MFDF

MUTUAL FUND DIRECTORS FORUM

2023 Investment Firm Profitability and Director Oversight

Today's Speakers

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Agenda

- Profitability Oversight Directive and Guidance
- Resulting Standard Profitability Practices During the 15(c) Process
  - Evolution of Standard Practices
  - Benchmarking Profitability
  - 2023 Asset Management Profitability Analysis
- Practical Application of Profitability Analysis
- Profitability and Economies of Scale

Profitability Oversight Directive

Profitability Oversight Directive

A number of courts have addressed a board's consideration of profitability

- Under *Gartenberg*, an advisory fee must not be so disproportionately large that it bears no reasonable relationship to the services provided to a fund by an adviser
- It must not be so excessive that it could not reflect the results of arm's length bargaining
- In this context, no court has found profitability of an adviser to be excessive; conversely, no court has found that a specific level of profitability is *per se* permissible
- This does not mean, however, that a profit margin could <u>never</u> be excessive
- Importantly, the courts have suggested that high profits earned by an adviser are not necessarily indicative of an excessive fee
- There are no guidelines or generally accepted accounting principles related to profitability calculations, except that (however calculated) profitability should be presented to exclude marketing and distribution

Guidance Available to the Board

- Courts consistently emphasize the need for boards to engage in a vigorous process for reviewing an adviser’s compensation
- If a board can demonstrate such a process, its approval of an advisory contract is entitled to “considerable weight”
- EXAMS Staff routinely review board minutes to determine a board’s level of involvement
- The Staff seeks to ensure that boards are not “rubber-stamping” matters put in front of them
- Staff examiners may seek to speak with individual trustees in certain instances

Understanding the Objectives of Analyzing Fund Profitability

- There is **<u>no</u>** target margin for profitability margins
- High profits are not necessarily indicative of an excessive fee
- Section 36(b) does not create a duty that advisers receive the lowest possible fee amount as compensation for the services they provide (*Goodman v. JP Morgan*)
- When adopting Section 36(b), Congress considered that an adviser is entitled to make a fair profit; a "cost-plus" contract is not intended (1970 Senate Report)
- Consideration of the profitability of the adviser and the costs incurred by the adviser is only one of the *Gartenberg* factors
- Higher profit margins can be justified based on the quality of services provided by a highly qualified and conscientious adviser (*Schuyt*)

Resulting Standard Profitability Practices

Standard Profitability Practices

Common practices include:

- The methodology for calculating an adviser’s profitability
  - Creating a methodology that is logical considering the adviser’s business operations
  - While there is no “right way” to calculate profitability, a documented methodology to calculate profitability should be discussed with and understood by the board
  - The methodology should generally be consistent from year-to-year; documenting any changes
- A record of a robust board discussion in board minutes regarding the board’s consideration of this factor, including discussions with management and requesting further information and asking follow-up questions

Standard Materials

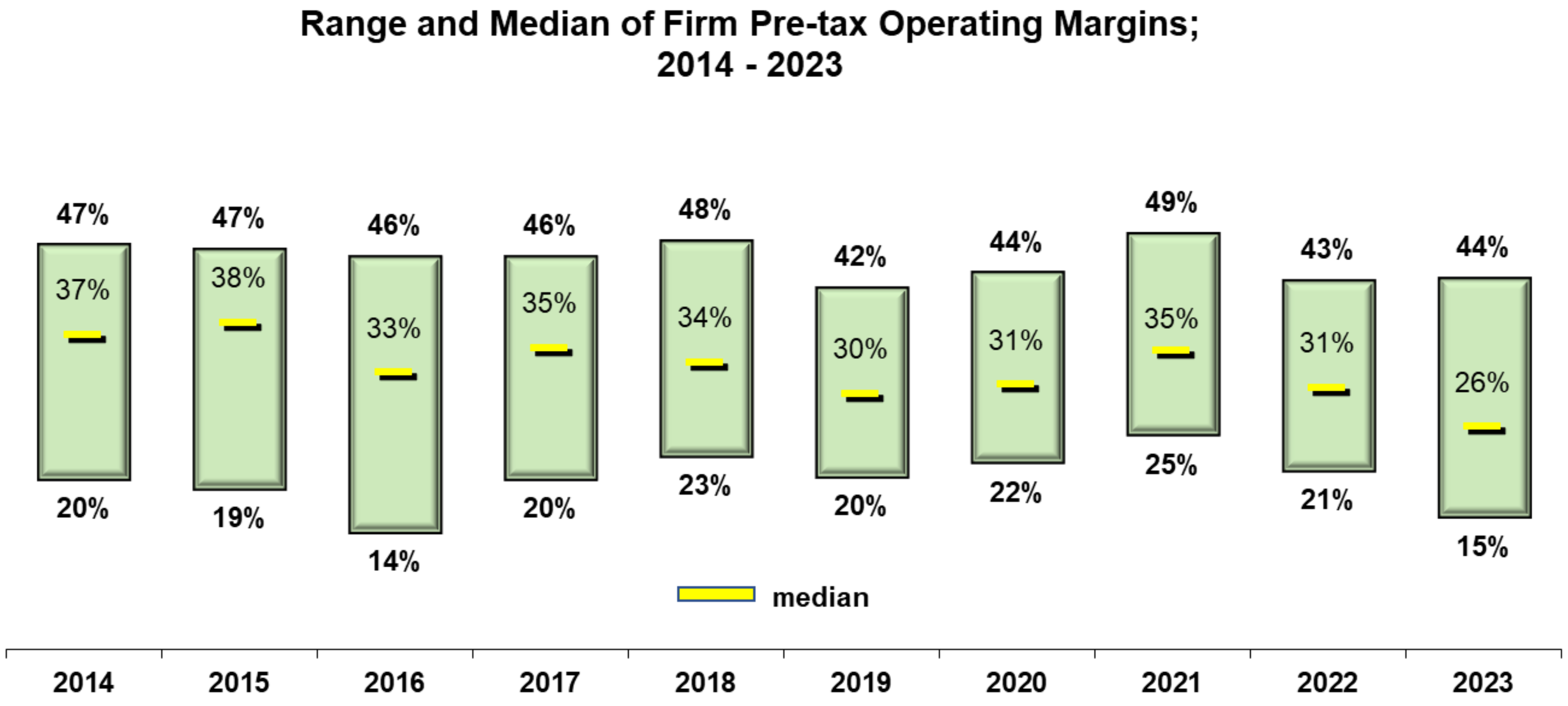
Materials provided to trustees have become more standard:

- Profitability margin calculations for the following:
  - Fund-by-fund advisory margins
  - Fund profitability including all business operations (not only advisory)
  - Product level profitability (mutual fund vs. institutional products, etc.)
  - Firm level profitability

- Trending profitability
- Management discussion of significant changes in methodology or profitability, as well as outliers
- Available benchmarks to facilitate discussion

2023 Asset Management Profitability Analysis

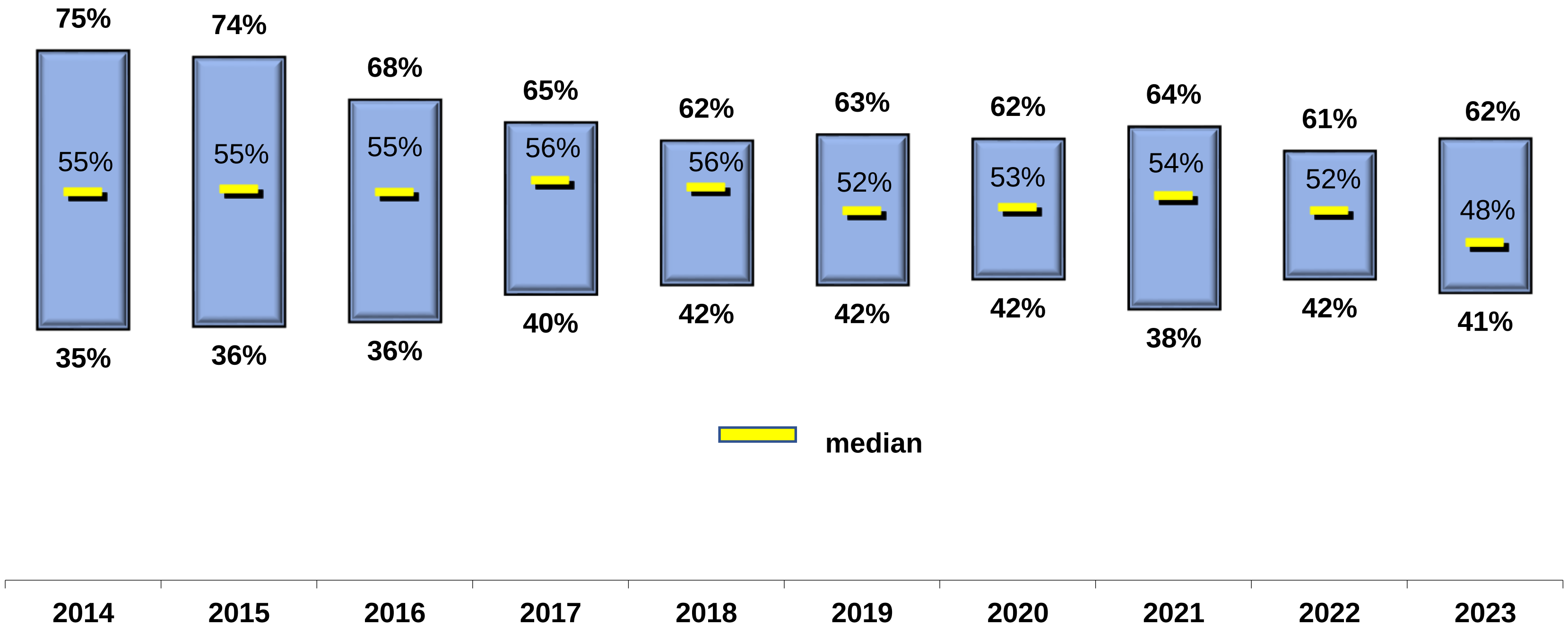
Pre-tax Operating Margins of Publicly-reported Firms Significantly Engaged in Investment Management



16 selected companies in 2023 meet current and historical requirements for comparability

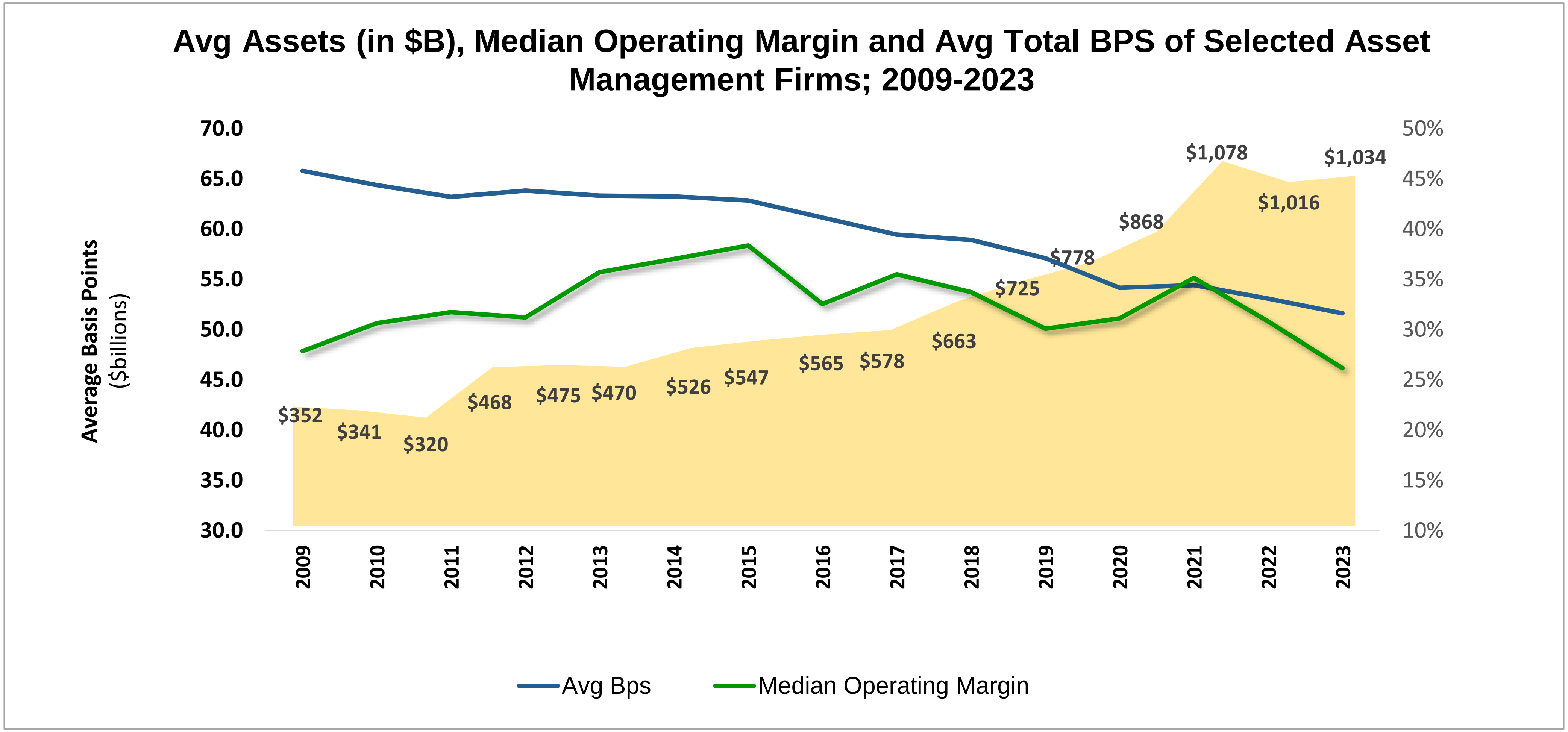
Summary of Estimated Pre-tax Operating Margin from **Advisory Activities** of Selected Publicly-reported Companies

Range and Median of Advisory Channel Pre-tax Operating Margins; 2014 - 2023



16 selected companies in 2022 meet current and historical requirements for comparability

Margin and Asset Trends

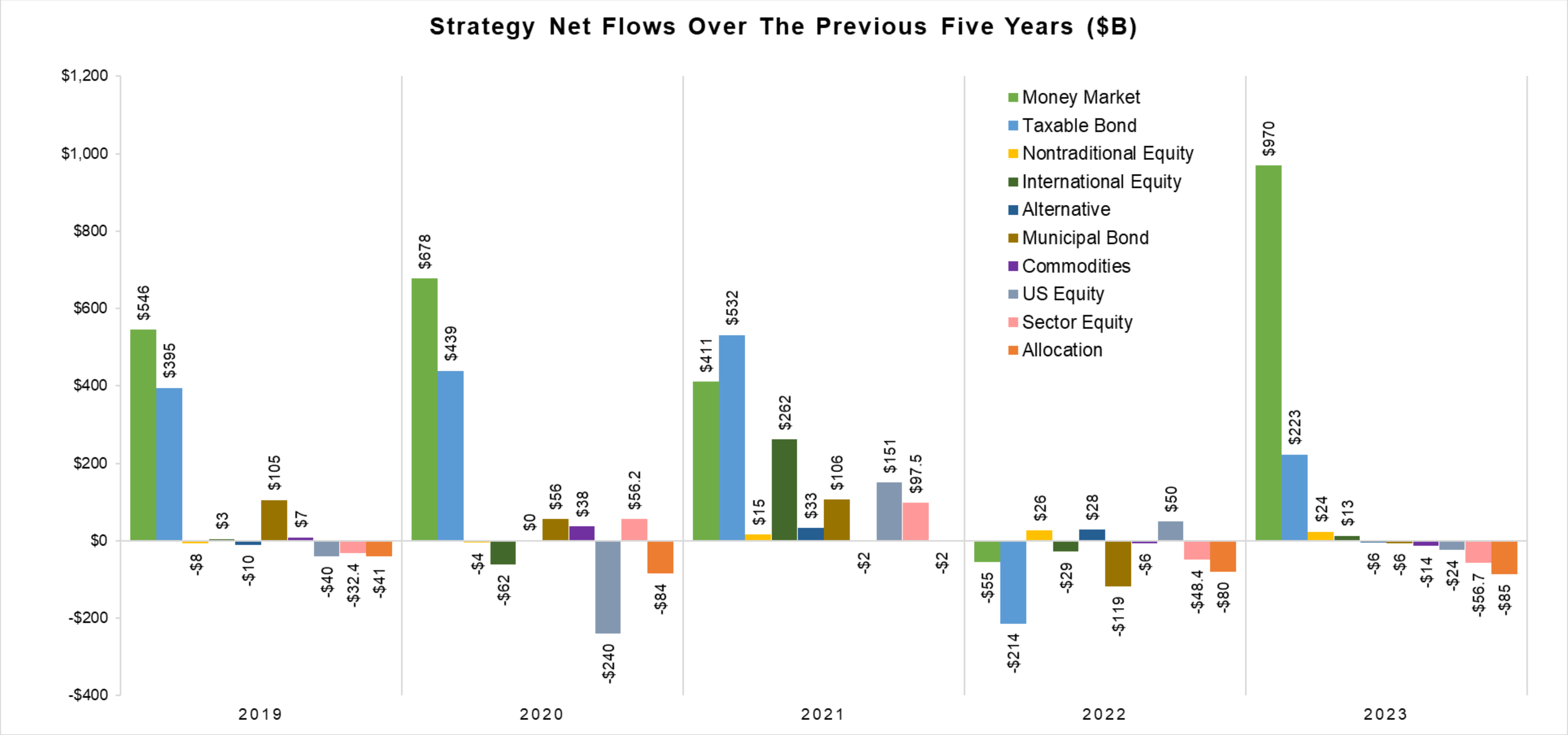


Declining Average Basis Points Fees

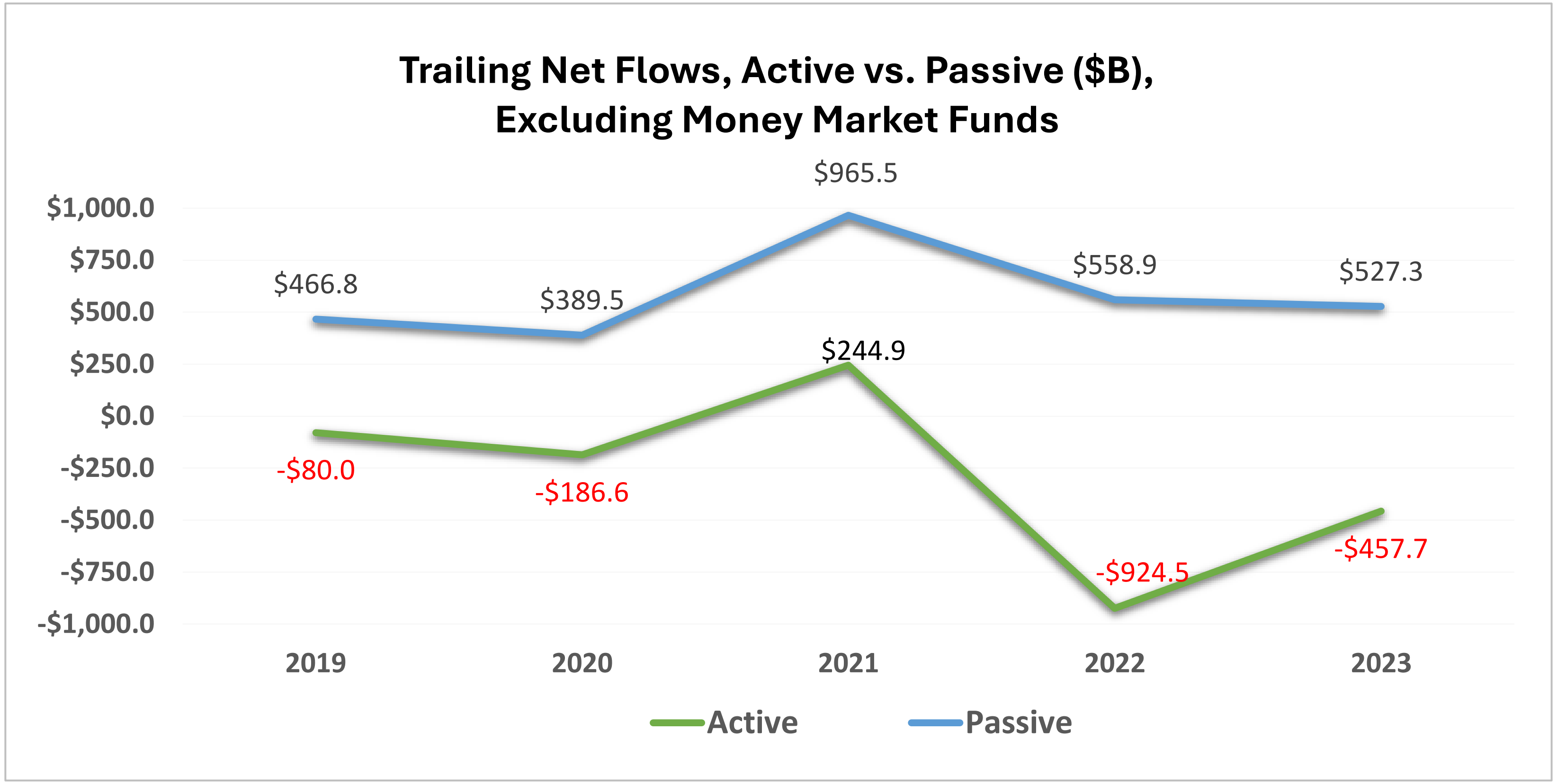
From 2014 to 2023, the sample firms' average bps collected as advisory fees decreased from 63 to 52; a decline of 17% in ten years.

- Influences on declining average fees over the years, 2023 was impacted more by some of these factors than others
  - Reduced fees for competitive pricing
  - Offering low and no-fee products
  - Product demand:
    - Strategy
    - Active vs. passive
    - Channel (retail, high net worth, institutional)
    - Distribution type
    - Lower cost share classes

Open-end Fund and ETF Product Demand



Actively and Passively Managed Product Demand



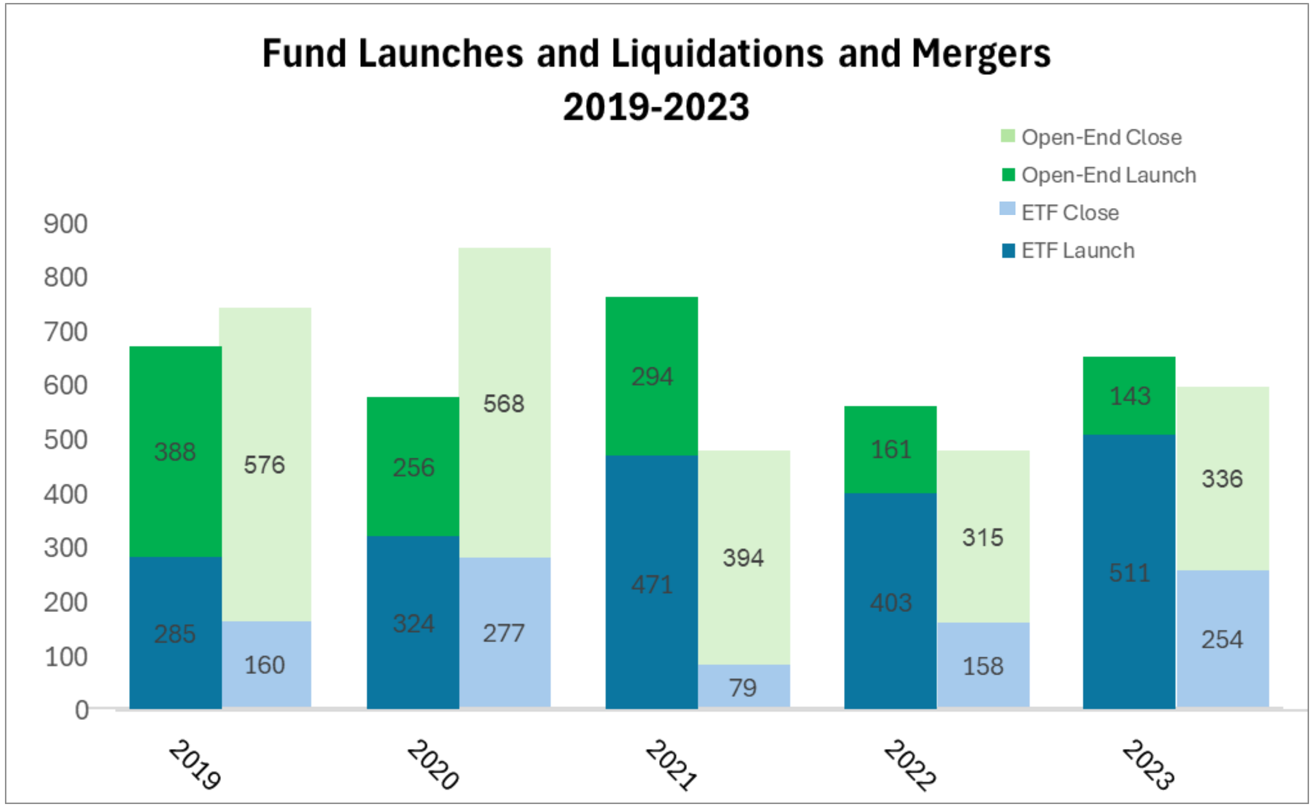
Expenses Influencing Margins

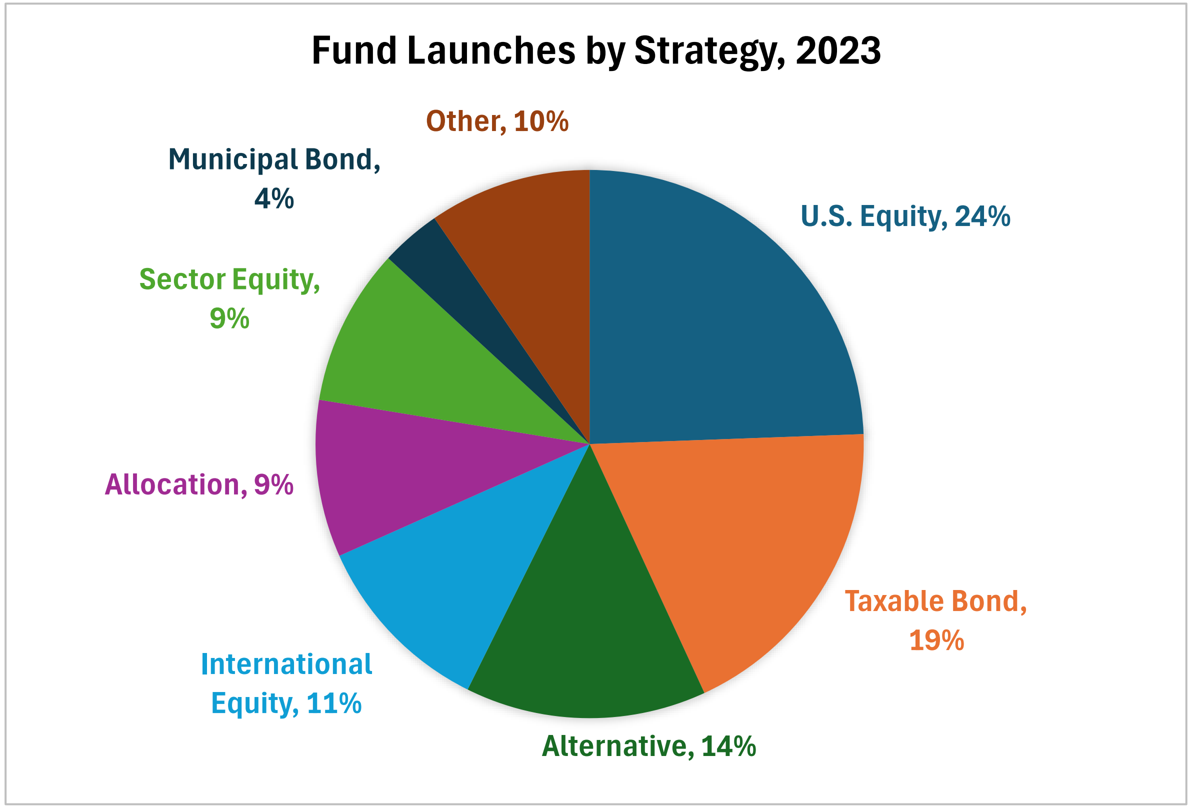
2023 expense trends further impacting margins:

- Compensation
  - Sample firms' compensation as a percentage of revenue increased from 38% in 2022 to 41% in 2023:
    - Base compensation and benefits related to inflation and headcount increases
    - Increases in compensation of legal and compliance related to new and changing SEC requirements (e.g., Tailored Shareholder Reporting)
    - Variable compensation decreased with revenue, but often not at the same rate because of market performance
    - Variable expenses related to asset and revenue declines: sales and investment compensation and distribution expenses
- Increases in travel and marketing
- Investments in business:
  - Technology related to cybersecurity and regulatory requirements
  - Adding specialty investment capabilities – through acquisition or development of internal investment capabilities
  - New product offerings

Trends in New Product Launches

- Open-end fund and ETF launches increased in 2023, with targeted products and strategies





Practical Application of Profitability Analysis

How Profitability Can Be Useful

Fund-by-fund profitability, without context, is not informative and therefore, at times has been dismissed

The practical application of fund-by-fund profitability can be useful in the following applications:

- Providing insight to direct and indirect (allocated) fund expenses
- Helping assess appropriate fees
  - Determining the level of AUM at which funds become profitable
  - Understanding the implication of necessary waivers or reimbursements to maintain desired expense ratios
  - Clarifies the profitability ranges between product type and strategy because of drivers such as average basis point fees and expenses
  - Assists in assessing economies of and sharing in scale
- Including profitability in proposed new funds to set expectations
- Comparing newly launched funds to AUM and profitability goals to aid in success discussions
- Highlighting unprofitable funds and any need for action plans
- Trending profitability can highlight:
  - Sensitivity to AUM changes and the volatility in AUM for specific funds
  - Any material change in profitability in products between years and the logic underlying those changes
  - Significant changes in expenses

Beyond Fund-by-Fund Profitability

While not the *Gartenberg* directive, expanding the profitability analysis beyond the advisory contract can provide a board with deeper insight

This information often includes the following:

- Fund profitability including all business operations (not only advisory) which highlights:
  - The need for waivers or reimbursements to maintain desired expense ratios
  - Both dollar and margin presentations show the director the impact of the profits, providing better context
- Channel level profitability (mutual fund vs. institutional products, etc.) that provides:
  - Adviser's business channel materiality and expense allocation
  - Information on comparative productive fees and profitability
- Firm level profitability which highlights:
  - Ability for the adviser to provide needed legal, compliance and operations staff to the funds
  - Potential for reinvestment in business
  - Financial stability of the adviser

Profitability and Economies of Scale

Future Growth of Existing Products

Because of 2023 market performance and timing, average AUM of many funds and firms may have been relatively flat

Most year-end assets were much higher, and looking forward, boards may be assessing economies of scale and sharing scale with the investor

As a result of 2023 market performance:

- 65% of funds' ending AUM (excluding money market funds) grew between 12/31/2022 and 12/31/2023
- The median of a fund's AUM growth was 8%
- AUM may have continued to grow in the 1st quarter of 2024

Discussions that surface reviewing profitability in relation to growth:

- As assets grow, how is the corresponding profitability responding, and why?
- Typically, won't be an equivalent % increase in profits
- Understanding what is a variable vs. fixed component of expenses
- Are fund expenses decreasing with AUM growth
- Are decreasing expense ratios a result of breakpoints on advisory fees or non-advisory fixed expenses
- What are changes in fund expense ratios vs. firm profits

Assessing Economies of Scale

Approaches to Sharing Economies of Scale:

- Breakpoints in the advisory fee schedule
- Breakpoints in administrative fees as an alternative or in addition to advisory fee breakpoints
- Reduction in non-advisory expense with growth in assets; certain fund expenses are semi-fixed, and as assets grow, the trustees should see a reduction in basis point fee charges
- Renegotiating administrative expenses with growth and leverage (transfer agent, custodial etc.)

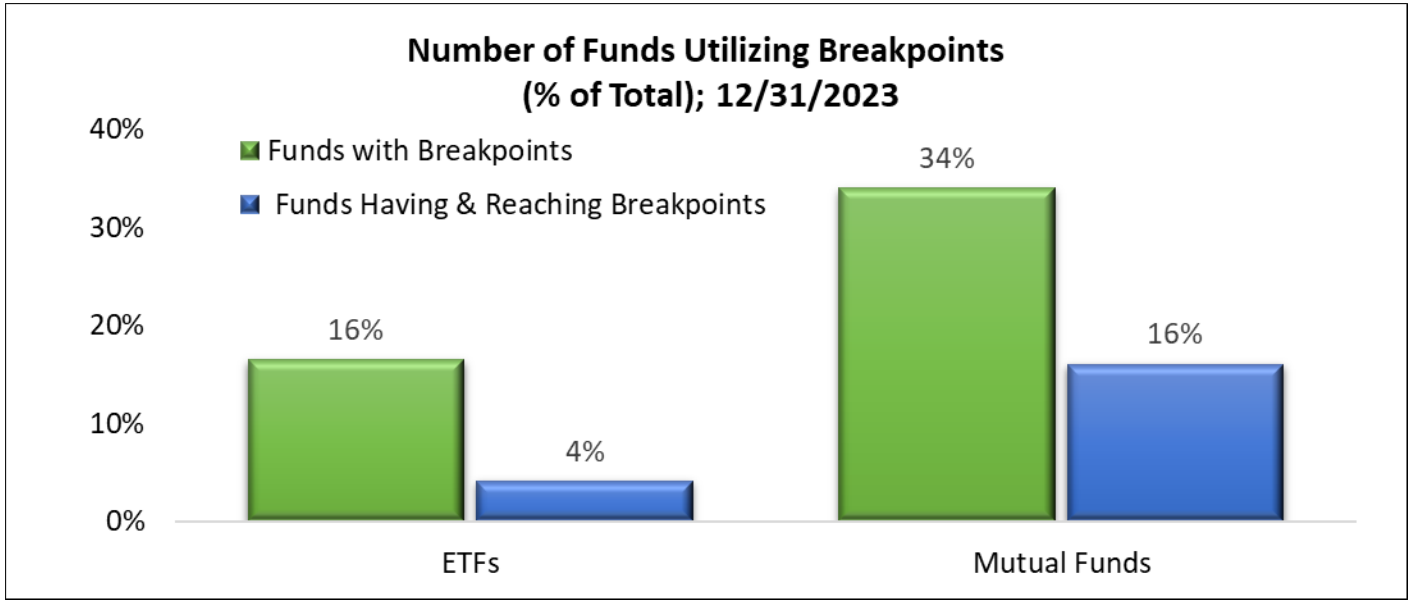
Additional Expense Sharing Strategies:

- Consideration and application of contractual or voluntary fee waivers and reimbursements
- Changes to share class offerings
- Additional ancillary benefits and *reinvestments in the business* recognized by fund investors (products, marketing, technology, staffing and infrastructure)

Advisory Fee Breakpoint Use

Advisory fee breakpoints are commonly thought of as a way to share scale with investors, but less commonly used:

- The rate of use is significantly different depending on product type, fee structure, and strategy
- There is a gap between funds having breakpoints in the advisory fee and having scale to reach even the first breakpoint:
- 25% of ETFs and 47% of open-end funds that have breakpoints reach the first breakpoint



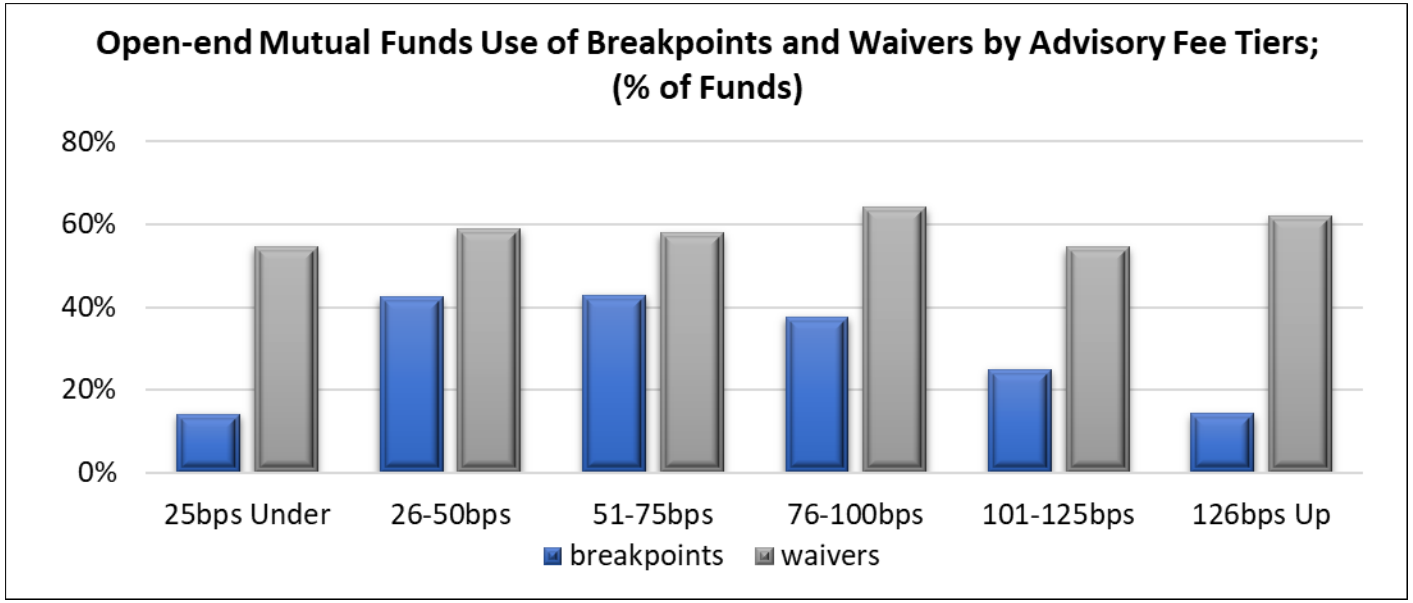
Use of Fee Waivers

Another tool firms use for expense sharing is waivers

Reasons the waivers are in place (among others):

- Capping expenses on funds
- Reducing fees for competitive purposes
- Reimbursements on underlying fund holdings

The use of breakpoints varies across fee levels, but waivers are applied at relatively the same rate



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