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ICI Study Examines Economies of Scale in Equity Mutual Funds, December 1999

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Washington, DC, December 21, 1999 - The Investment Company Institute, the national association of the American mutual fund industry, has released a new study that examines the relationship between assets of individual equity mutual funds and their operating expense ratios. The study found that operating expense ratios generally decline with asset growth and that large funds generally have significantly lower operating expense ratios than small funds.

The Institute's research found that 74 percent of a group of large equity mutual funds lowered their operating expense ratios as they grew to exceed $500 million in assets. These funds represent nearly three-quarters of all equity fund shareholder accounts and 71 percent of equity fund assets in 1998.

Institute research also found that large equity mutual funds have lower operating expense ratios than small equity funds. For example, equity funds that exceed $5 billion in assets have average operating expense ratios that are 50 percent lower than equity funds with assets of $250 million or less. It is important to note that even though the study examined average asset levels, many factors can cause operating expense ratios to vary from fund to fund.

"These and other findings support the conclusion that a substantial majority of equity fund shareholders appear to have benefited from economies of scale," Institute President Matthew P. Fink said. The term "economies of scale" refers to the expectation that the operating expense ratio of an individual mutual fund should decline as its assets increase. "It is important to remember that economies of scale should only be examined on a fund-by-fund basis rather than industry-wide," Fink said.

Fink noted that the new research, by Institute Vice President and Chief Economist John Rea, Assistant Vice President and Director of Industry and Financial Analysis Brian Reid and Senior Research Associate Kimberlee Millar, expands the Institute's previous examination of the downward trend in mutual fund fees and expenses. (See, for example, Mutual Fund Costs, 1980 - 1998.)

Perhaps the most significant aspect of the Institute's study results from a review of the complete expense history for 497 of the largest equity mutual funds, all of which had more than $500 million in assets at the end of 1998. For the entire group of 497 funds, the average decrease in the operating expense ratio was 26 basis points from 1.17 percent to

0.91 percent. The median decrease in the operating expense ratio was 16 basis points. The average decrease was 13 percent and the median decrease was 15 percent.

Of this group, 74 percent, or 368 funds, had lower operating expense ratios in 1998 than at the end of their first full year of operation, when they were significantly smaller in size. These reductions tended to be large. The average operating expense ratio for the funds in this group decreased by 40 basis points from 1.30 percent to 0.90 percent. The median decrease was 28 basis points. The average decrease was 28 percent and the median decrease was 25 percent.

Twenty-one percent, or 106 of the 497 equity funds that were examined, had higher operating expense ratios in 1998 than at the end of their first full year of operation. The study found that these increases tended to be modest, with the average operating expense ratio of the funds in this group increasing by 18 basis points, from 0.77 percent to 0.95 percent. The median increase was 10 basis points. The average increase was 33 percent and the median increase was 12 percent. Rea noted that funds in this group tended to have low initial operating expense ratios. In fact, nearly half of these funds had initial operating expense ratios in the lowest 20 percent of the group.

The study also found that the average operating expense ratio for funds with $5 billion or more in assets was 70 basis points in 1998, compared with an average of 139 basis points for funds with assets of $250 million or less. Fifty-one percent of shareholder accounts are in funds with assets of more than $5 billion, while funds with less than $250 million in assets represent 6 percent of shareholder accounts.

The Institute’s study focuses on the relationship between mutual fund assets and operating expenses, which consist of all fees and expenses relating to the management and administration of the fund. Operating expenses do not include sales loads paid by fund investors or rule 12b-1 fees. Rea explained that because both are primarily used to compensate sales professionals for advice and assistance given to buyers of fund shares, they are distinct from expenses arising from a fund’s investment management activities.

The Investment Company Institute is the national association of the investment company industry. Its members include mutual funds, closed-end funds and unit investment trusts.