

Canadian Mutual Fund Ownership Costs:
Competitive Relative to the U.S.
- Report -

September 2010

Published by Mackenzie Financial based on research conducted by a respected global consulting firm

Executive summary

The majority of investors purchase mutual funds with the assistance of an advisor in both Canada and the United States (U.S.). However, the calculation of expenses is very different between the two countries. Research done by Bain & Company, a leading global consulting firm, indicates that when an accurate comparison of advisor sold funds is made, mutual fund Cost of Ownership (COO) in Canada is very comparable to the U.S.

There are four key differences between the Canadian and U.S. mutual fund markets that must be controlled for when making comparisons between the Cost of Ownership for Canadian versus U.S. mutual funds:

Differences in product type and the need to exclude group mutual funds (e.g. U.S. 401k, Canadian defined contribution) with different advice models and service levels.

Differences in asset mix, such as a higher share of Fixed Income assets in the U.S., and the need to profile Cost of Ownership separately for each asset type to avoid inaccurate aggregate comparisons.

Differences in front-end load advisor compensation structure and the need to accurately measure all components of the Cost of Ownership including applicable sales taxes.

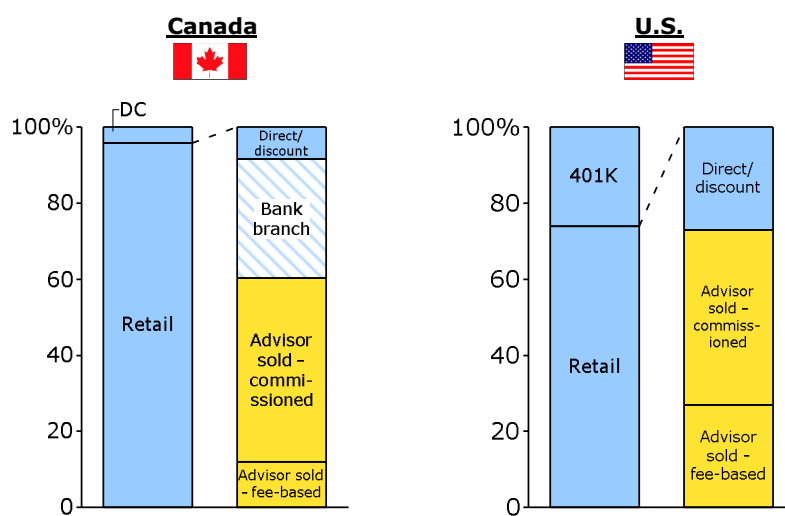
Differences in level of advice received by an investor and the need to properly compare purchase methods.

After controlling for these differences, the Canadian pre-tax COO of mutual funds is very similar to that of the U.S. for the large majority of Canadian investors. This majority purchases their mutual funds with the assistance of a financial advisor. The results are consistent across asset classes.

Most Investors in Canada and the U.S. Purchase Retail Mutual Funds with the Assistance of an Advisor

In the United States (U.S.), approximately 25% of mutual fund assets are invested through employer sponsored 401k plans. In Canada, this is far less prevalent, with employer sponsored defined contribution (DC) plans representing only 3% of the market (see table 1). As group plan products are not comparable to individually purchased products due to varying levels of advice and service, the analysis excludes group assets.

Table 1 – Mutual fund assets¹ by distribution method



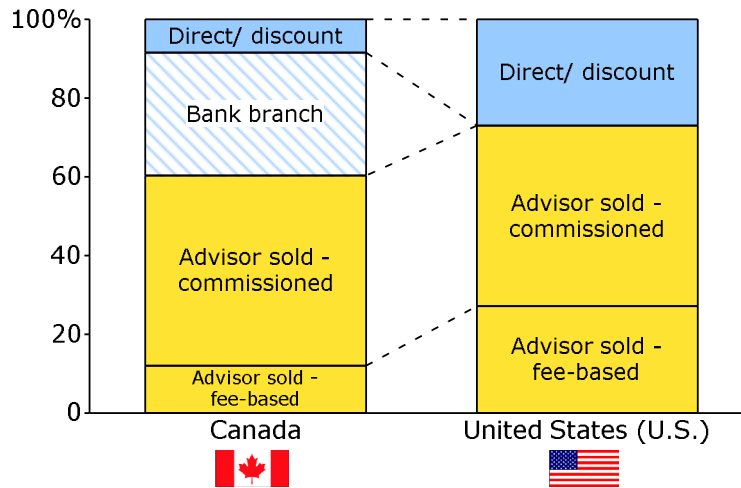
In both Canada and the U.S., advisors are a significant means of providing investors with assistance in purchasing and managing their mutual funds. For comparability, this analysis focuses on funds sold by financial advisors² (see table 2).

¹ U.S. data excludes Money Market funds

² Financial advisors includes traditional independent planners and brokers

Source (table 1): Investor Economics, ICI, Cerulli

Table 2 - Retail mutual fund assets³ by distribution method (excl. group plan/ 401k assets)



In the U.S., direct/ discount complexes, such as Vanguard and Fidelity, have large scale efficiencies. Both firms manage greater than \$500B in mutual fund assets, and including index funds and exchange-traded funds they manage over \$1T and \$700B in assets, respectively. With significant scale and no advisor compensation paid, the cost of mutual funds sold direct/ discount is much lower than advisor sold funds.

In Canada, the 31% of assets distributed by the banks offer a hybrid of the direct and advice approaches.

Due to structural differences in advice received and compensation paid by the investor, direct and bank complexes have been removed from this analysis.

Approach: Building an “Apples to Apples” Comparison

In order to build a Cost of Ownership comparison, it was important to collect fee data from a wide selection of managers and asset classes. Through Simfund, FINRA, Morningstar, Globefund, and fund prospectuses, fee data was collected for the largest advisor sold funds⁴ from each of the largest 30 managers in the U.S. and the largest 16 managers in Canada for each of 10 major asset classes, excluding Money Market Funds. This approach resulted in a database of over 1,000 U.S. mutual funds and over 350 Canadian mutual funds with assets that represent approximately 80% of their respective, relevant mutual fund markets. The 20% of the relevant

³ U.S. data excludes Money Market funds

⁴ Largest funds defined as up to the top four funds by assets for each manager within each of the CIFSC asset categories

Source (table 2): Investor Economics, ICI, Cerulli

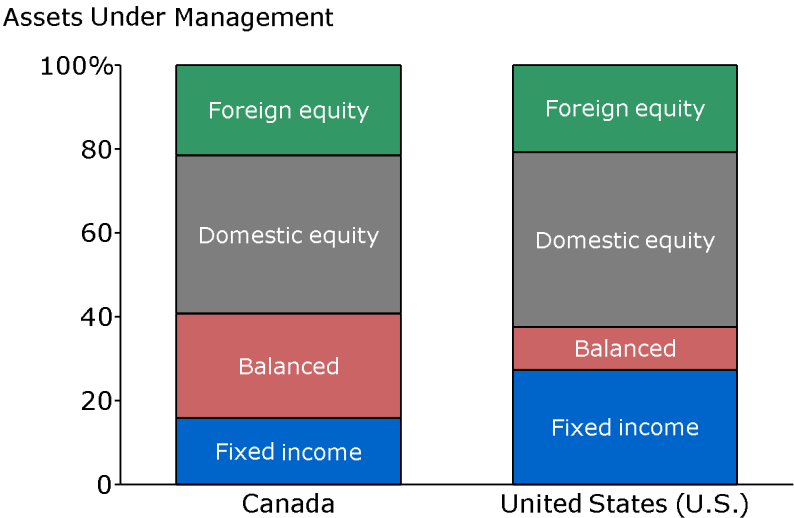
market that has not been included in the analysis includes smaller funds offered by complexes examined and all funds from complexes outside of the size threshold defined above. It is important to note that adding these smaller funds or smaller companies back into the analysis would not be expected to materially decrease the COO in the U.S., or increase it in Canada.

Fee data was then weighted by assets in order to create average COO figures by asset class. Unless otherwise stated, front-end load charges have been amortized over a five-year holding period in order to represent more accurately the correct cost of distribution in the United States. Finally, redemption fees were added into the COO for Canadian mutual funds to reflect the higher penetration of back-end load assets.

“Apples to Apples” Comparison of Mutual Fund Cost of Ownership (COO) between Canada and the U.S.

Aside from Money Market Funds, virtually all Canadian mutual funds fall into one of four categories: Domestic Equity, International Equity, Balanced, and Fixed Income. Due to differences in the asset mix between countries (see table 3), which could distort aggregate comparisons, this analysis compares each of these four major asset classes separately.

Table 3 – Share of mutual fund assets by product type⁵

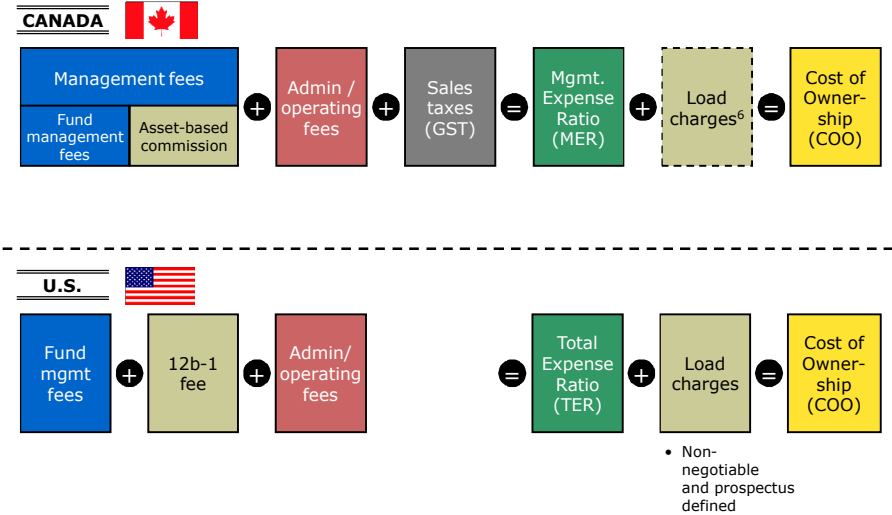


Cost of Ownership reflects two types of costs: the cost of managing and administering mutual funds and the cost associated with distribution. The popularly referenced metrics of mutual fund pricing, the expense ratio, is not a comparable measure of the Cost of Ownership for a mutual fund between Canada and the United States. Although the fees paid to mutual fund manufacturers (management and administration fees) are most often reported similarly inside

⁵ Table 3 excludes Index Funds and Money Market mutual funds
 Source (table 3): Investor Economics; Cerulli; Simfund

the expense ratio, commission based advisor compensation is generally reported and structured differently across the two countries and across different load types. Table 4 provides a visual comparison of the various components in each country that need to be considered:

Table 4 – Canada versus U.S. Cost of Ownership (COO), commission-sold example



1. Differences in front-end advisor load charges (U.S.)

In both countries, front-end load structures are the most commonly sold mutual funds. For these funds, in Canada, dealer and advisor compensation is generally included in the expense ratio in the form of annual compensation equal to 1% of assets. Although Canadian fund prospectuses also allow for the charging of front-end load charges, they are stated as negotiable in Canadian prospectuses and are waived ~95% of the time. For the small percentage of the time front-end load charges are charged, the amount is typically 2% or less.⁷

In the U.S., front-end load charges are non-negotiable and fund managers must include commission schedules in fund prospectuses.⁸ Therefore, U.S. advisors receive compensation through a combination of 12b-1 fees, which fund managers report inside the expense ratio, and through the load charges, which are reported outside. In order to compare the true cost of owning a mutual fund in Canada versus in the U.S., the COO of mutual funds (not simply the expense ratios) must be compared, which is the sum of ongoing compensation and amortized load charges. This allows the analysis to be indifferent to the structure of advisor compensation.

⁶ Load charges refer to commission paid by the investor to an advisor to purchase a front-end fund; refer to redemption fees for back-end funds.

⁷ IFIC: The Investment Funds Institute of Canada; industry experience

⁸ Although U.S. front-end load charges are non-negotiable when sold by an advisor, they may be waived when sold through discount brokerages or managed programs with advisor fees charged outside of the fund

Source (table 4): IFIC; Morningstar; Globefund; Fund Documents

In Canada, the average annual compensation for standard domestic equity funds is ~1% of assets.⁹ Since this is sufficient for dealers to pay their advisors, advisors waive upfront load charges the majority of the time, as discussed above. In the U.S., the most comparable fee to this Canadian compensation is the 12b-1 fee, which U.S. prospectuses report similarly – inside the expense ratio. However, the average 12b-1 fee for standard domestic equity front-end load funds is only ~0.25%¹⁰, which does not support sufficient advisor compensation on its own. In order to earn sufficient compensation, U.S. advisors charge front-end load charges as specified in fund prospectuses. It is important to note that these do not get included inside of the expense ratio. Due to this, U.S. expense ratios are not comparable to Canadian ones, and the expense ratio is not an accurate measure of the true COO of U.S. mutual funds.

Front-end load charges typically range from 4.25-5.75% for equity funds¹¹ (see table 5), and can be added to the expense ratio by amortizing them over the holding period of the investment. For example, the amortization of a 5% front-end load charge can raise standard expense ratio for U.S. domestic equity funds by ~0.70% to ~1.00%, using a five-year holding period.

Table 5 - Example front load sales commission schedules

Equity				
Example fund manager	\$0-25K	\$25-50K	\$50-100K	\$100-250K
American Funds	5.75%	5.00%	4.50%	3.50%
Oppenheimer	5.75%	5.50%	4.75%	3.75%
AllianceBerstein	4.25%	4.25%	4.25%	3.25%
Putnam	5.75%	5.75%	4.50%	3.50%
Van Kampen	5.50%	5.50%	4.50%	2.50%

There is some variance in the U.S. average holding period found in available data and published journals (see table 6).

⁹ Fund prospectuses

¹⁰ Simfund

¹¹ Fund prospectuses; FINRA: Financial Industry Regulatory Authority
Source (table 5): FINRA; Fund Prospectuses

Table 6 – Example holding period data

Source	Date of publication	Stated average U.S. holding period	Methodology
DALBAR	2006	4.3 years (Eq.) 3.4 years (FI)	Calculated based on redemption rates
DALBAR	2010	3.2 years (Eq.) 3.2 years (FI)	Calculated based on redemption rates
Mackenzie affiliate experience	2009	5-years	Calculated based on redemption rates
MarketWatch	2009	3-years	Not disclosed
Financial Times	2010	4-years	Not disclosed
Milestone Investment Counsel	2003	3-years	Sourced from DALBAR

The majority of references available source DALBAR, which reports a 4.3 year holding period for equity funds and a 3.4 year holding period for income funds¹². This is slightly lower than Mackenzie affiliate internal experience of five years¹³. To remain conservative and ensure comparability of addressable distribution methods, the longer value was used in the analysis.

On a related note, in both Canada and in the U.S. investors may choose to invest through an advisor in a fee-based account. In these cases, the compensation to the dealer and advisor is not included inside the expense ratio in Canada or the U.S. To understand the true COO for investing through fee-based accounts, it is important to add the fixed fee-based amount (typically 1% in Canada¹⁴) to the expense ratio of the investor's fee-based mutual funds.

2. Deferred Sales Commission Charges (Canada)

In Canada, a back load or deferred sales charge option is also available to investors. However, there is not a comparable U.S. product, as advisors have little usage of back load funds in the United States¹⁵. The U.S. back load assets represent a small proportion (<5%¹⁶) of the U.S. market. In Canada, prospectuses define management fees and expense ratios by fund and by series, independent of load structure. Back load funds have almost the same cost to the investor

¹² DALBAR Quantitative Analysis of Investor Behavior, Advisor Edition; 2006; Bob Stowe

¹³ Mackenzie U.S. affiliate data; controls for long-term, non-proprietary mutual funds from 2005-2009

¹⁴ IFIC: The Investment Funds Institute of Canada

¹⁵ Back load funds have had net outflows for each of the past eight years (ICI Factbook 2009)

¹⁶ Simfund

as front load funds in the majority of Canadian complexes.¹⁷ The one incremental cost to back load funds is a redemption fee, which is charged to investors who exit a fund family before the stated holding requirement. It is important to note that at most complexes, investors may change funds and avoid the redemption fee so long as they remain within their original fund family. The typical fund family includes a broad selection of funds. Additionally, the majority of Canadian complexes allow investors to redeem 10% of back-end load assets free of charge each year. Consequently, the redemption fee is immaterial to Canadian COO at 0.03%.

3. The application of sales tax (Canada)

Unlike most consumer products in Canada, which tend to advertise prices pre-tax, Canadian expense ratios contain embedded value added sales taxes. Expense ratios in the U.S. do not include any taxes, as mutual funds are not subject to sales tax in the U.S. This factor alone can increase the cost of owning mutual funds by approximately 0.10%¹⁸ in Canada. The introduction of HST in Canada will further increase COO by another 0.10%. It is, therefore, important to compare both the pre and post tax COO of mutual funds between Canada and the U.S.

Results

Given the above findings, it is evident that four stipulations should be considered before comparing the Cost of Ownership (COO) for mutual funds in Canada versus in the United States (U.S.):

- Identify the difference in asset class mix between Canada and the U.S. and profile Cost of Ownership separately for each major asset class.
- Understand the differences in front-end load advisor compensation structure to accurately compare the COO of mutual funds (instead of expense ratios) with amortized U.S. load charges.
- Include deferred sales commission (DSC) funds in Canada and adjust COO for redemption fees.
- Recognize sales tax implications in Canada and compare the costs of mutual funds pre and post tax.

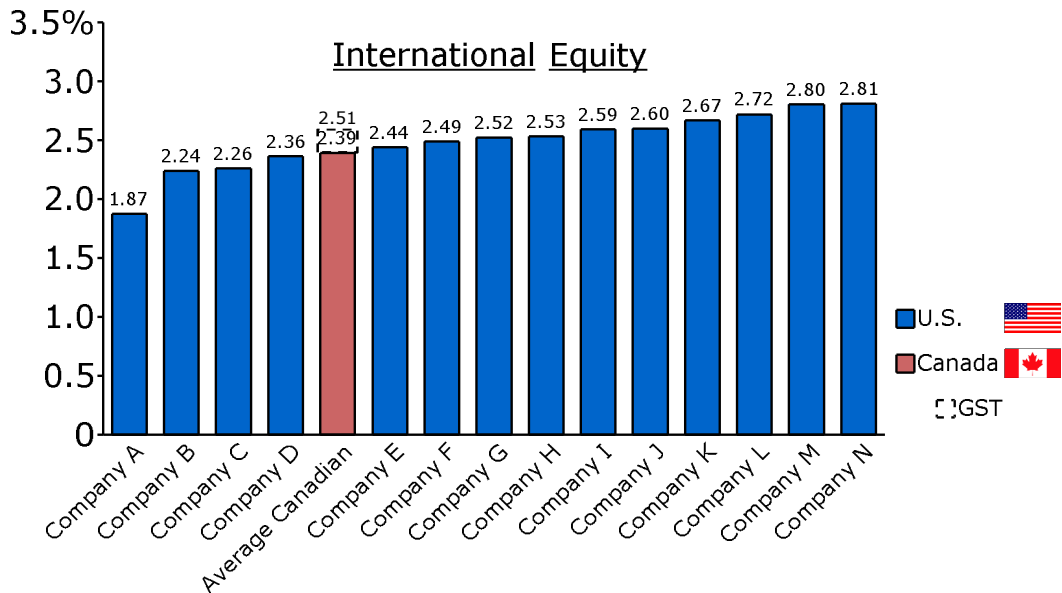
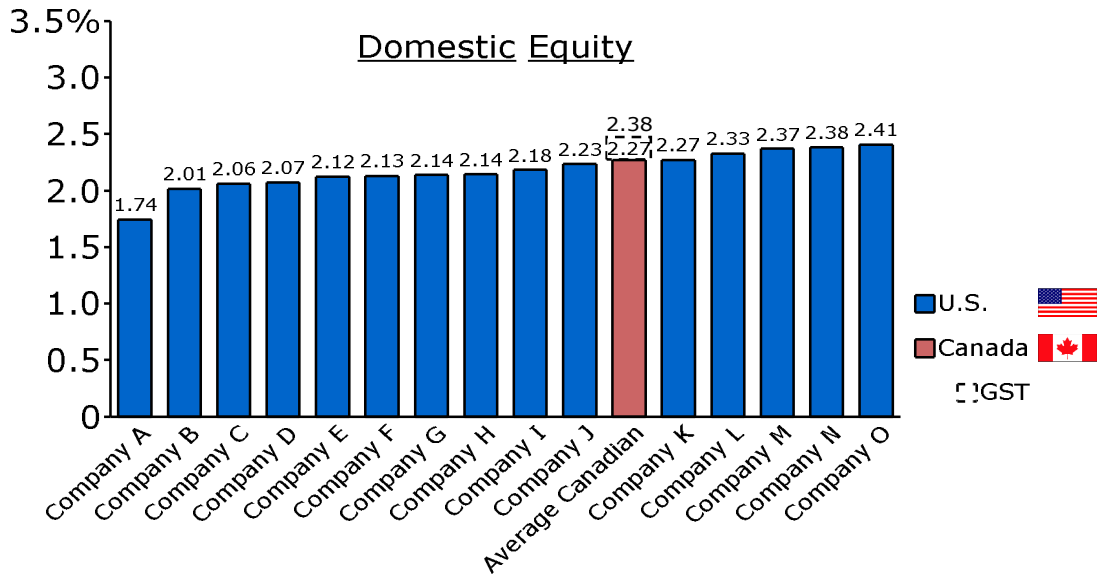
After controlling for these factors, it is evident that the vast majority of investors in Canada and the U.S. incur a comparable Cost of Ownership¹⁹ (COO) when purchasing mutual funds with the assistance of an advisor. This is illustrated in table 7, which shows mutual fund COO for 15 of the largest U.S. fund managers, excluding those whose funds are sold primarily direct. For each of the major mutual fund categories (Domestic Equity, International Equity, Balanced, Fixed Income), the average Canadian pre-GST COO falls within the range of U.S. managers.

¹⁷ The majority of Canadian complexes offer an optional load retail series which allows the investor to choose their preferred series. A minority (eg. Fidelity, Investors Group) separates retail series by load

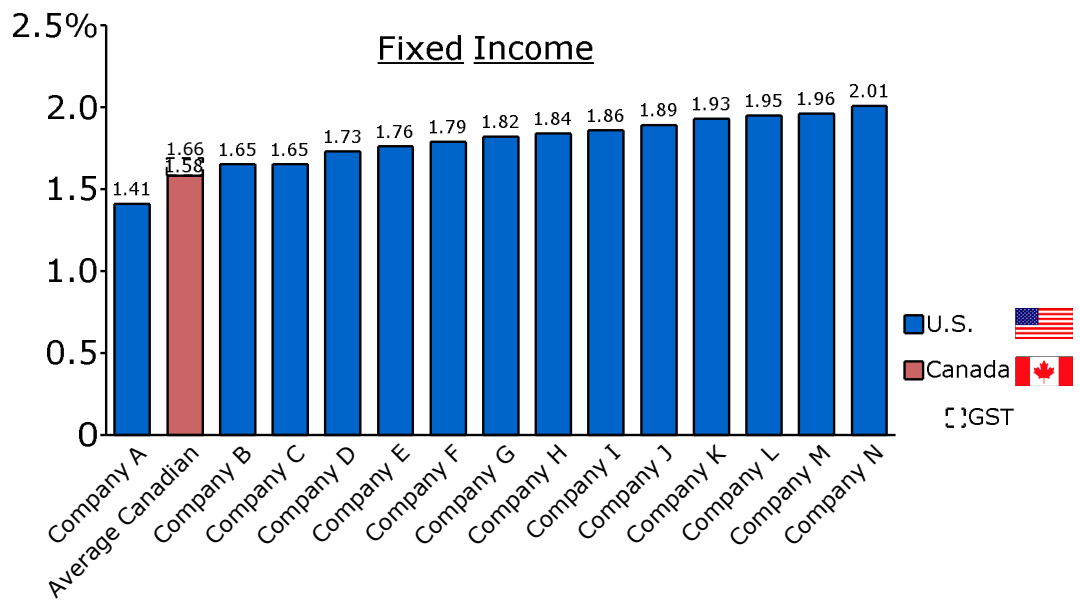
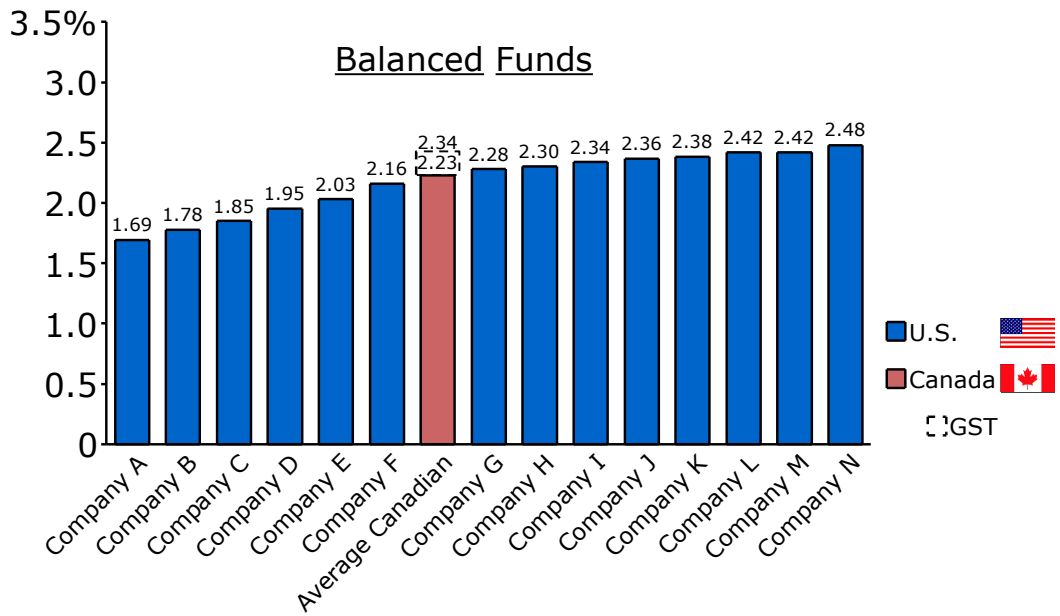
¹⁸ Canadian GST rate of 5% applied to mutual fund fees

¹⁹ Investors with <\$100K in assets with a given fund company represents ~95%+ of Canadian mutual fund accounts (industry experience)

Table 7 – Cost of Ownership for front load advisor sold mutual funds by manager²⁰ (\$0-100K account size)



²⁰ U.S. managers labelled company A through O; letters given to a specific manager may not be consistent between graphs



Other Methods of Fund Distribution

As discussed earlier, direct / discount funds are more prominent in the United States (representing ~30% of assets) – led by two significant scale players, Vanguard and Fidelity. In Canada, direct and discount funds represent only 8% of the total mutual fund assets. Investors purchasing funds in this way, without a financial advisor, do experience lower COO in the U.S. than in Canada. This is due to the fact that U.S. direct complexes do not include compensation to the advisor, whereas similar Canadian complexes typically do. The Canadian market has an additional distribution method in the banks, which represent 31% of assets and offers a hybrid of the direct and advice approaches.

Summary of conclusions

The majority of Canadians seek advice and have competitive costs versus investors in the U.S. for advisor sold funds. After controlling for structural differences between the two countries, including advisor compensation structure, back-end load penetration, and government imposed sales tax, it is possible to make valid comparisons between the COO of mutual funds in both countries (see table 7). As illustrated, the vast majority of Canadian investors fare well across all asset types when compared to their U.S. peers.

List of U.S. Fund Companies Shown in Table 7

Summary of complexes profiled in Table 7²¹

U.S. Complex	Mutual Fund Assets (\$B)
AllianceBernstein	64.4
American Century	63.5
American Funds	914.3
Eaton Vance	62.1
Franklin Templeton	284.8
Invesco	43.9
Legg Mason	62.2
Lord Abbett	50.8
MFS	68.6
Oppenheimer	123.2
PIMCO	348.2
Putnam	49.3
Riversource	45.6
Van Kampen	53.5
Waddell & Reed	54.6

²¹ Mutual fund assets given are as of December 2009
Source (U.S. fund companies data table): Simfund

References

Mutual Fund Fees Around the World; 2007; A. Khorana, H. Servaes, P. Tufano

Global Fund Investor Experience; Morningstar; 2009; J. Rekenhaller, M. Swartzentruber, C. Sin-Yi Tsai

Canadian databases and industry associations:

- Globefund
- IFIC: The Investment Funds Institute of Canada
- Investor Economics
- Morningstar
- Sedar

U.S. databases and industry associations:

- Cerulli
- FINRA: Financial Industry Regulatory Authority
- ICI: Investment Company Institute
- Morningstar
- Simfund

Reports specific to each fund manager:

- Prospectuses
- Manager reports on fund performance
- Annual information forms