basis points for fixed income and 100 basis points for balanced and equity categories would be paid by the fund companies. Typically, back-end and low load assets which are still on-schedule pay half-trailers. Amortizations of 54 basis points for back-end and 30 basis points for low load assets were assumed.

Total distributor compensation (trailer + amortization of any advisor commission) was asset-weighted among load structures to capture all components. The asset-weighted distributor compensation is displayed as a portion of the categories' MER.

11.2.6 Trading Expense Ratio (TER)

Whereas MERs differ by mutual fund series, the TER is calculated at the fund level and is the same across all series. As such, 1,782 unique funds out of a total 2,215 were represented in our TER calculation. The assets of these funds accounted for $492 billion 83% of the $596 billion mutual fund universe used as the basis for our analysis in this report.

SECTION 12: Glossary of Terms

Distribution Channels

1. Branch advice (BA)

The branch advice channel is a creation of the major banks and credit unions and accounts for $314 billion in client assets. 13,500 in-branch advisors are engaged primarily in investment and financial planning. Advisors are predominantly registered to the MFDA arm of deposit-takers, although some BA advisors are registered through IIROC.

2. Branch direct (BD)

This channel is made up of personal banking officers and employees with similar responsibilities. They initiate mutual fund transactions at the request of customers and provide limited advice. Individuals in the branch direct channel may move into the firms' branch advice channel.

3. Financial advisor (FA)

The FA channel is the most varied of the channels. It is made up of a wide range of firms including registered dealer firms; unregistered, fee-only planning firms; and life insurance distributors. These business models have varying degrees of independence and different product shelf capabilities. In the dealer category, models range from those with dedicated sales forces to firms with a high degree of product independence.

The FA channel also includes insurance distribution firms through which licensed insurance agents distribute life insurance products and segregated funds. The majority of these insurance distributor firms (approximately 300) are managing general agencies.

4. Full-service brokerage (FSB)

In terms of assets, FSB is the largest intermediated channel. The channel includes those IIROC member firms that have client-facing advisors with a retail offering of directly-held securities and fee-based managed asset solutions, including discretionary management. The open architecture and investment dealer registration allow these firms to distribute the widest range of investment products and wealth management solutions of any channel. Over 10,000 advisors operate in the full-service channel, though the number of firms operating in the channel continues to be reduced by consolidation.

5. Online/discount brokerage (ODB) and direct-to-public

This channel delivers products and its value proposition largely through centrally managed technology platforms. The channel is dominated by bank-owned firms although some small firms operate in the deep discount and specialized sectors. This channel is growing rapidly in terms of both assets under administration and the number of users.

The direct-to-public channel is represented by a small group of firms that include private investment counsellors and specialist firms. The share of the mutual fund market represented by this channel is modest.

6. Private investment counsel (PIC)
The firms in this channel are firms registered directly with the provincial securities regulators as portfolio managers. Advisors in this channel are typically registered as advising representatives at a portfolio management firm and must meet the discretionary PM requirements. With over 250 individual firms, the channel is fragmented. Many of these firms are small, principal-owned firms or small private client operations attached to large institutional asset management firms. There are also several IIROC member firms in this channel that we consider to be part of the PIC channel rather than the FSB channel because of their singular focus on discretionary management for the high-end client segment.

Load options
Load options refers to various types of sales commissions that are payable by the investor to their financial advisor, either directly or indirectly via the fund, at the time of investment in a mutual fund. Mutual funds are offered in two broad categories, load and no load structures.

Load structures:

1. Front-end sales charge
A sales commission negotiated between the investor and his/her advisor. This charge typically ranges from 0% to 5% and is payable directly to the advisor by the investor. The payment of this commission if applied, reduces the initial amount invested in the fund.

2. Low load sales charge
The mechanics of this load are similar to the deferred sales charge structure (see below) but follow an abbreviated redemption schedule. The sales commission payable by the fund to the advisor at the time of investment ranges from 1% to 3%.

3. Back-end load /deferred sales charge (DSC)
The sales commission is borne indirectly via fund expenses (included in the MER). The fund company pays the advisor a sales commission, typically 5% of the initial investment.

4. No load
This fund structure does not provide for the payment of a sales commission to the advisor at the time of investment.

5. Trailer fees
These are fees payable to the dealer and, subsequently to the advisor, to compensate the dealer/advisor for the maintenance of the relationship with the investor.
Trailers typically range from 0.5%-1.0% for front-end load and 0.25%-0.5% for back-end and low load funds.

Money market funds
Money market funds invest mainly in money market instruments with a maturity of one year or less. Due to the transactional nature of money market funds, which have a short holding period when compared to long-term offerings, this asset class has been excluded from the analysis. Money market funds can be classified into three separate categories, namely Canadian, U.S. and International.

Mutual fund series or classes of shares

Mutual funds are often issued in multiple series that provide different options in terms of advisor compensation (embedded, excluded or discounted). Each series of mutual fund is associated with distinct pricing objectives.

The primary fund series are:

1. A-series
This series represents the original class of units issued by a fund.

2. Advisor series
This series is made up of units of an original no load fund with a sales commission and an embedded trailer fee.

3. D-series
This series of funds is sold exclusively by bank-owned fund companies through the online/discount brokerage channel. The embedded trailer fee of the corresponding no load fund is reduced or eliminated in recognition of the lack of an ongoing advisory relationship with the investor.

4. F-series
This series is available to investors who maintain a fee-based account. The embedded trailer compensation is removed from the MER; any fee charged by the dealer/advisor is paid directly by the investor.

5. HNW-series
This series of funds has replaced the institutional series in the retail channel and targets the high net worth investor. Management fees are lower than the original series and, in most cases, are negotiable between the investor and the fund company. In the context of this project, HNW-series excludes any assets attributed to institutional series (originally termed I/O-series) and focuses exclusively on the retail HNW clients. The analysis also disregards HNW pools or funds whose MERs reflect only operating expenses and are used as part of a high-end fund wrap program.

6. T-series
This series of funds offers a proportionate return of capital to create tax-efficient cash flows for the investor.

Managed asset solutions
These include fund wraps, fee-based brokerage, advisor managed, in-house managed wraps, separately managed wraps, hedge funds, pooled funds, separately managed accounts, estates and trusts, and universal life.

Fund wraps
Fund wraps are fee-based programs that use investment funds as building blocks. For this project, fund wraps refer to mutual fund of funds that use only mutual funds as underlying blocks.

Acronyms

TFSA – Tax Free Savings Account

RESP – Registered Education Savings Plan

RRSP – Registered Retirement Savings Plan

RRIF – Registered Retirement Income Fund

LIRA – Locked-in Retirement Account

LRIF – Locked-in Retirement Income Fund

LRSP – Locked-In Retirement Savings Plan

STRATEGIC
INSIGHT

A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry

NOVEMBER 2012

Strategic Insight an Asset International Company
805 Third Avenue, New York, NY 10022
Tel: (212) 944-4455, Fax: (212) 730-7730
www.sionline.com

Introduction and Strategic Insight Background

In the summer of 2012, Strategic Insight was commissioned by the Investment Funds Institute of Canada (IFIC) to provide a study of the U.S. mutual fund industry that in particular offers a perspective on mutual fund shareholders' costs. IFIC requested a Toronto-based research firm, Investor Economics, to similarly study Canadian mutual funds. To provide a view of the U.S. mutual fund marketplace that is most comparable to the experience of Canada, Strategic Insight's report focuses for the most part on investors who purchase funds with the assistance of a financial advisor.

Strategic Insight (SI) was founded more than 25 years ago in New York City as a research firm specializing in the mutual fund industry. In 1986, the year of SI's founding, the U.S. mutual fund industry had just crossed the $500 billion mark in assets under management (AUM) and was part of a $1 trillion global mutual fund industry. Today, mutual funds (including ETFs) oversee over $25 trillion in AUM around the world, including about $14 trillion in the U.S. Strategic Insight observes the evolution of the global mutual fund industry and provides research services in New York, Boston, London, Hong Kong, and Melbourne.

Strategic Insight's observations in this report are based on a number of sources, including SI's proprietary database (Strategic Insight Simfund) which tracks the mutual fund industry and incorporates data based on mutual funds' filings with the SEC, as well as data provided by Lipper, Morningstar, and SI's own research. Also used for this study is data and findings published by the Washington D.C. based Investment Company Institute, the national association of U.S. investment companies.

This report includes commentary based on Strategic Insight's past studies, SI's proprietary surveys of U.S. fund managers, data sourced from other research firms, and our firm's cumulative knowledge of the mutual fund marketplace acquired over the more than two decades since its founding. A number of previously published Strategic Insight studies also address the topic of mutual fund shareholder costs in the U.S. and globally and have in the past been shared with the fund management industry, industry observers, and regulators. The studies referenced below are available upon request to SI:

- *Mutual Fund Fees: Facts, Trends, Economies of Scale, and Market Forces*, 2004 (at the advice of the ICI, this study was shared with the U.S. Senate Banking Committee)
- *Rule 12b-1: Looking Back, Looking Forward, in the Context of a $12 Trillion Mutual Fund Industry*, 2007 (following SI's Director of Research participation at the S.E.C. June 2007 Public Hearing on the future of Rule 12b-1, this report was published and posted in the public comment page of the U.S. SEC)
- *Fund Fees in Europe*, 2011 (commissioned by the European Fund and Asset Management Association - EFAMA), this report was shared with the EFAMA member firms and with the public.)

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I. Executive Summary

- Mutual funds are widely accepted in the U.S. Their ownership is encouraged by the marketplace and enabled through regulatory initiatives. More than 80% of wealthy households in the U.S. invest in mutual funds.

- The $14 trillion U.S. fund industry has benefitted over the past three decades from the emergence of funds as the primary savings vehicle for retirement income, as well as from innovation in investment products, development of share class pricing alternatives aligned with evolving market demands, and transparency of fee information. In combination with these factors, the open architecture culture in the U.S. for fund selection and portfolio construction has also contributed to the fund industry's ability to serve the expanding and diverse needs of a wide range of individual and institutional investors across a wide range of distribution channels.

- The U.S. mutual fund industry is dominated by retirement savings, and has benefited from a number of U.S. government initiatives since the 1970s encouraging such investments. U.S. mutual fund investments dedicated for retirement savings within tax-advantaged accounts exceeds $5.5 trillion. About two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in such accounts, and during both bull and bear markets new stock fund investments are dominated by retirement savings. In addition to these tax-advantaged retirement account structures, a significant portion of U.S. mutual fund investments in taxable accounts are also intended for long-term savings and retirement income. Indeed, according to the Investment Company Institute, the majority of U.S. fund investors (62%) have been introduced to mutual funds through their corporate retirement Defined Contribution plan. Overall, 94% of U.S. mutual fund investors use funds to "save for retirement" (whether in taxable or tax-advantaged accounts).

- About one-quarter of all stock and bond mutual fund assets under management in the U.S. are held in Defined Contribution (DC) retirement plans. Outside of DC plans, about four in five individual investors in mutual funds have made the choice to be helped by a financial advisor (FA) for the management of all or the majority of their mutual fund investments.

- For investors choosing to be assisted by a FA, the methods through which funds are sold and FAs are compensated have dramatically changed over the years. During the 1980s-1990s, most funds were sold one-fund-at-a-time and FA compensation was primarily paid at point-of-sale. Today, most funds are purchased wrapped within an asset allocation portfolio, and compensation to the FA is mainly structured as a fee-for-advice paid year after year.

- For mutual funds purchased in recent years, fees-for-advice (comprising the great majority of U.S. financial advisor compensation for mutual fund new sales and oversight lately) are generally paid by the investor directly to the financial intermediary. These fees are in addition (and external) to the fees of the underlying mutual funds used within such a portfolio of investments. Such annual charges typically range from 1.00-1.50% of asset invested, with fees on account sizes typical of a middle-income mutual fund shareholder higher than those of high-net-worth investors.

- The fees-for-advice described above are added to the mutual fund fees embedded in such funds' Total Expense Ratios (TERs). Industrywide, TERs for actively managed stock and bond funds sold in the U.S. and typically used by financial advisors average around 0.85%. An investment portfolio made of multiple funds with above-average allocation to smaller cap, international, or non-traditional investments will have higher underlying fund costs; while a portfolio with higher than average allocation to bond funds or large cap U.S. stock funds may have slightly lower underlying fund costs.

- In sum, for a U.S. investor choosing actively-managed mutual funds selected and managed with the help of a financial advisor, total costs for fund selection, management, and oversight are roughly 2.00% of the portfolio holdings each year. (Generally, under one-third of this total cost is retained by the fund manager for investment management – with the balance captured by the fund's distributor and the financial advisor serving the investor, or used to cover operational and legal expenses.) This total shareholder cost level is not dissimilar to what is observed for European-sold mutual funds.

- The transition from point-of-sale compensation to fees-for-advice compensation over the past two decades in the U.S. was not driven by regulation. In Strategic Insight's view, a key reason for such transition has been the desire of fund distributors to establish a more stable revenue base for their financial advisors. The fees-for-advice model provided this more stable base, as compared to the revenue generated by "transactions" – which can decline dramatically during periods of financial uncertainty.

- Overall, some of our observations from the market-driven evolution of fund distribution within the large, mature, and well-regulated U.S. mutual fund marketplace raise a number of considerations for market observers in other countries:

- Shareholders total costs: What is the cost impact of the transition to a fee-for-advice structure and the resultant unbundling of the fees for financial advice and portfolio construction and monitoring from mutual fund management fees? Naturally the move away from point-of-sales commissions to fee-for-advice reduces instances of ill-timed and unnecessary transactions just for the purpose of generating commissions for advisors. It is our view, though, that such inappropriate activity by financial advisors is much less common than is argued by some observers (for evidence: mutual fund redemption activity in U.S. commission-based platforms is significantly *lower* than in fee-for-advice platforms. Broker-dealers at times acknowledge that their own generated revenues in commission-based platforms are dramatically lower than in fee-for-advice platforms, and thus such broker-dealers are consistently trying to shift their clients' invested assets to fee-based relationships.)

Overall, Strategic Insight believes that for many "buy-and-hold" inclined U.S. mutual fund investors, total shareholder costs over the lifetime of an investment have increased as a result of the transition to a fee-for-advice model. Many investors no longer have the benefit of paying commissions just once (or taking advantage of discounts of such commissions available to U.S. fund investors based on aggregate investments held within one distributor or across funds of the same investment manager). Note also that in the U.S. there are tax-advantages associated with paying for shareholder costs through fees embedded within the fund, and it is tax-inefficient to pay for such fees in an unbundled way. In total, the unbundling of fees has resulted in an increase in the total shareholder costs for many mutual fund investors – with such increases amplified due to tax considerations at times.

- <u>Shareholder investment results</u>: The shift to an asset allocation-based portfolio of funds, wrapped with a fee-for-advice, undoubtedly created more balanced and prudent investment strategies. This transition toward more a more structured asset allocation culture also eliminated some instances of opportunistic, market-driven, and thus ill-timed transactions due to selling "one-fund-at-a-time." Yet, one theme of concern is the higher-than-average asset velocity which Strategic Insight observes within fee-for-advice account structures. This more frequent activity at times may be reducing potential investment gains for some investors. Mutual funds held within commission-based platforms show asset turnover (i.e. redeeming one fund and using the proceeds to purchase another fund) in line with industry averages in recent years. In contrast, fee-for-advice platforms experience higher asset turnover. In particular, discretionary fee-based accounts (where financial advisors hold full discretion over their clients assets and can change and rebalance the portfolio of funds at-will and without the prior approval of the investor) show at times significantly higher average turnover of assets. This higher asset turnover typical within fee-for-advice accounts raises concerns about investment results, as compared to lower turnover "buy-and-hold" strategies. (Does such higher frequency rebalancing add to, or subtract from, investment results? We note that a number of academic studies have concluded that higher asset velocity correlates with lower relative investment results, as compared to lower asset velocity balanced investing.)

- <u>Diversify of investment strategies from many investment managers</u>: Higher asset velocity in fee-for-advice accounts results in shorter investor holding periods of fund investments. This, in turn, translates into lower fee revenues collected by the investment manager. With investment managers' costs of raising new assets in the

U.S. rising lately, such shorter projected holding periods (and thus lower projected investment management fees over the life of an investment) are placing increasing pressure on investment manager profitability. Over time, a continuation of these trends (higher distribution costs, lower fee revenues) may result in a smaller number of investment management firms – and thus a narrower scope of investment strategies – participating in the marketplace.

- Transparency of cost information: Investors and other marketplace participants can easily compare total shareholder costs when such costs are bundled within the typical U.S. reported Total Expense Ratio (and similarly, Canadian mutual funds' Management Expense Rations (MERs)). These expense ratios are consistently reported by each fund and captured by numerous companies tracking the mutual fund industry – thus making them easily benchmarked as a result. It is Strategic Insight's view that when total shareholder costs are unbundled – with fees-for-advice ratios reported by each distribution company separately, and to each investor individually – the transparency of total shareholder cost is reduced. In addition, the ability to compare total shareholder costs across different distribution organizations is lessened. With reduced transparency and industry-wide comparability, the asymmetric nature of the relationship between a financial advisor and their investment client becomes more one-sided. This is due to the reality that the trusted advisor drives both the investment choices and the fee-for-advice price equilibrium.

- Small investors' access: are costs and access to fee-for-advice platforms limiting opportunities for lower wealth investors to receive advice? With unbundled fees-for-advice typically rising as investor account sizes decrease (due to the lack of economies of scale in servicing such smaller accounts), many middle-income mutual fund investors are faced with the reality of significantly higher ongoing costs for financial advice – or even the complete lack of an advice option – within the continued transition to a fee-for-advice culture in the U.S.

Ultimately, the desire for professional financial advice in an increasingly uncertain global financial market continues to gain in emphasis among U.S. fund shareholders and many investors globally. Given the growing demand for such guidance (and the acceptance of its cost) the $14 trillion U.S. mutual fund marketplace exemplifies how naturally occurring marketplace forces and other factors can serve as powerful conduits in creating an effective environment for both investment managers and investors. The evolution of investment strategies, advisory services and pricing mechanisms for the compensation to financial advisors across many distribution channels, costs efficiencies due to scale, regulatory guidance, and transparency of key cost comparison variables all combine to enable access to advice across varying investor wealth and sophistication levels in the U.S.

II. History, Structure, and Evolution of the U.S. Mutual Fund Industry: A Perspective

U.S. Investment Companies: Assets Under Management ($ Trillion)							
	12/85	**12/90**	**12/95**	**12/00**	**12/05**	**12/10**	**6/12**
Open- and Closed-End Funds							
Equity and Balanced	0.1	0.3	1.3	3.7	4.9	5.7	5.6
Bond	0.1	0.3	0.7	0.9	1.4	2.5	2.8
Money Market	0.2	0.5	0.8	1.8	2.0	2.7	2.4
Total Open- and Closed-End	***0.5***	***1.2***	***2.8***	***6.4***	***8.3***	***10.9***	***10.8***
Other							
VA Underlying Funds	<0.1	0.1	0.3	0.9	1.1	1.4	1.4
Exchange Traded Products	--	--	0.0	0.1	0.3	1.0	1.2
Total	**0.5**	**1.2**	**3.1**	**7.3**	**9.7**	**13.3**	**13.4**

Source: Strategic Insight Simfund

Regulatory Initiatives and Marketplace Developments Facilitate and Promote Wide Acceptance of Mutual Funds as an Investment Vehicle

The acceptance of the mutual fund vehicle for savings and investments, income and capital accumulation, and retirement security is reflected in the over $1 trillion net invested into bond and stock U.S. mutual funds since 2008's extraordinary crisis.

The evolution of U.S. mutual funds since the 1970s benefitted from a confluence of regulatory initiatives enabling tax advantaged retirement savings, new investment areas, and technological innovations. The industry's growth has also been spurred by a favorable financial environment for bond, stock, and cash-equivalent mutual funds for most of the past four decades. Mutual funds offer an important foundation to retirement savings in America. More than $5.5 trillion are invested in mutual funds held in tax-advantaged retirement accounts (including individual retirement accounts (IRAs), Defined Contribution (DC) plans, and mutual funds underlying variable annuities). About two-thirds of the total assets in all equity and balanced mutual funds are held in such accounts, and during both bull and bear markets new stock fund investments are dominated by retirement savings. Indeed, the majority of U.S. fund investors (62%) have been introduced to mutual funds through their corporate retirement Defined Contribution plan. And 94% of U.S. mutual fund investors, according to the ICI, use funds to "save for retirement."

A few highlights of regulatory initiatives and other pricing innovations enabling fund growth:

- **1974** Individual Retirement Accounts (IRAs) for workers not covered by employer retirement plans are introduced (today mutual fund IRA accounts exceed $2 trillion)

- **1978** 401(k) retirement plans are introduced (about $2.5 trillion are held through mutual funds in Defined Contribution plans in the U.S.)
- **1980** The SEC adopts Rule 12b-1, allowing funds to pay for distribution (in a tax-advantaged way). Over the next three decades, 12b-1 fees became a dominant source of fees paid for distribution and advice. The role of 12b-1 fees in advisor compensation has, however, greatly diminished lately, as a result of a movement towards an externalized-fee-for-advice culture. Fees for advice are now largely charged and paid outside the mutual fund expense ratio, as increasingly funds with no embedded 12b-1 fees are sold
- **1988** Merrill Lynch launches the first multi-share-class funds ("A" with point-of-sale commissions, or "load," are charged to the investor and are paid to the financial advisor (FA), and "B," where the point-compensation to the FA is recovered through 12b-1 fee charges over the following 6-8 years. Very quickly, the new "B"-priced funds outsold front-load classes by more than 10:1 ratio
- **1989** The first mutual fund wrap program (charging a fee for advice paid externally by the investor, not through the fund's expense ratio) is introduced. Today, fee-based wrap programs account for over 70% of fund sales within the leading distributors in the U.S. serving investors seeking financial advice
- **1992** Schwab debuts OneSource, the first no-transaction-fee mutual fund "supermarket" (a "market" offering a wide range of investment options from a large number of fund managers, aggregated and reported by the platform administrator). Such platforms soon became the dominant place for fund purchases by self-directed investors. In addition, such "supermarkets" are used heavily by independent Registered Investment Advisors (RIAs) who manage over $1 trillion for individual investors. Schwab, Fidelity's National Financial, and TD Ameritrade are the dominant administrators for the fast growing distribution segment of independent RIAs
- **1993** The SPDR S&P 500, the first successful ETF, is launched. Today, overall assets managed by U.S.-registered Exchange Traded Funds exceed $1 trillion (and globally have eclipsed $1.5 trillion)
- **1994** The first Target-Date funds are launched. AUMs in such funds now exceed $400 billion, almost all in retirement plans, and such funds are increasingly the dominant default option choice in Defined Contribution (DC) plans
- **1997** The Taxpayer Relief Act of 1997 creates the Roth IRA (enabling investing without deductions, and tax-free accumulation into retirement years; today Roth IRA AUMs are near $200 billion)
- **2006** The Pension Protection Act (PPA) bolsters the role played by 401(k) and other DC plans in providing retirement security, and also sparks the growth of target-date funds.

A. U.S. Mutual Funds' Widespread Role in U.S. Wealth Accumulation

According to the U.S. Investment Company Institute (ICI), as of year-end 2011, mutual funds invested in the U.S. held:

- 29% of all U.S. corporate equity
- 26% of U.S. municipal securities
- 43% of all Commercial Papers
- 13% of all U.S. Government securities.

The acceptance of mutual funds is widespread in the U.S.

- Mutual funds are owned by 81% of wealthier households in the U.S. (those with over $100,000 of annual income).
- Among all households, 44% own mutual funds (about 52 million households).
- Most households that own mutual funds earn only a modest income: 62% of all households owning mutual funds earn less than $100,000 each year and 24% earn less than $50,000.
- Among fund-owning households, the median assets held in mutual funds were $120,000, making mutual funds among the most important financial assets for such families.
- It is not surprising that mutual funds are an investment vehicle adopted by "middle-income" investors (as well as by wealthier investors). These pooled investment vehicles have provided access to a wide range of strategies (e.g., U.S. fund investors benefit from more than 100 investment categories).
- Strict regulatory structure, oversight by funds' boards of directors, technological innovation, and a liquidity promise have all served to establish the leading role of mutual funds in the U.S. and elsewhere.
- Most fees charged in a mutual fund are allocated to investors based on their assets held within the fund. As such, some fixed per-account costs (e.g., transfer-agent fees) are actually higher than the amount paid by investors with very small accounts – thus such costs to the fund and their associated fees are in reality subsidized by larger shareholders. Overall, mutual funds are investments where higher-balance investors "subsidize" some of the costs of lower-balance investors (costs of investment management, transfer agency, or legal and operational that are pro-rated by assets held). Similarly, the "pooling" nature of mutual funds allows access to many difficult-to-invest-in sectors for shareholders with only $1,000 or $3,000 accounts.

B. Evolution of a Competitive Landscape: Increasing Asymmetric Power of the Largest Distributors Necessitates Investment Managers' Adaptations

Following the remarkable dislocation in the U.S. and global financial markets in 2008 and early 2009, demand for mutual funds has experienced dramatic changes in recent years. Among the key features of this evolving demand are:

- **Income and safety focus among U.S. fund investors**
- **Away from diversified U.S. stock funds**
- **Towards investments with low-correlation to main indices**
- **Global exposure**
- **Pre-packaged asset allocation**
- **Passive management, low fees.**

The dramatic rotation in investors' preferences in recent years, and even before the eruption of the 2008 financial crisis, has significantly influenced leadership among U.S. mutual fund managers. Note, for instance: of the 30 largest, thus dominant and most profitable U.S. mutual fund firms in the mid 2000s (based on December 2005 assets in actively managed stock and bond funds), close to half (or 40%) found it challenging to benefit from their scale and presence to achieve organic growth in the following six and a half years. Some such firms lost a quarter or more of their total fund assets over the six-plus year period, a time during which financial markets experienced boom, bust, and recovery. Naturally, other large fund firms thrived over the period – some among the top 30 (as of 12/05) had doubled their assets by mid 2012.

Clearly, a variety of market forces were at work in addition to evolving investment preferences: some of the leading fund managers benefitted from mutual fund assets previously held elsewhere or from transfers of money from other investments and savings. Yet, others managers suffered attrition. Asset mobility is a constant in the investment management business, as money is always in motion.

Additional reasons for the continuing asset losses (and inversely, for asset gains) of individual fund companies include relative fund performance amplified by transparency and accessible technology; brand awareness; and the near disappearance of closed architecture in the U.S. mutual fund industry (Target Date funds offered by the leading Defined Contribution Plan administrators being one of the exceptions). Naturally, how the excellent relative-performers on a mutual fund firm's lineup are aligned with the contemporary investment demand themes is also important.

Even funds attracting new money at a rapid pace due to their perceived performance excellence at times grow too fast and lose their relative past performance advantage, or reach capacity and close to new investors.

Overall, asset attrition is inherent to the investment management business. Each year, a stock or a bond fund tends to lose about 20-30% of its assets under management due to natural attrition, rotations from one investment strategy to another, performance and service reasons, and other factors (some exceptions exist). It is, therefore, critical for fund managers to continue to have access to distribution outlets in order to replace redeemed assets, as well as to give their portfolio managers opportunities to deploy new cash in recently discovered investment opportunities. Thus, to attract new investment flows, fund management firms must align the pricing of their funds, and their ability to finance the cost of distribution, to what is expected (and demanded) by the leading mutual fund distributors. As the leading distributors beginning in the 1990s transitioned their pricing model from point-of-sale compensation (financed with fund's embedded commissions and fees) to fees-for-service paid over time, fund companies similarly modified their offering of share classes suitable for fee-for-service relationships.

Two decades into such a transition, the great majority of today's U.S. fund sales via financial advisors are through low-fee fund share classes wrapped with an externalized annual fee (of over 1% each year) set and collected by the financial intermediary. (This topic is discussed at length in Chapter IV.)

Overall, the market and pricing power of the leading distributors in the U.S. is rising. The dominance of the top fund distributors has increased in the past few decades, as consolidations became a common theme among U.S. broker dealers. For example, the top 10 distributors in the U.S. (among them Bank of America's Merrill Lynch, Morgan Stanley Smith Barney, LPL, Schwab and Fidelity) oversee in total more than $10 trillion of assets, including maybe half of more of all intermediary-distributed mutual funds.

Continuing access to new investors and their financial assets – and to financial advisors among broker dealer distributors or Registered Investment Advisors (RIAs) – is essential to virtually every fund firm. Even those U.S. firms focusing historically on connecting with self-directed investors today strive to partner with financial advisors. (For example: Schwab has been the leading "supermarket" for funds sold to do-it-yourself investors. Yet during 2Q'2012, Schwab's RIA custody unit attracted $10 billion in net inflows while its individual investor business gained just $3 billion. Similarly, more than half of 2Q'2012's net flows at TD Ameritrade were from RIAs, as reported in Investment News.)

Given this reality, aligning fund firm's initiatives to the preferences in place among its broker dealer distributors (e.g., share class alternatives, FA education, technology, and profit sharing) are paramount. As discussed later in this report, the ways in which costs of fund distribution and access to FAs are evolving have determined the manner in which such costs are charged to fund investors.

A final note: Growth in the U.S. mutual fund industry is experienced by small and large fund firms. That said, a small number of highly visible firms benefit from a very high share of incremental inflows (the top three inflow-gathering firms in 1H'12 benefitted from net flows equal to one-half of the total net flows during 1H'12 into all stock and bond funds). Such success stems at times from the ability to offer lower fees due to scale (e.g., Vanguard has nearly $2 trillion in managed assets today); as well as efficient investment management in some market segments (witness the success of PIMCO's bond funds in recent years); and efficient distribution (such as achieved by JP Morgan Asset Management) – which in many cases mirror the benefits of scale in the U.S. mutual fund industry.

III. U.S. Fund Distribution

Over the past few decades, the U.S. mutual fund industry has evolved and matured. The range of investment strategies has increased, and fund distribution expanded greatly. Key marketplace trends such as the importance of retirement investing, the emergence of fund "supermarkets", and the dominance achieved by advice-driven distribution have had significant impacts on the mutual fund industry in the U.S.

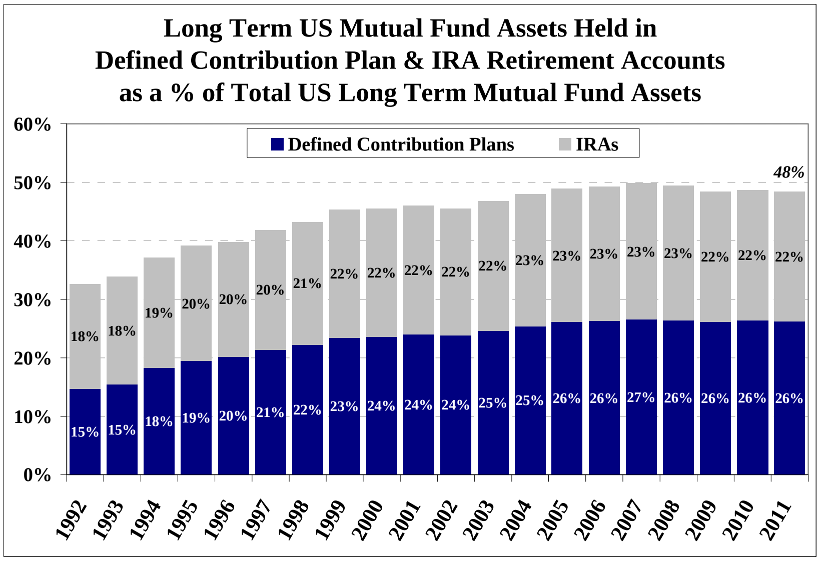
A. Role of Retirement Investing in the U.S. Fund Industry

While many important similarities exist between the Canadian and U.S. mutual fund marketplaces (including the prevalence of fund sales through financial advisors), there are also clearly important structural differences. One such difference is the configuration of retirement investing, which serves as one of the central pillars of the U.S. mutual fund industry. Presented below is a brief overview of the role that retirement accounts play within the U.S. fund market.

The growth of retirement investing in the U.S. was spurred by key legislation and national policies which created tax-advantaged savings accounts – including Individual Retirement Accounts (IRAs) and 401(k) Plans – that Americans can leverage for their long-term retirement investing. The Employee Retirement Income Security Act of 1974 (ERISA) was federal U.S. legislation that established minimum standards for employer retirement plans, as well as protections for retirement investors. Importantly for the U.S. mutual fund industry, the ERISA legislation also included the creation of IRAs. These accounts allowed individuals the opportunity to save for retirement on their own in tax deferred accounts made available through private financial institutions. Subsequently, The Revenue Act of 1978 created new Section 401(k) to the U.S. Internal Revenue Code. This paved the way for workers to utilize pre-tax salary deductions as a source of retirement plan contributions – leading to the widespread adoption of 401(k) retirement plans by U.S. employers. More broadly over time, this spurred the structural shift in retirement savings in the U.S. away from defined benefit plans (in which the employer assumes the investment risk) and toward defined contribution (DC) plans (in which the employee assumes the investment risk).

This evolution toward individuals, rather than their employers, assuming primary responsibility for managing the allocation and accumulation of their retirement savings created an opportunity for investors to leverage the diversified and cost-effective structure of the mutual fund vehicle to save toward their retirement goals. Mutual funds have since comprised a substantive portion of the retirement investment marketplace. As of the end of 2011, the U.S. retirement market in total held $17.9 trillion of assets and mutual funds accounted for nearly $5 trillion, or 26%, of such holdings according to the ICI.

Retirement savings accounts made up 48% of total long-term (stock and bond) U.S. mutual fund assets as of the end of 2011. The two tax-advantaged retirement account types through which mutual funds are held most prominently are employer-sponsored Defined Contribution (DC) Plans and IRAs (the latter are often comprised of retirement assets "rolled-over" from previous DC plan balances and now managed under the guidance of a financial advisor). The graph below charts long term mutual fund assets held within each of DC plan and IRA accounts, respectively, as a proportion of total long term fund assets in the U.S. Since 1992, overall fund assets in retirement accounts have increased their share of total long term fund assets by 15%.



Source: Investment Company Institute (ICI)

The structure of the U.S. retirement system has enabled mutual funds to serve as the primary vehicle used by millions of Americans to prudently save for retirement. At the same time, the steady inflow of regular employee salary deductions into retirement accounts – along with the low redemption rate and high asset stability benefits associated with many retirement investors' long-term investment horizons – have served to establish a solid foundation of scale and stability for the U.S. mutual fund industry. While DC plans and IRAs both provide U.S. investors with tax-advantaged means of saving for retirement, these account structures also carry important differences.

The structure of the Defined Contribution market in the U.S. – from the perspective of pricing options, access to advice, fund selection and total shareholder costs – is unique from other avenues of the U.S. marketplace. Because of these dynamics, a direct comparison of such DC plan participants' total shareholder costs (which in many cases would exclude payment for advice) to those of Canadian advisor-sold mutual funds would be largely out of context. Given DC plans' influence on the U.S. fund industry, however, some foundational information regarding their structure and pricing is important.

Many participants within employer-sponsored DC plans are acting without the services of a financial advisor, although such professional advice is often available as a plan option to participants if they choose to utilize it. In addition, investors' choice of fund offerings is limited to the specific funds available within each respective DC plan (often, particularly for smaller plans, encompassing mainly proprietary offerings from the financial services firm providing administrative and recordkeeping services to the plan). Given this combination of factors, "embedded advice" funds (mainly in the form of fund-of-funds which manage and rebalance ongoing allocations between stocks, bonds and other investments) are a significant and growing piece of investor demand within DC plans. In particular, Target Date funds – which provide ongoing asset allocation management and risk controls over the life of the fund based on an anticipated retirement date – have grown to $376 billion as of the end of 2011 (up from just $12 billion in 2001), with $270 billion of this total held within Defined Contribution Plans according to the ICI.

Given this environment within DC plans, pricing options and the determinants of overall shareholder costs can differ significantly from accounts held outside of such plans via a financial advisor relationship. The asset-based fee-for-advice compensation model has become the dominant means of accessing mutual funds via a financial advisor (as discussed in greater detail in subsequent sections of this report). Within DC plans, however, a majority of shareholders' total costs come via underlying fund expenses across a variety of share class pricing options.

One key factor influencing investor costs within DC plans is the size of the overall plan. As captured in the table below, large plans with over $100 million in assets account for more than two-thirds of total DC plan assets within the U.S. and more than one-half of DC plan participants. In particular, mega-sized plans of over $1 billion (representing many large S&P 500 U.S. corporations) make up the largest segment of plan assets (40%) and also plan participants (27%).

Total Defined Contribution Assets by Plan Asset Size

	Assets ($B)	Share of Total Assets	Share of Plans	Share of Participants
<$1MM	$132	3%	70%	8%
$1MM-$5MM	$334	7%	21%	11%
$5MM-$10MM	$192	4%	4%	6%
$10MM-$49MM	$523	12%	3%	14%
$50MM-$99MM	$286	6%	1%	7%
$100MM-$249MM	$465	10%	0.4%	11%
$250MM-$499MM	$398	9%	0.2%	8%
$500MM-$1 Billion	$407	9%	0.1%	7%
>$1 Billion	$1,794	40%	0.1%	27%
Total 2011 DC Assets	**$4,531**			

Source: PLANSPONSOR 2011 Recordkeeper Survey / ICI's "The U.S. Retirement Market, Fourth Quarter 2011" / SI Analysis
Assets reflect year-end 2011 ICI statistics; Plan data reflects PLANSPONSOR year-end 2010 data based on 83 million participants across 653,000 plans

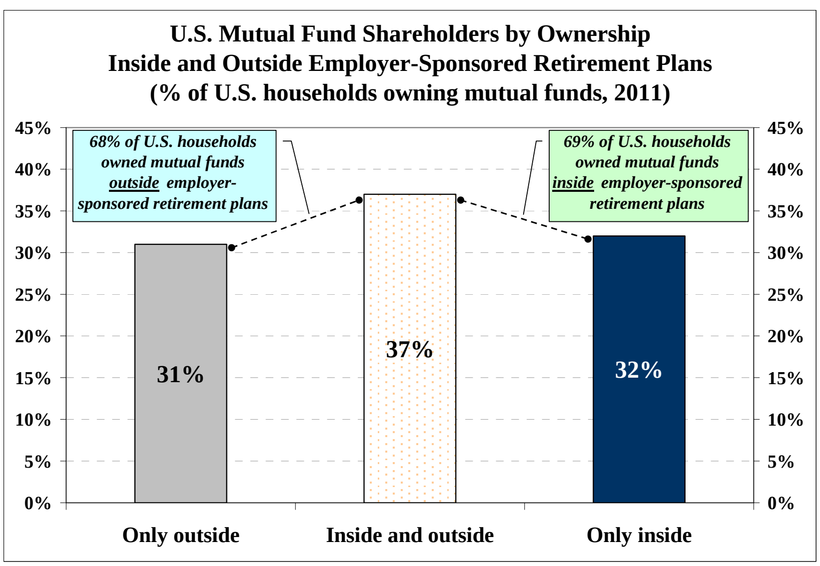
Against this backdrop within the DC plan marketplace, the table below charts examples of typical share class pricing options utilized within DC plans of different sizes ("micro" to "mega"). As captured below, the embedded service fees component of fund expenses (largely via 12b-1 fees) constitutes the largest cost variable across retirement-focused share classes and is mainly based on DC plan size.

Typical Share Class Characteristics by Defined Contribution Plan Size										
	Embedded Service Fees		Total Assets							
			2009		2010		2011		June 2012	
Share Class (Example)	via 12b-1 Fee	DC Plan Size	$Billions	Share %	$Billions	Share %	$Billions	Share %	$Billions	Share %
R1	1.00	Micro/Small	3	1%	4	1%	5	1%	5	1%
R2	0.75	Small	17	6%	18	5%	17	4%	17	4%
R3, R, Rtrm, N, P	0.50	Mid	83	29%	98	26%	92	23%	98	21%
R4	0.25	Mid/Large	50	18%	59	15%	50	12%	50	11%
R5, R6 W, K, I	0.00	Large/Mega	132	46%	203	53%	239	59%	291	63%
			285		*383*		*402*		*461*	

Source: Strategic Insight

The level of 12b-1 fees included within share classes typically utilized in DC plans tends to carry an inverse relationship to plan size – with larger plans benefitting from their overall scale to necessitate lower (often zero) embedded service fees, but smaller plans often warranting share classes with up to 1% in ongoing 12b-1 fees in order to help offset plan administration and other costs. Given the makeup of the DC plan marketplace, these pricing dynamics equate to significantly lower overall shareholder costs for a majority of DC plan assets and participants, as compared to the externalized fee-for-advice model utilized most prevalently for investors accessing funds through the professional guidance of a financial advisor.

While DC plans encompass just over one-half of U.S. fund assets held within retirement accounts and are clearly a key avenue of investment for many Americans, a majority of U.S. investors hold mutual fund assets both inside and outside of such plans. The graph below charts the percentage of U.S. households which own mutual funds both inside and outside of employer-sponsored retirement plans, as tracked by the ICI. While a robust 69% of U.S. households own mutual funds within an employer-sponsored retirement plan, only 32% of households own funds *exclusively* within such structures.



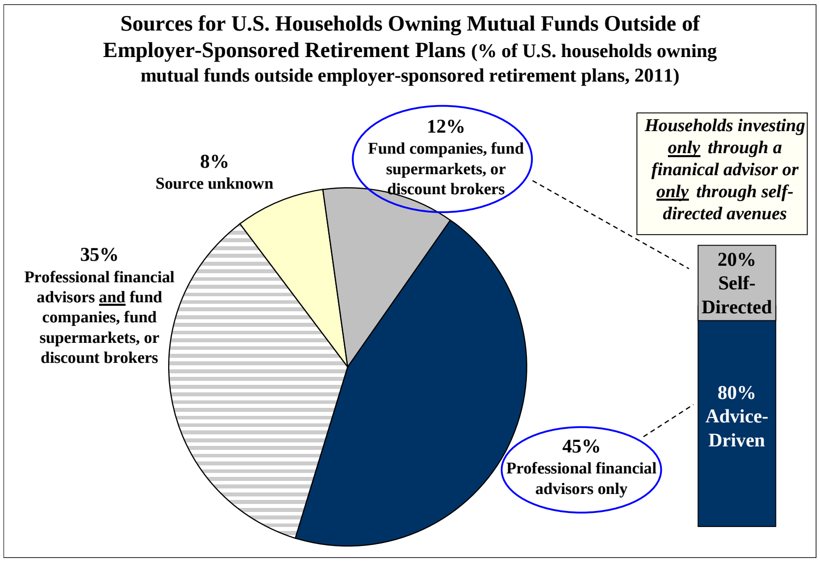
Source: Investment Company Institute (ICI)

Outside of employer-sponsored retirement plans, IRAs constitute a large proportion of the remaining fund ownership of U.S. households (as captured previously in this section, fund assets held in IRAs accounted for 22% of total U.S. long-term fund assets as of the end of 2011 and slightly under one-half of the total fund assets held within retirement accounts). Based on ICI research, 73% of the households captured in the graph above which owned funds outside of employer-sponsored retirement plans held funds within IRAs. Most IRAs are not employer-sponsored vehicles, but offer individuals the opportunity to save for retirement on their own within tax-advantaged accounts offered through private financial institutions (excluding certain IRAs – SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs – which are structured as employer-sponsored plans for small businesses).

These IRA accounts – often comprised of assets rolled-over from previous DC plan investments – are frequently held under the guidance of a financial intermediary. This offers IRA investors the benefits of professional financial advice and an open-architecture range of mutual funds to choose from. As such, this substantive portion of U.S. retirement assets often take on significantly different (and higher) shareholder cost characteristics than most assets held within DC plans. As retirement assets move into the intermediary-sold space via the IRA vehicle, shareholder cost begins to more closely mirror the dynamics of the fee-for-advice compensation structure most common among U.S. financial advisors. The evolution toward this fee-based environment in the U.S. and its implications around total shareholder cost are discussed in more detail in the following sections. (Note: the U.S. Department of Labor established new rules in late 2011 which accelerated the transition to a fee-for-service model among financial advisors guiding investors holding retirement accounts – both IRA and DC investments – see a link at http://www.dol.gov/ebsa/newsroom/factsheet/fsinvestmentadvicefinal.html.)

B. Advice-Driven vs. Self-Directed Distribution

One of the most important secular trends influencing U.S. fund distribution over the past 25 years has been investors' increasing reliance on financial advisors to manage their investments. The graph below, based on ICI research, focuses on the avenues outside of employer-sponsored retirement plans through which U.S. investors purchase mutual funds (the statistics below would be inclusive of fund purchases within most IRA retirement accounts).



Source: Investment Company Institute (ICI) / Strategic Insight analysis

While only 12% of U.S. households are exclusively "do-it-yourselfers" with regard to their fund purchases outside of retirement plans, overlap clearly exists between the same investors utilizing advice-driven and self-directed avenues for different portions of their fund holdings. A focus on those households purchasing funds only via a financial advisor or only via self-directed means reveals that roughly 80% of such investors within one of these two buckets purchased funds through a financial advisor in 2011. Or, analyzed another way, 45% of investors purchase funds exclusively through financial advisors and 35% purchase a portion of their fund holdings through an advisor – equaling to 80% of investors utilizing a financial advisor in some capacity.

The dominant role which professional advice plays in the U.S. investment marketplace has had a profound impact on the country's mutual fund industry. As fund distribution has expanded, the range of intermediary-sold distribution channels and types of financial advisors through which mutual funds are sold has also increased – from full service brokerages to independent financial planners and more. This growth has significantly influenced U.S. fund firms' sales and marketing efforts, while also impacting important aspects of mutual fund pricing, financial advisor compensation and overall shareholder cost (as discussed in greater detail in subsequent chapters).

At the same time, the expansion of fund sales through third-parties has also facilitated the fundamental movement toward an open architecture culture in the U.S. – providing investors and advisors with choice across a wide range of mutual fund sponsors. This environment has contributed to spurring competitive forces within the U.S. fund industry which have steered important market-driven equilibriums around pricing, investment product innovation, and more.

While financial advisors have always played an important role as partners to the U.S. mutual fund industry, one significant impetus which accelerated both the trend away from investors purchasing mutual funds directly from fund companies as well as the foundational movement toward open architecture was Charles Schwab's development of the first fund supermarket in the early 1990s. Schwab's "OneSource" platform offered investors and advisors their first opportunity to choose from a menu of no-load mutual funds from several different fund families under a single account structure (whereas previously investors would be required to purchase no-load funds on an individual basis directly from each fund company).

In its early stages, this centralized platform offered "do-it-yourself" investors a superior means to accessing a range of mutual funds. As the U.S. marketplace has evolved toward today's dominant reliance on the professional advice of financial advisors, however, new business within fund supermarkets has come to be increasingly led by the fast-growing Registered Investment Advisor (RIA) community – which utilizes these platforms as a key avenue to access mutual funds as part of their client portfolio construction process. RIAs are independent, primarily fee-only advisors whose client base typically includes high-net-worth and ultra-high-net-worth investors. There were 28,714 RIAs operating in the U.S. as of the end of 2011, up nearly 40% from 20,851 in 2004 according to Boston-based research and consulting firm Cerulli Associates. These RIAs managed nearly $3 trillion in total assets as of the end of 2011 (with roughly $1 trillion held in mutual funds and an additional $250 billion in ETFs), up from approximately $1.6 trillion of total RIA-controlled assets in 2004.

Today, fund supermarkets offered by Schwab, Fidelity's National Financial Services, Pershing, TD Ameritrade and others are utilized extensively by RIAs. These advisors leverage such platforms for asset custodial services, as well as for outsourcing of administrative and back office functions such as recordkeeping, technology, compliance, and more. Roughly 7,000 independent RIAs are dependent on Schwab's platforms to access mutual funds and other investments, construct portions of their clients' investment portfolios and to custody their clients' assets. From an overall asset composition perspective, Schwab's RIA custody unit held $728 billion of total assets as of the end of June 2012, while its individual investor business accounted for $737 billion. Among these two units, however, the RIA business has clearly been the key driver of growth at Schwab – attracted $23 billion in net new assets during the first half of 2012, as compared to just $9 billion within the individual investor unit.

Over time, RIAs' influence within fund supermarkets has significantly facilitated the expansion of traditionally direct-sold funds within the financial advisor marketplace. At the same time, this access to the RIA community has allowed traditionally broker dealer-sold U.S. fund firms to reach RIAs by offering no-load share classes (often their institutional shares) via supermarket platforms. This combination of forces has spurred even greater expansion of mutual fund sales across widening ranges of the advisor community.

The growth and success of fund supermarkets in the U.S. stems from a combination of the factors discussed, but is led in many ways by the size, diversity and structure of the U.S. marketplace. These fundamental factors have helped to facilitate the establishment and sustainability of the large supermarkets' "magnet" theory – with the availability of a wide selection of investment options attracting a diverse range of investors and advisors to these platforms, and vice versa with the supermarkets' investor presence (particularly RIAs) drawing an ever-increasing number of asset managers to offer funds via these programs. This tremendous scale of assets and diversity of investors and advisors is in many ways unique to the U.S. as compared to Canada, making the fund supermarket concept (and more broadly, the wide range of distribution channels in the U.S.) a difficult proposition to successfully establish within the Canadian marketplace at this point in its evolution.

From a shareholder cost perspective, the substantive presence within fund supermarket platforms of RIAs, who typically charge 1% or more for their advice and guidance, encapsulates an important theme within the U.S. distribution marketplace. A majority of the funds sold via such platforms and in fee-based wrap programs are no-load share classes (some with small levels of embedded distribution fees – primarily via Rule 12b-1 fees of up to 0.25% – and others without any embedded distribution financing). But the use of such funds' Total Expense Ratios (TERs) as a proxy for total shareholder cost paid by their investors can at times be misleading. As more investors use advisors, and as advisors shift toward a fee-based compensation model, more fund shareholders are paying for advice via an externalized, asset-based overlay fee charged outside of – and in addition to – total fund expenses.

C. Focus on U.S. Intermediary-Sold Fund Distribution

Amid the longer-term secular trend of U.S. mutual fund investors increasingly relying on the professional guidance of financial advisors to help manage their assets, the intermediary-sold fund distribution landscape in the U.S. has also continued to evolve. This advisor-sold marketplace in total represents roughly $5.5 trillion of mutual fund assets in the U.S. across a range of diverse channels. Among the largest and most important advisor-sold channels for fund firms are National Broker Dealers, Independent / Regional Broker Dealers and RIAs.

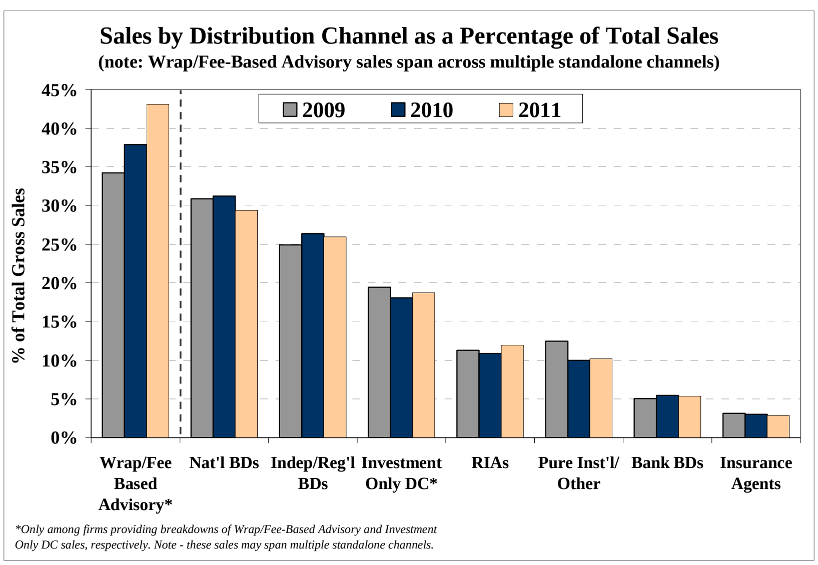
- The National Broker Dealer channel has experienced significant consolidation over the past several years and now encompasses four large firms – Merrill Lynch, Morgan Stanley, Wells Fargo and UBS. These firms, however, account for more than 50,000 financial advisors and represent a very substantive proportion of overall fund industry sales. From an asset perspective, the four National Broker Dealers account for in aggregate over $1 trillion in total mutual fund assets.
- Independent and Regional Broker Dealers also represent an important advisor-sold distribution avenue in the U.S. Many advisors affiliated with these firms operate as independent contractors (as opposed to National BD advisors who are employees of their firms). The Independent and Regional Broker Dealer marketplace is made up of a majority of small firms, but also encompasses several large and growing players such as LPL, Ameriprise, Edward Jones and others. Although much less concentrated than the National BD channel, Independent and Regional Broker Dealers in total account for about $1.2 trillion in total U.S. mutual fund assets.
- The RIA channel, as discussed previously, encompasses independent and largely fee-only advisors whose primary means of accessing mutual funds is via supermarket platforms such as Schwab, Fidelity, etc. While the RIA channel has been an emerging area of focus for many of the large, traditionally broker dealer sold fund firms in the U.S., much of the established mutual fund presence within

the RIA community has been concentrated largely among no load boutique and specialized fund managers. In total, RIAs hold roughly $1 trillion in U.S. fund assets.

Beyond these three distribution channels, advisor-controlled fund assets in the U.S. also reside within the wealth management units of private banks and trust companies, within bank broker dealer networks, and at insurance companies. For many U.S. fund firms, access to DC retirement plan investments is also a key focus of their new business strategy. The Investment Only DC channel accounts for fund sales via employer-sponsored DC plans by fund companies who do not maintain an affiliated DC plan recordkeeping unit. This channel is the most common avenue through which most fund firms distribute into DC plans.

Within the context of this distribution channel makeup, the following graph shifts perspective slightly to provide a more current depiction of important new sales trends within the intermediary-sold marketplace. In particular, the increasing importance of the fee-based compensation structure across widening ranges of advisors and investors has been one of the most important trends shaping the U.S. fund marketplace.

The graph below charts the proportion of gross long-term fund sales captured by various distribution channels in the U.S. over the last three calendar years for fund firms that distribute primarily through financial intermediaries. The results are based on an annual Strategic Insight survey of such fund managers. The 2011 survey results encompassed data from 45 fund managers and were reflective of over $900 billion in aggregate gross sales.



Source: Strategic Insight Fund Sales Survey

The U.S. financial services marketplace has experienced a fundamental shift over the past decade-plus toward an advice-based, asset allocation culture. With this shift has come the expansion of the fee-for-advice compensation structure among a growing number of financial advisors (largely at the expense of the point-of-sale commission-based compensation model). As captured in the preceding graph, the increasing dominance of fee-based advisory programs within the U.S. intermediary-sold fund landscape has only accelerated during the post-crisis period.

Sales via Wrap/Fee-Based Advisory platforms (which span across a number of the standalone channels captured above) accounted for 43% of total sales during 2011, up significantly from 34% in 2009. When excluding more institutionally-natured avenues such as Pure Institutional and the retirement plan-focused Investment-only DC channel from the total sales universe analyzed above, the data suggests that within the five remaining standalone channels (which are focused primarily on financial advisors serving individual investors), Wrap/Fee-Based Advisory programs captured roughly 60% of total fund sales in 2011 (up from 46% in 2009). In addition to fund sales within fee-based programs, many financial advisors use the "C" share class fund pricing structure (which carries 1% of annual trailer fees within the fund's expense ratio via 12b-1 fees) as a substitute for Wrap/Fee-Based Advisory programs. If such "C" share class sales are considered a form of ongoing fee-based payment for advice, as much as 70+% of all long-term fund purchases by individual investors made with the assistance of financial advisors in 2011 involved a fee-for-advice payment.

The fee-for-advice compensation model is increasingly prevalent across expanding segments of the largest U.S. distribution channels. Within the National Broker Dealer (or Wirehouse) channel, fee-based sales regularly make up at least of two-thirds of ongoing gross fund sales. In addition, a growing number of Independent and Regional Broker Dealers continue to see (and actively promote) accelerating transition of their advisors' business models from commission-based to fee-based structures.

In parallel with the increasing fee-based fund sales made by financial advisors within many large U.S. broker dealers, the rapid growth of the primarily fee-only independent RIA market also continues to serve as an important catalyst for the expanding fee-for-advice culture among U.S. advisors. The table below (also sourced from Strategic Insight's annual Fund Sales Survey) details annual sales growth rates for each U.S. distribution channel, based on the aggregated results from SI's survey group of mutual fund firms.

Sales by Distribution Channel
Annual Sales Growth (%)

	2007	2008	2009	2010	2011
Total Gross Sales	*19%*	*-9%*	*-5%*	*15%*	***8%***
Wrap / Fee Based Advisory	19%	17%	12%	27%	**26%**
RIAs	16%	22%	2%	5%	**16%**
Investment Only DC	29%	-7%	-10%	13%	**13%**
Independent / Regional BDs	16%	-15%	2%	23%	**7%**
Pure Institutional / Other	18%	-20%	-22%	10%	**7%**
Insurance Agents	17%	-22%	-33%	15%	**4%**
National BDs	22%	-13%	2%	17%	**2%**
Bank BDs	24%	-46%	-6%	5%	**-1%**

Source: Strategic Insight Fund Sales Survey

Mutual fund sales via Wrap/Fee-Based Advisory programs have clearly been a key driver of growth within the advisor-sold marketplace. The sales via such programs have grown at a faster pace than any standalone channel captured in the preceding table during each of the past three years (2009 through 2011). In addition, RIAs have registered as the fastest-growing standalone channel for fund firms in the SI survey group during three of the past four years (2008, 2009 and 2011). The growth of this fee-based advisor community continues to have significant impact on the fund sales of both large intermediary-sold U.S. fund managers (many of which are captured in the SI survey results), as well as many boutique and specialized fund firms (through supermarket platforms such as Schwab and via direct interaction with RIAs.)

D. Point-of-Sale Compensation Platforms vs. Fee-Based Platforms: The Reality of Investor Experience Is At Times Different from the Common Belief

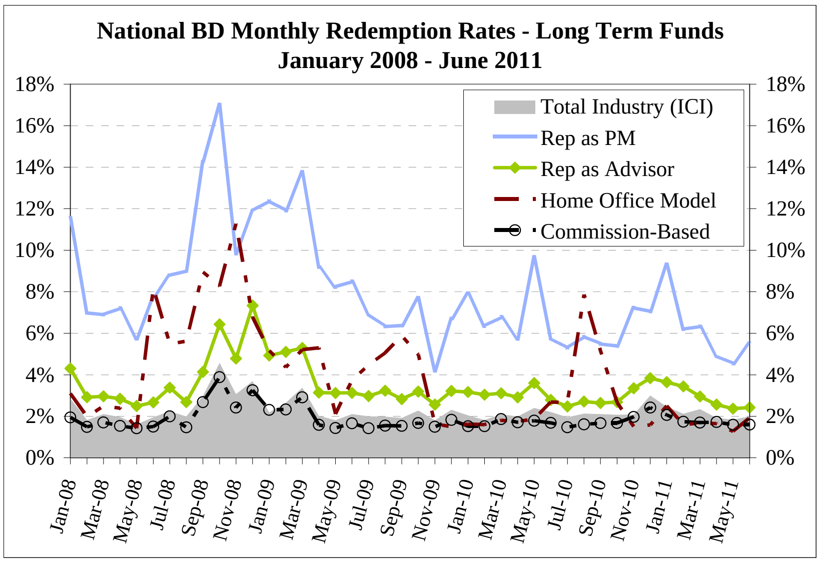
In addition to the impact which the dominant shift toward fee-based sales in the U.S. has had on the mutual fund industry, this evolution also continues to affect investor experience in many ways. One common theme often presented as a truism in the popular advocacy for transition from point-of-sale advisor compensation to fee-based compensation is the claim that when advisors are paid over time, they are not incentivized to imprudently "trade" their clients' investments in order to earn new commissions, and therefore the interests of the adviser and investor are better aligned. Another contention made with regard to fee-based compensation is that it increases transparency and reduces total shareholder costs in funds.

Similar arguments underlie a number of regulatory initiatives globally – such as in India and the "Retail Distribution Review" (RDR) in the U.K. While investor experience within some less-evolved mutual fund markets may be very different from that in the U.S., the observations made below may be helpful in international regulatory deliberations around the preferred model of compensation for investor guidance.

In many cases, over the life of an investment, a one-time compensation for financial advice based on the initial invested dollar amount (i.e. point-of-sale load) is less expensive than continual annual fees that are charged based on ongoing current total assets invested (and increase in conjunction with any appreciation of assets year after year). This is especially true when the point-of-sale commissions charged are reduced because of the investor having significant total assets at the fund or fund firm in total. (In the U.S., investors are offered discounted front-end sales charge rates for larger purchases, and the sales load "breakpoints" are based on their total assets invested at a single fund company or within many single broker dealers.) Not surprisingly, broker dealers often observe that their revenues generated in fee-for-service accounts are significantly larger than in commission-based accounts. While aggregate lifetime fees paid in fee-for-service relationships are higher than in many transaction-based accounts, it is believed that the value offered to investors in such ongoing services justifies additional costs.

The asset-based charges levied within fee-based programs, at times an overlooked component of total shareholder cost for mutual fund investors, are disclosed to and paid by each individual investor, but are not easily compared across the industry. In comparison, mutual fund expenses are transparent, publicly disclosed, and easy to compare across the industry for similarly invested funds.

In addition to shareholder cost and transparency factors, investor experience within commission-based versus fee-based scenarios can also be impacted by other fundamental factors such as trading activity and asset velocity. The data presented in the graph below captures gross monthly redemption rates (redemptions as a percentage of assets) segmented across different mutual fund platform structures at U.S. National Broker Dealers (representing over 30,000 financial advisors) as well as across the U.S. fund industry as a whole (as tracked by the ICI). The Rep as PM, Rep as Advisor and Home Office Model universes included in the graph represent three different mutual fund wrap platform types through which financial advisors can structure their fee-based relationships with clients (more detailed descriptions of each are included below).



Source: Coates Analytics Distribution Management System / Strategic Insight Analysis

The redemption patterns charted above show that funds held within commission-based platforms are not, on average, traded (or "churned") often. In reality, such funds generally incur the lowest trading activity, while funds held in fee-based accounts experience structurally higher asset movement. These trends represent a critical, but often not well recognized, reality. The stability of assets within funds sold by advisors earning commission-based compensation mirrors the satisfaction of advisors and investors in such accounts. Beyond cost, the data also implies that – based on the truism that higher frequency of trading and market timing will on average result in poorer shareholder investment experience over time – long-term investment returns in many commission-based platforms may be better than those experienced at times in higher trading-frequency fee-based accounts. (While not in the scope of this paper, a body of academic research in the behavioral finance area found repeatedly that over-confidence by the more active stock "traders" leads to under-performance; see, for example, the published research of University of California Berkeley's Terrance Odean http://faculty.haas.berkeley.edu/odean/. Strategic Insight believes that similar experiences are likely among active traders of ETFs as well as, on average, by financial advisors reallocating their clients' portfolio holdings with above average frequency.)

A few additional key observations:

- Commission-based platforms show monthly redemption rates often below 2%, virtually mirroring the industry's overall trends (which are anchored by the low-trading activity within most retirement investments).

- "Rep as Advisor" platforms – which encompass non-discretionary fee-based programs where the advisor must gain the investor's approval for each incremental transaction – generally show monthly redemption rates that are consistently higher than commission-based platforms, and rise notably during periods of market uncertainty and increased downside volatility.

- "Rep as Portfolio Manager (PM)" platforms are discretionary fee-based accounts, in which the advisor can buy and sell securities on the investor's behalf without gaining prior investor approval. Advisors within such programs are also most likely to adopt and experiment with non-traditional investment strategies and other innovative funds, and are dramatically more inclined (on average) to modify their clients' positions. On average, the redemption rates within Rep as PM platforms are three- to four-times higher than in commission-based platforms.

  Notably, discretionary account management by financial advisors (both via Rep as PM programs at broker dealers, as well as within the expanding RIA community) has been the fastest-growing avenue of the U.S. intermediary-sold distribution marketplace over the past several years.

- Home Office Models are fee-based platforms where the decision to change and rebalance funds is centralized at an institutional-selection team within the broker dealer, and is not triggered by the advisor or the investor. On average, Home Office Model redemption rates are low and stable, with the exception of months with significant portfolio rebalancing.

These factors around asset movement characteristics within different investor-advisor relationship structures and the associated implications for shareholder cost and investment performance offer another important component of overall investor experience in the U.S. As the movement from point-of-sale to fee-based compensation continues to evolve at different paces within the U.S. and other markets around the world, its ramifications for shareholder experience must be recognized and considered.

E. Implications around Shareholder Cost

The continued expansion of the fee-for-advice relationship structure in the U.S. carries wide-ranging implications for asset managers, financial intermediaries and investors. One of the most important aspects of this trend involves the evolution of advisor compensation and, in turn, shareholders' overall cost of financial advice and mutual fund ownership. Investors in the U.S. are increasingly paying for advice via ongoing asset-based overlay fees which are externalized from the mutual fund expense ratio and paid directly to the financial intermediary. Given this dynamic, total shareholder cost for mutual fund investors in the U.S. has significantly migrated outside of the fund expense ratio – as discussed in detail within the next chapter.

IV. The Evolution of Financial Advisor Compensation for Mutual Fund Advice: Marketplace Impact, Regulatory Guidance, and Price Equilibrium

Over the past few decades, the acceptance and use of mutual funds in the U.S. has become widespread and encouraged at a societal level. With such broad acceptance, marketplace forces largely drove the evolution of pricing equilibrium for mutual fund management and financial adviser guidance – balancing fees charged to investors, fees earned by investment management firms, and compensation paid to financial advisors, fund distributors and administrators. The scale of the $13 trillion+ U.S. mutual fund industry, and the diversity of its investment managers (with over 100 firms managing over $10 billion in mutual fund assets today), have allowed for the development of innovation in products and technology, as well as expanded options in fund distribution. Naturally the smaller Canadian mutual fund marketplace is evolving differently.

As the fee-for-advice model has become a dominant theme for advisor-guided relationships in the U.S., the ways in which investors pay for advice and fund selection – and the mechanisms through which financial advisors are compensated for providing such advice – have also evolved. Such evolution has been driven in large part by the strong preference among broker-dealer fund distributors for the fee-for-advice model. In many ways, the concentrated (thus asymmetric) market power of the leading distribution firms in the U.S. has driven much of the pricing choices offered to investors.

A. The Evolution of Compensation for Financial Advisors: A Broker Dealer Viewpoint

The past two decades have witnessed dramatic changes in how financial advisors in the U.S. are compensated. Much of these changes have been anchored on the business model preferences of broker-dealers and other fund distributors – as they aimed to transition compensation to their advisors to be paid over time as a percentage of assets under management, instead of as one-time point-of-sale commissions triggered by trading activity.

Over time, broker dealers have learned that the volume of opportunistic trading can fall sharply following market dislocations (beyond just the weeks of turmoil), as investors' confidence shrinks and they default to "inaction". This naturally can lead to a collapse of trading-based commission revenues and related profits. Equally important in broker dealer planning since the early 1990s has been the realization that technology and the internet were certain to shrink the cost of trading dramatically (today many trading platforms charge less than $10 per trade – a fraction of the trading commissions 20 years ago – and some have eliminated commissions altogether for certain trades).

Overall, revenue collected in asset-based fee-for-service platforms tends to decline only modestly following a significant market rupture (unlike the potential dramatic decline of trading activity and resultant commission revenues). In addition, broker dealers have certain flexibility to manage their fee-for-service ratios and revenues. For example, effective ratios of fees-for-advice often rise following a down market – as shrinking portfolios are charged higher effective fees.

The diversity of features across different fee-based platform types also provides broker dealers with some pricing flexibility. Fees in advisor discretionary fee-based accounts (where the financial advisor has the client's permission to manage their investments without the need for client approval before each incremental buy or sell action) are at times higher than in non-discretionary accounts. In addition, unlike many other account structures, some discretionary platforms allow advisors to also earn a fee-for-service on the portion of client portfolios held in cash. In the wake of the 2008-2009 turmoil, investors are becoming even more dependent on the guidance of their financial advisors – with discretionary fee-based account management registering as the fastest growing segment of the U.S. fund distribution landscape over the past few years.

Overall – and possibly inherent in the nature of the asymmetric relationships that exist between financial advisors and their clients – fees-for-advice largely do not decline in times of increased financial uncertainty. In fact, it can be argued that the importance of advice, rebalancing, and support in "staying the course" is actually greater in more uncertain times.

These asymmetric relationships are important to recognize as drivers of the dramatic changes in financial advisor compensation over the past few decades. For much of the 1980s and 1990s, compensation to advisors selling mutual funds was paid primarily by investors being charged a point-of-sale commission or "load". In the past decade, however, such compensation has evolved to be almost always paid over time as an ongoing fee-for-advice.

B. Compensation for Financial Advisors: Mutual Fund Share Class Structure and Evolution

For roughly 20 years, U.S. mutual funds have been offered in a range of share class pricing options – affording investors and advisors a variety of choices in structuring the cost of fund ownership (although each individual fund may not offer every potential share class). U.S. fund share classes can be broken into four basic groupings – Front Load ("As"), Back Load/Contingent Deferred Sales Charge (CDSC) ("Bs"), Level Load ("Cs"), and No-Load. The key characteristics of each of these pricing options are defined in the table below:

Share Class Type	Typical Naming Convention	Sales Charge Characteristics	Embedded Distribution & Marketing Fee (i.e. 12b-1 fee)	Total Assets ($Trillion) (as of May 2012)
No Load	Institutional, direct-sold, retirement, advisor class, etc.	No sales charge	25 basis points or less	**$5.9**
Front Load	"A"	Front-end sales load (typically ranging from zero to 5.75%, based on size of investments and rights-of-accumulation incentives)	Less than 50 basis points (typically 25 bps)	**$1.9**
Level Load	"C" & certain retirement-specific classes	These shares typically carry no sales load (though some may contain a front- or back-end load of 1% or less)	Greater than 50 basis points (typically 100 bps)	**$0.4**
Back Load/CDSC	"B"	No point-of-sale load, but a contingent deferred sales charge schedule exceeding 1% and extending past 1 year (typically starting at 4% and declining by 1% each year)	Greater than 50 basis points (typically 100 bps)	**$0.04**

Note: Total Asset figures include open-end stock and bond funds only (exclude money market funds, closed-end funds and ETFs)
Source: Strategic Insight Simfund MF / SI Analysis

As captured in the far-right column above, no-load shares account for the largest asset pool among U.S. share classes at $5.9 trillion as of May 2012. No-load shares encompass a range of investor types – including shareholders investing through fee-based financial advisory programs (as discussed in the previous chapter), as well as retirement plan savers, investors purchasing shares directly from fund companies, and institutional investors. These shares carry no sales loads and may contain an embedded small distribution and marketing fee in the form of 12b-1 fees of up to 0.25% (although investment flows have increasingly moved toward shares with zero 12b-1 fee, as discussed later in this chapter.) (Not included in the above table are the $1.1 trillion in ETF assets, about half of which are owned by individuals.)

Front Load "A" shares hold the second-largest asset base in the U.S. at $1.9 trillion (although such funds in aggregate have net redeemed over $250 billion since the end of 2006). A substantive portion of these "A" share assets include retail investors who purchased mutual funds through a financial advisor via a point-of-sale commission 10, 20, or even 30 years ago. (Note that in 2011, funds sold with a significant point-of-sale commission accounted for less than 10% of all fund sales through financial advisors, as sales migrated towards fee-for-service relationships.) The sales charge on "A" shares typically ranges up to 5.75% of an investor's deposit amount, but can be reduced or eliminated through rights-of-accumulation (ROA) discounts – which allow investors to pay a decreasing sales charge percentage as the size of their purchase increases (down to zero for investments over $1 million within most equity funds and at lower levels for many bond funds.) These ROA discounts are applicable not only within single funds but also across the accumulated total of an investor's purchases across a fund company's entire fund lineup. Sales loads on class "A" shares are also typically waived when purchased within a retirement plan or within fee-based advisory programs.

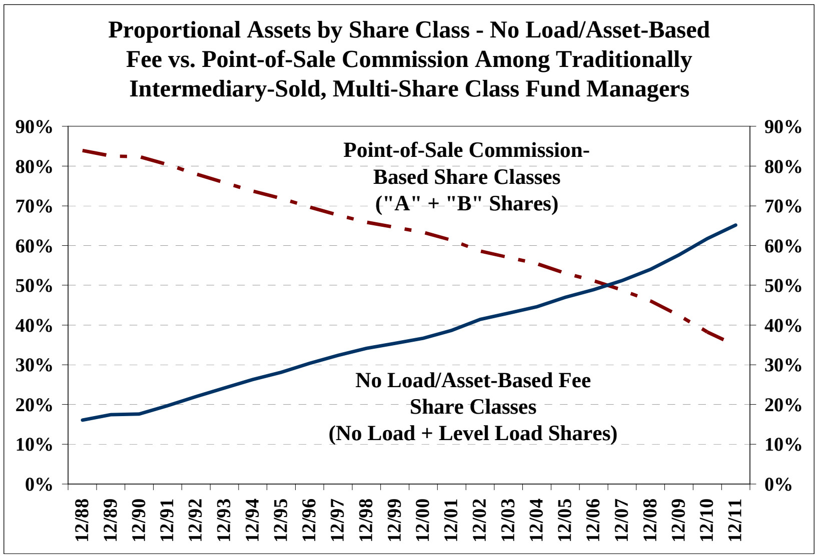
Level Load shares, accounting for $0.4 trillion, are made up primarily of class "C" shares – in which the cost of distribution is embedded within the mutual fund total expense ratio via the 12b-1 fee (normally 1%). These shares are typically utilized by investors and advisors to enable a fee-for-advice relationship within the structure of the fund expenses (often a cost-effective and tax-advantaged means of paying for advice – particularly for small investors), as an alternative to the externalized overlay pricing of fee-based advisory programs.

The Back Load/CDSC pricing structure of class "B" shares has moved increasingly toward extinction within the US marketplace – accounting for just $44 billion of total stock and bond fund assets (or less than 0.5% of total industry assets) and fewer than 0.5% of new sales annually. While as recently as the end of 2000, "B" shares made up over 10% of industry stock and bond fund assets, a combination of minimal new sales (with many fund families actually discontinuing new sales of "B" shares), naturally occurring redemptions and automatic conversions to "A" shares with lower 12b-1 fees continue to accelerate the pace of "B" shares' disappearance. The movement of financial intermediaries away from "B" shares in the U.S. has been triggered by a the overall transition to fee-based sales, as well as pricing disadvantages for many investors as compared to other share classes (such as for investors meeting ROA discounts within "A" shares, and many longer-term investors.)

C. Evolution of U.S. Share Class Demand: Transaction-Based vs. Fee-Based Fund Sales

The overarching movement toward the fee-for-advice compensation model across widening segments of the U.S. distribution landscape has had profound impact on mutual fund share class pricing (as well as overall shareholder cost). While share classes enabling point-of-sale commission (through either commissionable "A" shares or "B" shares) once served as the primary pricing structure through which financial advisors were compensated, such shares are diminishing in importance at an increasingly rapid pace.

The relationship over time between share classes carrying point-of-sale commission and share classes enabling a fee-based compensation arrangement provides a perspective on the evolution of U.S. share class demand, on the structure of shareholder cost, and on the overall distribution landscape. The graph below charts proportion of assets from 1988 through 2011 within share classes offering point-of-sale commissions versus those enabling a fee-based compensation structure. The data includes U.S. fund managers distributing primarily through financial advisors and offering a multi-share class pricing menu (i.e. some combination of "A", "B", "C" and Institutional/No Load shares). This comparison excludes traditionally direct-sold, no-load fund managers such as Vanguard and others in order to focus more specifically on scenarios in which investors and advisors have multiple pricing options within the same mutual fund (the inclusion of exclusively no-load fund managers would increase even more significantly the proportion of assets within No-Load / Asset-Based Fee shares).



Note: Includes open-end stock and bond funds only (exclude money market funds, closed-end funds and ETFs)
Source: Strategic Insight Simfund MF / SI Analysis

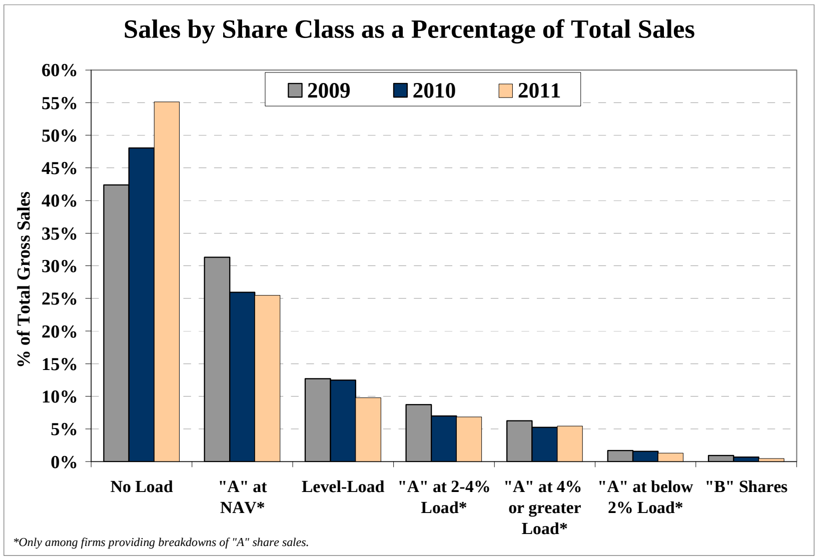
As the prevalence of fee-based programs has risen, No Load/Asset-Based Fee share classes have seen a steady increase in their share of total assets – rising from just 16% of the total assets captured above at the end of 1988 to 65% as of December 2011. In addition, large portions of "A" share sales over the past five to ten years have actually been made at net asset value (NAV), with the front-end sales load waived – mainly within fee-based programs or via retirement accounts. In 2011, SI survey data shows that 70% of "A" share gross sales were made at NAV. This would imply that the actual share of assets held in No Load/Asset-Based Fee scenarios is even greater than the proportions illustrated above.

From a shareholder cost perspective, the mechanisms of payment for professional financial advice have also shifted from primarily point-of-sale payment to ongoing asset-based fees. This movement to fee-based advisory programs has brought a number of benefits to investors – such as the ability to allocate assets across a more diversified range of "best-in-class" individual fund managers, more detailed portfolio monitoring and rebalancing processes, and more direct association between advisors' compensation structure and their success in successfully managing their clients' assets and retaining such accounts (i.e. based on ongoing assets under management, as opposed to transaction-based). From a pure cost perspective, however, payment of an ongoing, asset-adjusted annual fee may at times not be the most cost-effective means of accessing mutual funds for long-term investors.

Although sales of front load "A" shares have decreased significantly over the past decade within the U.S., the pricing structure of these shares does offer certain cost benefits over time for many investors. The payment of a one-time sales load based on initial investment size and amortized over the life of an investment can often encompass much lower total cost for long-term shareholders than the ongoing asset-based fees charged within fee-based advisory programs. Such cost benefits over time are increasingly greater for investors who meet Rights of Accumulation (ROA) front-load discount thresholds – up to those large investors who qualify for load-waived purchases of "A" shares at NAV.

D. The Accelerating Use of No Load Shares and the Increased Unbundling of Distribution Costs

Current demand trends for different share class pricing structures within the U.S. fund marketplace clearly illustrate the increasing dominance of the fee-for-advice compensation model. The graph below charts the proportion of gross sales captured by the different types of share classes (including a breakout of front load "A" share sales by actual load level). This data is based on the same annual Strategic Insight Fund Sales Survey on which the distribution channel analysis in the previous chapter was based. (The survey captures the results of 45 primarily intermediary-sold fund firms with a collective $900+ billion in long-term fund sales in 2011.)



Source: Strategic Insight Fund Sales Survey

Share classes most conducive for use within fee-based advisory programs – no-load shares and "A" shares sold at NAV (where the front-end sales charge is waived) – combined to account for 80% of total sales in 2011 among the SI peer group of 45 multi-share-class U.S. fund managers. At the same time, just 5% of total sales (or 1 in every 20 dollars sold) came via "A" shares with 4% or greater front load in 2011 – as the point-of-sale commission model for fund sales continues to decline among financial intermediaries in the U.S.

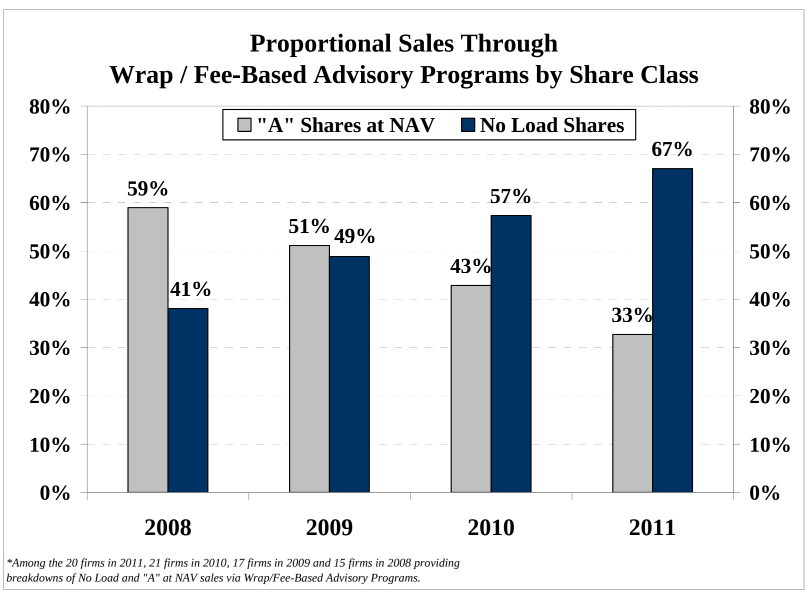
Level-load shares have been a steady source of demand among U.S. investors and advisors as an alternative to the externalized fee-based pricing model. During 2011, however, level-load shares saw their proportion of fund sales decline amid continued push among broker-dealers towards their fee-of-service platforms, as well as possibly the unresolved regulatory debate around Rule 12b-1 (some "C" share-reliant financial advisors have begun to proactively transition business to fee-based advisory programs, in anticipation of potential regulation-induced disruptions to their business, such as those stemming from possible new rules effecting Fiduciary Standards, Rule 12b-2 reform, new point-of-sales disclosure, or other concerns).

For many investors, such a transition to the externalized pricing model often equates to an increase in overall shareholder cost over the life of their investments (both in the form of higher annual fees for advice, as well as at times the loss of tax benefits associated with deducting internalized fund fees from a fund's taxable distributions to shareholders). In addition, as financial advisors transition more of their business to fee-based structures, some smaller accounts may ultimately face decreased access to financial advice – due to a combination of higher ongoing fees to the smallest investors and diseconomies of scale for intermediaries in servicing smaller accounts.

E. Unbundling and Externalization of Distribution Costs

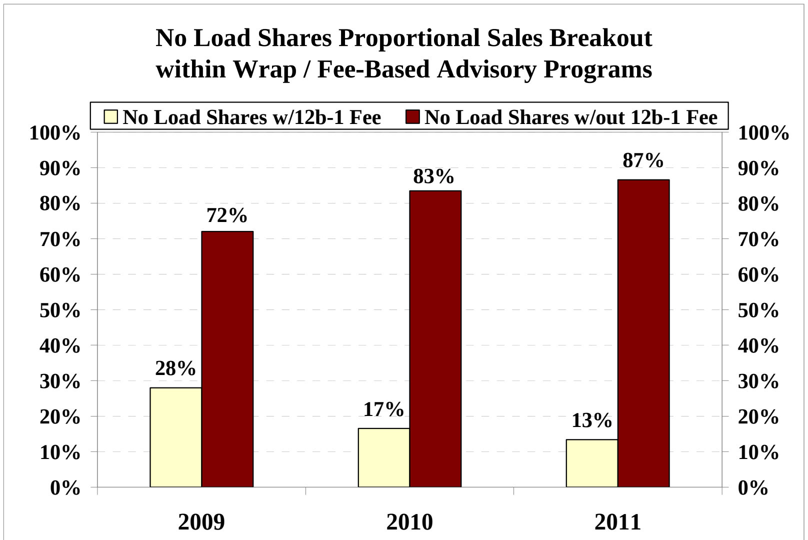
Against the backdrop of an overarching movement toward share classes enabling a fee-based compensation structure, the unbundling of distribution costs paid by investors has accelerated in recent years. Growth in the sales share of no-load share classes (which by SI definition are often with zero 12b-1 fees but can carry a 12b-1 fee of up to 0.25%) has accelerated most significantly over the past five years – increasing from 34% in 2007 to 55% in 2011. No-load shares with zero 12b-1 fees have been the key driver of growth over the past several years, as the cost of advice continues to increasingly migrate outside of mutual fund expenses and into the externalized overlay charges of fee-based programs.

The two graphs that follow immediately below take a closer look at this trend. The first shows the proportion of fee-based program fund sales that are made through "A" shares at NAV (which typically carry 0.25% of 12b-1 fees) as opposed to no-load shares. As can be seen in the chart, fund demand within fee-based programs has moved sharply away from "A" shares at NAV and toward no-load share classes.



Source: Strategic Insight Fund Sales Survey

The following chart shows that an increasingly dominant majority of the no-load sales in fee-based programs have come within share classes *without* any 12b-1 fee.



*Among the 22 firms in 2011, 25 firms in 2010 and 17 firms in 2009 providing such breakdowns of No Load share sales via Wrap/Fee-Based Advisory Programs.

Source: Strategic Insight Fund Sales Survey

Naturally occurring market forces within the fastest-growing portions of the intermediary-sold space continue to push more of the U.S. mutual fund business toward fund providers' lowest-cost share class options. The increasing demand among many distributors and advisors for funds' lowest-cost share classes continues to shift an even greater proportion of total shareholder cost outside of the mutual fund expense ratio. Today, the primary cost of fund ownership for a growing number of mutual fund shareholders in the U.S. lies outside of the fund expense ratio and within distributors' externalized asset-based overlay fees. (In the context of the ongoing regulatory debate in the U.S. around embedded distribution costs via Rule 12b-1 fees, these trends point toward the diminished need for dramatic and costly overhaul of U.S. fund pricing.)

This continued structural shift nevertheless carries significant implications for both funds and investors. As a growing portion of the increasing fee-based demand within the U.S. distribution landscape continues to migrate toward share classes with very low, or zero, embedded distribution fees, overall fund expenses may trend down, but total shareholder costs may in many instances actually increase.

F. Externalized Overlay Fee Component of US Shareholder Cost

The total cost to mutual fund shareholders within fee-based advisory programs is comprised of two primary components – the expense ratios of the underlying funds (analyzed in more detail in the next chapter) and the asset-based fees-for-advice charged to investors outside of (and in addition to) underlying fund expenses. The asset-based charges levied within fee-based programs are generally difficult to benchmark (as compared to the detailed transparency of publicly disclosed mutual fund expenses) and are at times an overlooked component of total shareholder cost for mutual fund investors. As the fee-for-advice compensation structure has become embedded in the foundation of the U.S. intermediary-sold fund marketplace, however, these charges have come to comprise a significant proportion (typically more than half) of the total cost associated with mutual fund ownership for many U.S. investors.

As fee-based programs continue to expand in prevalence across a wider range of financial intermediaries in the U.S., they also continue to inevitably encompass a greater diversity of investor types and account sizes (beyond their legacy use by primarily wealthy investors). In the U.S., those fee-based advisory programs in which mutual funds play an important role can vary significantly in the services provided to investors (discretionary vs. non-discretionary account management, etc.), the composition of underlying investments (ranging from exclusively mutual funds, to combinations of funds and various other securities), and ultimately in their pricing.

Because of these factors, pinpointing a precise measurement of the "average" overlay fee paid by U.S. investors within fee-based advisory programs presents a difficult task. While many large investors may enjoy favorable pricing within fee-based programs, such structures are considerably more expensive for smaller investors. Given this diversity, it is important to understand measurements of both the fee paid on the "average dollar" (which will be weighted toward larger accounts and therefore lower given the breakpoints available within most advisory fee schedules) and the fee paid by the "average investor" (which takes into account the higher relative charges levied on many smaller investors).

The tables below capture the annual gross fee schedules for fee-based advisory programs within three prominent U.S. fund distribution firms, as disclosed within each firm's Form ADV filings with the US SEC. [Note – each of the distributors captured below offers a range of fee-based advisory program options. These fee schedules are applicable to only a portion of the mutual fund-centric fee-based advisory programs offered by each distributor. In addition, these stated fee schedules are at times negotiable.]

Gross Advisory Fee Schedules - Prominent US Distributor Samples

Distributor A (full service brokerage MF wrap program)		Distributor B (supermarket provider managed account program)		Distributor C (National Broker Dealer MF wrap programs)	
Client Account Size	**Annual Asset-Based Fee***	**Client Account Size**	**Annual Asset-Based Fee**	**Client Account Size**	**Annual Asset-Based Fee**
Less than $200,000	1.48%	Under $500,000	1.10%	First $500,000	1.50%
First $200,000	1.38%	$500,000 - $1,000,000	1.05%	Next $500,000	1.25%
Next $100,000	1.18%	$1,000,000 - $2,000,000	1.00%	Next $1,000,000	1.00%
Next $200,000	1.08%	$2,000,000 - $5,000,000	0.95%	Over $2,000,000	Negotiable
Next $500,000	0.88%	$5,000,000 - $10,000,000	0.90%		
Next $1,000,000	0.78%	Over $10,000,000	0.85%		
Next $1,000,000	0.63%				

**Additional discounted flat rates available for accounts over $3M*

Source: Form ADV filings

As captured in the fee schedules above, investors can face a range of potential overlay fees based on differences by firm and client account size. While $1 million-plus investors often pay fees of 1% of assets annually or at times less, smaller investors can face much higher ongoing charges (often exceeding the 1% embedded distribution costs via 12b-1 fees within level-load mutual fund shares.) For example, based on the parameters of the schedules above (and before any potential fee negotiation between an advisor and investor) an investor with an account size of $250,000 would pay an annual advisory fee of 1.34% at Distributor A, 1.10% at Distributor B and 1.50% at Distributor C.

While appreciating the diversity in types of fee-for-advice arrangements available to investors, the high level of competitive market forces within the U.S. also lead to certain pricing equilibriums. The table below, based on research from Boston-based research and consulting firm Cerulli Associates, charts the frequency of actual advisory fees charged by individual advisors to their clients across various account sizes.

In reading this table, the top row for example shows that only 1% of financial advisors charge less than 0.75% annually to clients with $100,000 accounts, while 65% of such advisors charge their $10 million dollar client accounts less than 0.75%.

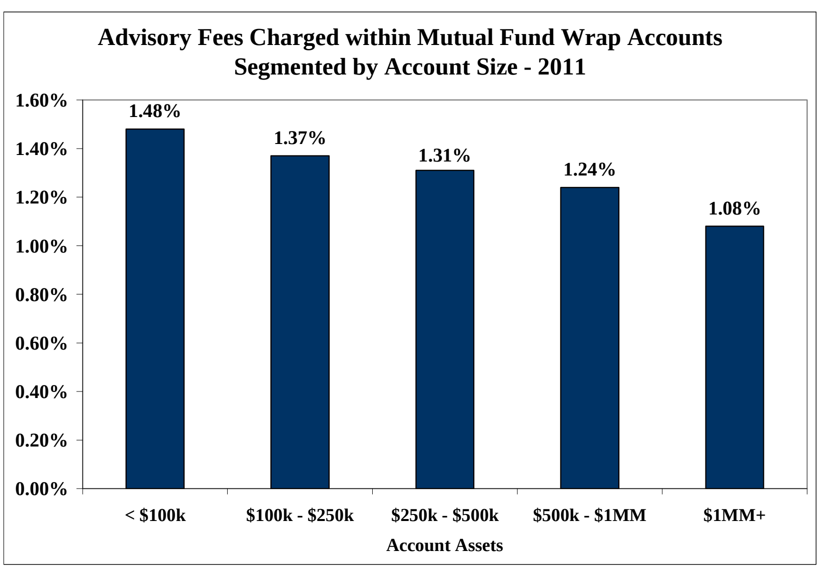
US Fee-Based Advisory Programs
Fequency of Advisory Fee Charged by Client Asset Size - 2011

Fee Range	$100K	$300K	$750K	$1.5m	$5m	$10m
Less than 0.75%	1%	1%	2%	7%	30%	65%
0.75% to 1.00%	6%	9%	22%	36%	45%	26%
1.00% to 1.25%	22%	35%	44%	36%	19%	6%
1.25% to 1.50%	39%	30%	16%	12%	3%	1%
1.50% to 1.75%	10%	12%	8%	6%	2%	1%
1.75% to 2.00%	10%	9%	6%	3%	1%	1%
2.00% to 2.50%	9%	3%	1%	0%	0%	0%
More than 2.50%	2%	0%	0%	0%	0%	0%

Sources: Cerulli Associates, in partnerships with the Financial Planning Association, the Investment Management Consultants Association, Advisor Perspectives, and Morningstar

As captured above, 70% of investors with account sizes of less than $100,000 are charged advisory fees higher than 1.25% and 31% are charged over 1.50%. This suggests that the externalized fees for an investment most typical of middle-income mutual fund investors would exceed 1.25%.

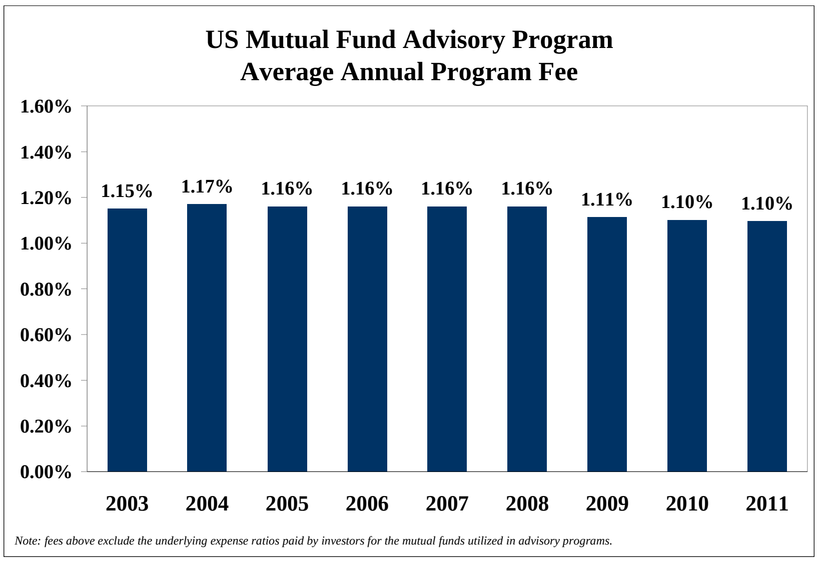
Similarly, the chart below – based on data and research from Toronto-based PriceMetrix – details the average overlay fee charged to investors of varying asset sizes across 11,000 mutual fund wrap accounts in the U.S.



Source: PriceMetrix, Inc. **Note: Advisory Fees expressed as RoA (Return on Assets)*

These fees for advice charged to small investors at times significantly exceed the embedded 1% ongoing 12b-1 fees typically charged within level-load mutual funds. Given these pricing realities and diseconomies of scale – spurred in large part by the fixed costs encountered by many distributors around various aspects of fee-based account maintenance – the fee-based account structure remains an expensive one relative to other options for many small investors.

In measuring the fee paid on the average dollar (as opposed to the average investor) within fee-based account structures in the U.S., the influence of larger investor accounts clearly plays a significant role – with a relatively lower number of accounts holding a very high proportion of actual dollars. The graph below, based on research from Cerulli Associates, charts the dollar-weighted-average annual program fee paid by U.S. investors in aggregate, incorporating all account-size breakpoints, within mutual fund-centric fee-based advisory programs (this data excludes underlying fund expenses and additional ticket charges that are levied in some programs, typically independent broker dealers).



Source: Cerulli Associates

The dollar-weighted-average annual overlay charge within fee-based U.S. mutual fund advisory programs during 2011 was estimated at 1.10%. This level has held relatively steady since declining in 2009 – likely due in part to advisors' post-crisis client retention efforts, as well as adjustments to account fees associated with investors' increased preference for bond funds over the past three years. (Many fixed income-centric portfolios often carry lower ongoing account fees than equity-centric models.)

The overlay fees charged to investors within fee-based advisory programs clearly comprise a substantive proportion of overall cost of ownership for many U.S. mutual fund shareholders. A holistic analysis of these externalized fees, however, also shows their variability across different shareholder types and sizes. This diversity in shareholder pricing within fee-based programs shines light on the actual cost-of-ownership realities faced by many investors in the U.S. At the same time, this analysis also illustrates the importance of maintaining a variety of pricing options within the marketplace to cost-effectively serve both large and small investors (including both embedded and externalized methods of paying for advice).

G. Some Additional Observations on the Regulation of Fees Earned by Financial Advisors

Generally, over the past few decades U.S. regulators have avoided price-setting initiatives regarding compensation for mutual fund sales or for investment management of funds (and such regulation's potential for "unintended" consequences).

One such initiative was set two decades ago, in the early 1990s. The securities industry's self regulating body, NASD (renamed FINRA in recent years), issued a rule in July 1992 ("NASD Cap") mandating a ceiling to the total permissible charges in sales of mutual funds through financial advisors. (This rule considered point-of-sale commissions, contingent exit / redemption fees, and annual on-going compensations to advisors – or "asset-based sales charges" – maxing at 0.75%.)

Importantly, this "cap" was not set based on each single transaction (and tracing the cumulative costs associated with single transactions throughout the life of the investment). Instead, the NASD Cap was calculated on the accumulation of many transactions across all share classes of a single investment portfolio. As such, for example, for each $100 million of additional sales across all share classes, the cap was raised by about $6 million (minus any point-of-sale commissions paid just for these sales). This created, in effect, pool of "permissible" dollars being replenished with each additional transaction.

Over the years, as fewer funds were sold with point-of-sale commissions, redemption fees, or high embedded fees-for-service ("asset based fees") – and instead were increasingly sold without any load or embedded asset-based fees – the 1992 NASD Cap rule ceased to be a limiting factor for fees charged to shareholders.

More broadly, Strategic Insight suspects that very few individual funds have, at any time since the introduction of this cap, reached a point when the cap prevented them from charging fees that were embedded in the fund's structure. Thus, we believe that it was not regulatory guidance, but market forces driven by the preferences of broker dealer fund distributors, which have dictated the dramatic shifts in advisor compensation over the past two decades.

The NASD Cap took into consideration the sales practices used in the period when investors were paying for financial advice in one of three ways generally:

- "A" shares – point-of-sale commissions (most of which was passed along to the financial advisor). Generally, 5.75% was the most commonly used "load" level for small purchases, with the "load" declining for larger purchases or once the investors and their families accumulated larger aggregated investments with a single fund family or at the same broker-dealer (termed "rights of accumulation", commissions declined to minimal amounts or disappeared altogether for $500,000 or $1 million household ownerships.)

- "B" shares – annual 1.00% fees made up of "service fee" of 0.25% and an additional "asset-based fee" generally of 0.75% paid for a limited, pre-set number of years. "B" shares also have redemption fees triggered upon redemptions within a certain number of years post-purchase. Generally, the financial advisor was assigned a 4% commission at point-of-sale of "B"s (such payment was paid by the fund manager's distribution division and recouped over time).

- "C" shares – annual 1.00% fees made up of "service fees" of 0.25% and additional "asset-based fees" generally of 0.75% without a limit of time and without redemption fees (after the first year of ownership).

In the years since this 1992 rule, compensation for financial advisors has changed dramatically.

- 1980s and 1990s: 90%+ of compensation to FAs were paid at point-of-sales (led by the dominance of "A" and "B" share transactions)

- 2011: Virtually the opposite marketplace reality, as three-quarters or more of compensation to the financial advisors selling mutual funds now is paid annually over time. Very little open-end mutual fund sales are done today with a significant point-of-sale compensation paid to the financial advisor

- It is Strategic Insight's view that such dramatic transition over the past two decades was mostly driven by marketplace forces (not regulatory mandates) and significantly by the preference of broker dealer distributors to have the compensation for their financial advice paid over time, as opposed to at the point-of-sales.

Another example of regulators deliberative approach is their review of Rule 12b-1 and its role in enabling the delivery of financial advice. Rule 12b-1 was set about three decades ago in the 1980s, and has become a key mechanism allowing investors to pay for advice and its delivery through fees charged and embedded within funds' annual expenses (thus in a tax-advantaged way for U.S. investors owning a taxable, non-retirement account.)

In recent years, the SEC has focused on Rule 12b-1 with the view that this 1980s-originated rule needs to be modified (and possibly repealed). SI's Director of Research participated in the SEC's Public Hearing on Rule 12b-1 in June 2007, and SI research on that topic was submitted to the SEC subsequently (this report is available by request to SI). The SEC's recommendations around changes to the rule – as captured in its proposed Rule 12b-2 (released in 2010) – triggered a new wave of market participant input, advocating the need for further deliberations and assessment.

Today, five years after the SEC Rule 12b-1 hearings in Washington, marketplace forces continue to reduce, if not eliminate, many of the concerns expressed originally by the SEC. The use of Rule 12b-1 fees to finance new fund sales is rapidly disappearing, as documented in this report. Thus, in Strategic Insight's view, dramatic regulatory intervention is no longer needed around Rule 12b-1.

V. U.S. Mutual Fund Expenses

A. Total Expense Ratios and Investment Management Fee Trends

Over the years, investment management fees in the U.S. have modestly trended downward, as many funds grew in size thus enabling economies of scale which were shared with the investors in such funds. During the past decade, independent directors of U.S. mutual funds (who, among other responsibilities, oversee the fees charged by each fund to its shareholders) have increased their focus on mutual fund fees and how they compare to similarly invested mutual funds. Overall, many investment management companies have modified their funds' advisory fee structures through the introduction of contractual advisory fee "breakpoints" (reducing marginal fees slowly as the fund grows in assets), or through non-contractual fee waivers.

According to the ICI (measuring actively-managed and index funds across all investment strategies), over the past two decades, on an asset-weighted basis, average expenses paid by U.S. mutual fund investors within the embedded fund total expense ratio have fallen significantly. In 1990, investors on average paid 99 basis points (0.99%) of fund expenses for assets invested in equity funds. That ratio fell to 79 basis points in 2011. The decline in the average expense ratio of hybrid funds mimicked that of equity funds, while that of bond funds was more marked – declining 30%, from 88 basis points in 1990 to 62 basis points in 2011. The accelerating shift to no-load funds and no-load share classes (where 70% of assets reside today, nearly double the share of 1990), and the gains among index funds (which represent 12% of the stock and bond fund assets today, versus 1% in 1990), are among the factors influencing the decline of ICI-reported asset-weighted fee ratios. (The decline in the fee ratios would be greater if the $1.1 trillion of ETF assets, not accounted for in the ICI fee data above, were incorporated into this analysis – as ETFs are primarily offered as low-fee indexed strategies.)

The decline in the asset-weighted fee ratios is also impacted by the economies of scale enjoyed by many U.S. mutual funds. Funds holding assets in excess of $1 billion account for a majority of shareholders assets in the U.S. – with such mega funds control 88% of stock and bond fund assets (while funds over $5 billion control 60% of assets). Additionally, the influence of a few "mega" investment management companies (which manage nearly $2.5 trillion of active equity and bond funds) impacts composite asset-weighted fee ratios. The three largest U.S. managers of actively managed equity and bond funds are American Funds, Fidelity, and Vanguard. American Funds is responsible for nearly $1 trillion of such assets; the at-cost Vanguard charges fees equalling its costs as part of a co-operative business model for the nearly $600 billion it maintains of actively managed assets; and Fidelity actively manages about $800 billion of equity and bond funds in the U.S. (For comparisons: the largest mutual fund manager in Canada runs under $100 billion in actively managed equity and bond mutual funds).

The expectation of lower fund fees at times contrasts the reality that many funds are still too small to offer meaningful economies of scale (about half of all U.S. funds are less than $200 million). Also, the introduction of innovative investment strategies and the search for global "alpha" within more complex portfolios limit early opportunities to pass scale savings to investors. At the same time, the recent trends of rising distribution costs in the U.S. (financed increasingly by fund managers' profits) suggest that future reduction of total expenses ratios will be difficult even among funds reaching economies of scale.

While fees for actively-managed funds have trended modestly lower in the past decade, individual and institutional investors in the U.S. increasingly benefit from lower-fee index funds and indexed Exchange Traded Products (ETPs). The U.S. mutual fund market has witnessed a dramatic expansion of low-fee index strategies since the introduction of the first S&P 500 Index fund in 1976. Today, index-based mutual fund assets in the U.S. exceed $1.2 trillion and index-based ETP assets exceed $1.1 trillion (interest in index funds and ETPs has accelerated since 2008). Fee transparency guided by regulatory-mandated disclosure and aided by technology has played an important role in these trends.

For an increasing majority of U.S. investors, especially more affluent ones, a key additional consideration impacting costs stems from their use and dependency on the professional guidance of financial advisors (employed by national or regional broker-dealers, financial planning firms, or independent advisors who hold their clients' assets at Schwab, Fidelity's National Financial, and other "supermarkets"). As was detailed in prior chapters, U.S. mutual fund investors increasingly pay financial advisors an externalized fee-for-service which typically ranges from 1.0% to 1.5% of assets.

In addition to the 1.0-1.5% externalized fee-for-service charged to investors by financial advisors, our estimates suggest that fund shareholders pay between 70 – 80 basis points (or a bit more) in underlying total expenses for a well diversified, actively-managed investment portfolio comprised of stock and bond mutual funds. Clearly, introducing index mutual funds and/or exchange-traded funds into the portfolio would likely drive down underlying portfolio costs. At the same time, however, investors' growing engagement of "alternative" investment solutions – which typically carry higher costs – would have an inverse and increasing effect on aggregate underlying portfolio expenses.

B. Investor Access to Fund Documents and Transparency Requirements

Today, U.S.-domiciled mutual funds are among the most regulated and transparent financial products available to individual investors. While many sophisticated individuals and institutions invest directly in mutual funds, a wide range of extensive disclosure requirements are in place to assist and protect individual retail investors. U.S. mutual funds are required to publish and periodically update their selling documents ("prospectus"), strike a daily NAV, provide fee disclosure, and put in place board oversight. The mutual fund prospectus provides investors with a variety of key fund facts such as investment strategies and objectives, fees and expenses, and performance to name just a few.

Beyond the prospectus, investors and mutual fund data aggregators have access to a detailed array of information in other SEC-required documents such as the statement of additional information (SAI), and annual and semi-annual shareholder reports. The SAI includes detailed information on service provider contracts, investment policies, portfolio managers, controlling shareholders, and mutual fund officers and directors. Annual and semi-annual reports are published 60 days post mid- and full-year fiscal periods. These reports provide updated portfolio manager commentary, portfolio holdings, and key financial statements.

Beyond required regulatory documents, many mutual fund companies offer investors, prospective investors, and financial advisors an array of educational and promotional materials. These materials include portfolio manager commentary, thought-leadership whitepapers, and general market commentary. Typically, mutual fund investors can access all of the regulatory filings and other educational materials directly from mutual fund companies (in either print or electronic form), through financial advisors, from a variety of third-party industry participants (e.g. Morningstar), and from the SEC EDGAR regulatory filing database.

C. Structure Underlying the Total Expense Ratio

Strategic Insight's Simfund database allows us to segment total expense ratios into three buckets: (1) management fees (including fund administration), (2) distribution, sales, and marketing, and (3) other operating expenses which include, but are not limited to, transfer agency, custody, fund accounting, auditing, and legal services. The segmentation provides a transparent understanding of the components that make up a total expense ratio.

Management fees include both investment advisory services and fund administration. In the U.S., about 60% of mutual funds report both an investment advisory services fee and a fund administration fee, whereas the remaining 40% do not segment the two fees for financial reporting purposes. Investment advisory services are the dollar amounts paid by a mutual fund to the investment advisor for portfolio management and securities selection. Fund administration fees are the amounts paid by a mutual fund to the administrator for general oversight of the operations of a fund.

Distribution expenses primarily include 12b-1 distribution and service fees which are used to pay for sales-related expenses such as portions of financial advisor compensation and on-going sales support. According to an ICI survey, 63% of 12b-1 fees are used for compensating financial advisors for the sale of fund shares and related expenses, 32% are used for paying for expenses associated with administrative services provided to existing shareholders by third parties, and the remaining 5% are used for advertising and other sales-promotion activities. Note, as discussed earlier in this report, fund distributors are increasingly using share classes with little or no 12b-1 fees, as fees-for-service migrate completely outside the fund's embedded fee structure or stated total expense ratio.

Beyond collecting and passing the 12b-1 fees to their broker-dealer distributors, fund managers still assume the cost of marketing, as well as supporting and servicing distribution organizations. This cost is paid out of the managers' revenues and profits. Moreover, the rising costs of distribution support demanded today by many distributors mean that an even larger share of profits is used for marketing and related activity.

Other Operating expenses are the general business costs associated with supporting the operations of a mutual fund or costs mandated by regulations. Some of the most common expenses include transfer agency, custodian, audit, legal, fund accounting, and registration (disclosure of additional other operating expenses vary by fund family). Typically, the contracts underlying many of the service providers responsible for providing the above duties can be found in a fund's SAI. Within an annual report, the statement of operations also providers actual other operating expenses as paid out by a fund over the fiscal year.

The granularity of fund disclosure varies throughout the world, as governed by various regulatory regimes. In 2011, Strategic Insight analyzed European-domiciled mutual funds and compared them to U.S.-domiciled mutual funds. At times, the varying degrees of disclosure throughout the world make it difficult to compare, on an apple-to-apples basis, mutual fund fees and expenses. For instance and as highlighted above, U.S.-domiciled mutual funds face some of the most rigid reporting and regulatory requirements. U.S. investors have a significant amount of information at their fingertips. In the U.S., an investor can efficiently and quickly segment many of the fees and expenses that make up the total expense ratio.

In contrast, among European-domiciled mutual funds, the Annual Management Charges (an underlying component of Total Expense Ratio) include both management fees and payments made for fund distribution. Our research of European funds, based on non-public data provided by many of the leading fund managers in Europe, found that, after accounting for fees transferred to their distributors ("retrocessions"), retained management fees in Europe were not dissimilar to management fees in the U.S. Asset-weighted average net investment management fees in Europe were found to be only about three basis points greater than management fees in the U.S. (when excluding the three largest U.S. fund managers each managing $600 billion or more).

Asset-Weighted Average Embedded Fund Expenses in the U.S. vs. Europe
(actively managed stock and bond funds)

	Management Fee			Distribution Expense			Other Operating Expenses		
Fund Type	All U.S[1]	U.S. ex-Mega[2]	Europe[3]	All U.S[1]	U.S. ex-Mega[2]	Europe[3]	All U.S[1]	U.S. ex-Mega[2]	Europe[3]
Stock	0.63	0.72	0.74	0.33	0.34	0.73	0.17	0.17	0.28
Bond	0.45	0.46	0.49	0.32	0.31	0.47	0.14	0.15	0.21

Footnotes:
[1]Actively (non-index or non-ETF) managed open-end U.S.-domiciled mutual funds as of fiscal year-end 2011 excluding: funds that operate an "at-cost" business model or employ an "all-inclusive/unified" management fee structure.
[2]Actively (non-index or non-ETF) managed open-end U.S.-domiciled mutual funds as of fiscal year-end 2011 excluding: funds that operate an "at-cost" business model or employ an "all-inclusive/unified" management fee structure. Additionally, the data excludes three "mega" fund managers that collectively manage over $2.5 trillion.
[3]Data represents Includes over EUR 1 trillion in EU-domiciled equity and bond mutual funds as of year-end 2010.

D. Historical Trends

When viewing the U.S. mutual fund industry as one large investor portfolio, the underlying allocation changes from year to year and thus the "average" fee paid by investors is affected as well. Overall, industry aggregate fee statistics have been driven lower over time due to the economies of scale created by the growth of the U.S. mutual fund business. Additionally, the changing distribution trends discussed previously – such as the shift away from load bearing share classes to lower load or no-load share classes – has reduced total expense ratios (on average) paid by investors for mutual funds. While aggregate industry fees have trended downward for the past two decades, it is important to note that such a decline was experienced unevenly across investment categories.

As the table below suggests, there is a degree of year-over-year variability in aggregate fee statistics. The collapse of global stock prices in 2008 has caused an increase in Total Expense Ratios, especially for stock funds. It resulted in a dramatic contraction of the "average account size" (often falling by half). Thus costs that are paid in fixed "dollars per account" (such as transfer agent fees) experienced a doubling of their fee ratios at times. Such a spike was most evidenced in stock funds with a high share of very small accounts. These falling asset levels also triggered some management fee breakpoints to work "in reverse", while fixed dollars operating fees were allocated across a smaller asset base.

The recovery of stock prices since March 2009 has reversed many, but not all, of these rising-cost influences. The data below charts asset-weighted net total expense ratios (excluding distribution costs) for actively managed funds from 2007 to 2011 (note the declining aggregate fee levels experienced in 2010 and 2011).

Asset-Weighted Average Net Total Expenses; excluding Distribution fees (actively managed stock and bond funds)					
Investment Category	**2007**	**2008**	**2009**	**2010**	**2011**
Large Cap U.S. Equity	0.67	0.69	0.74	0.73	0.71
Small Cap U.S. Equity	0.95	0.96	1.06	0.99	0.97
Large Cap International. Equity	0.87	0.87	0.89	0.89	0.86
Intermediate Term Bond	0.52	0.52	0.53	0.52	0.51

Source: Strategic Insight Simfund MF

In comparing 2007 pre-crisis fee ratio data above to that of 2011, Large Cap U.S. Equity and Small Cap U.S. Equity fund fees have risen somewhat, whereas Large Cap International Equity and Intermediate Term Bond fund fees have slightly decreased. In addition to the explanations above, the persistent net redemptions among diversified U.S. funds in recent years – and the only partial recovery of stock prices since 2008 – have resulted in significantly lower aggregate assets in Large Cap and Small Cap U.S. Equity funds today than in 2007 – reversing the benefits of economies of scale. Conversely, the Intermediate Term Bond investment category has grown over 50% over the past five years. The increased economies of scale have contributed to slightly lower fees.

An important contributor to the declining Total Expense Ratios for the average U.S. fund investor (as measured through asset-weighted fee ratios) is the increasing share of no-load funds or no-load share classes (who increasingly carry zero 12b-1 fees) – which have come to dominate the U.S. mutual fund industry. Today, three-quarters of all stock and bond fund assets are held in no-load share classes, as suggested below.

No Load Share Classes as Percentage of Total Assets[1]					
	1995	**2000**	**2005**	**2010**	**6/2012**
No-Load	50%	56%	62%	72%	75%
Other (Front, Back, Level)	50%	44%	38%	28%	25%

Source: Strategic Insight Simfund MF

Footnotes:

[1]Total Assets for stock and bond open-end funds including open-end ETFs

The table confirms many of the new sales themes previously addressed in this paper such as the acceleration away from traditional point-of-sale loaded shares to "cleaner" no-load share classes. Looking ahead, we expect this trend to persist as financial advisors continue to migrate their client assets towards fee-based wrap advisory relationships (at Strategic Insight's annual client conference held in June one national broker-dealer executive commented that over 80% of net flows at his firm are going to advisory accounts which use no-load funds, while another noted that his firm was moving 3-5% of mutual fund assets each year from brokerage to advisory platforms). Elsewhere, increased disclosure requirements within the defined contribution retirement investment space are also accelerating the sales of lower-load and no-load share classes.

VI. Reflections on the Evolution of Mutual Fund Shareholder Cost in the U.S.: Transparency, Unbundling, Competitive Forces, Price Equilibrium

Today, more than three decades into the modern era of the U.S. mutual fund industry, nearly half of all U.S. households (and over 80% of wealthy households) invest in mutual funds. The acceptance of the mutual fund vehicle for savings and investments, income and capital accumulation, and retirement security has been reflected in the $1 trillion-plus net invested into bond and stock U.S. mutual funds since 2008's extraordinary crisis.

A large share of U.S. mutual fund investments is held in Defined Contribution (DC) retirement plans. Beyond their DC investments, it is generally believed that four in five mutual fund investors in the U.S. are assisted by a financial advisor (FA).

Over the past two decades, the way financial advisors are compensated for their advice, guidance, and monitoring has dramatically changed. In the 1980s and 1990s, most funds were sold individually, and most compensation to FAs took the form of point-of-sales payment for each such transaction.

In contrast, most of today's U.S. fund sales that are guided by a financial advisor are anchored in an asset allocation approach – in which a number of funds with complementary investment strategies are packaged together, offering a balanced overall portfolio (stock and bonds, U.S. and international exposure, long-only and non-market-correlated strategies, etc.). In parallel with the dominance of a portfolio construction framework, the compensation preferences of increasingly powerful broker dealers and other fund distributors in the U.S. have shifted significantly toward ongoing payments for advice over time (as opposed to at point-of-sale).

These and other marketplace forces have combined to spur the dominance of fee-based investment programs in the U.S. – commonly referred to as "Mutual Fund Advisory" or "Mutual Fund Wrap" programs. For their evaluation of each investor's needs, fund selection, on-going monitoring, and periodic rebalancing, financial advisors are paid largely over time, not at point-of-sales.

Such compensation, paid directly by the investor (and not through the mutual fund expense ratio), is generally based on assets under management and typically ranges from 1.00% to 1.50% of AUM annually (with the higher annual fees charged for smaller size accounts). These fee ratios were discussed in Chapter IV. While the average fee ratio for all accounts within such mutual fund advisory programs is estimated at 1.10% of assets annually (see data from Cerulli Associates in Chapter IV), the fee ratio charged to a portfolio of less than $100,000 (typical of the mutual fund investor's middle-income and middle-wealth profile) can be significantly higher.

These annually-charged fees of 1%+ are levied on top of the total expense ratios (TERs) of the funds held within the asset allocation package. Industrywide, Strategic Insight calculates that the TERs of actively-managed stock and bond funds – similar to those typically held within an asset allocation mutual fund wrap portfolio – average around

0.70% or higher (based on an asset-weighted TER calculation of all actively managed stock and bond funds, excluding Rule 12b-1 distribution fees). The simple averages and median TERs of such funds are each over 0.90%.

In sum, the total cost of mutual fund ownership among the large proportion of U.S. investors investing through a fee-based advisory program of "wrapped" actively managed mutual funds is typically comprised of:

- Fees of the underlying funds – typically ranging from 0.70-0.90% of assets and inclusive of investment management and administration costs, transfer agent fees, legally-mandated fees, etc. Such fees are disclosed in quite a standardized manner in the funds' prospectus and other documents and are easily benchmarked to other funds. (Note that a portion of the fees collected by the investment managers may be passed along to the distributor.)

- Fees externalized to the funds' TERs – typically averaging 1.10% annually, but ranging from 1.25% to 1.5% for portfolios of less than $250,000. Such fees are set based on the overall size of each investor's overall portfolio (not on the holdings of each individual fund within it) and are disclosed in a customized way to each investor. While transparency on the "external-to-TER" fees is provided to the individual investor, a comparison of the externalized fees charged and services provided by the different broker dealers or individual advisors in the marketplace is not easily available.

In totality, U.S. mutual fund shareholders' total annual costs within fee-based advisory programs amount to roughly 2% of asset under management. Importantly, however, as alluded to above, this total can often be higher for smaller investors.

A wide range of competitive market forces around investor preferences, product innovation, regulatory initiatives, fund distribution shifts, and pricing evolution have been key factors driving the U.S. fund industry's maturation to a $14 trillion marketplace. While investors access mutual funds through a variety of avenues in the U.S. (within retirement plans, via the assistance of financial advisors, on their own), fund engagement through financial advisors has evolved into a primarily fee-for-advice relationship structure. As such, the total cost of mutual fund ownership for a growing number of U.S. investors has also evolved – with regard to structure, timing, level, and tax implications.

Ultimately, the desire for professional financial advice continues to gain in emphasis among U.S. fund shareholders and many investors globally. Given the growing demand for such guidance, the U.S. mutual fund marketplace exemplifies how evolution of pricing mechanisms can enable access to advice across varying investor wealth and sophistication levels.