2021 Investment Firm Profitability; Influences on Economies of Scale and Director Oversight Responsibilities

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A Mutual Fund Directors Forum Webinar

MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

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Agenda

2021 Profitability Analysis

- Industry environment
- Trending investment firm profitability
  - Revenue and expense drivers
- Changes and impacts to director oversight
  - Existing oversight responsibilities
  - 2022 profitability topics surfacing in the board room

Economies of Scale

- Board oversight and assessment

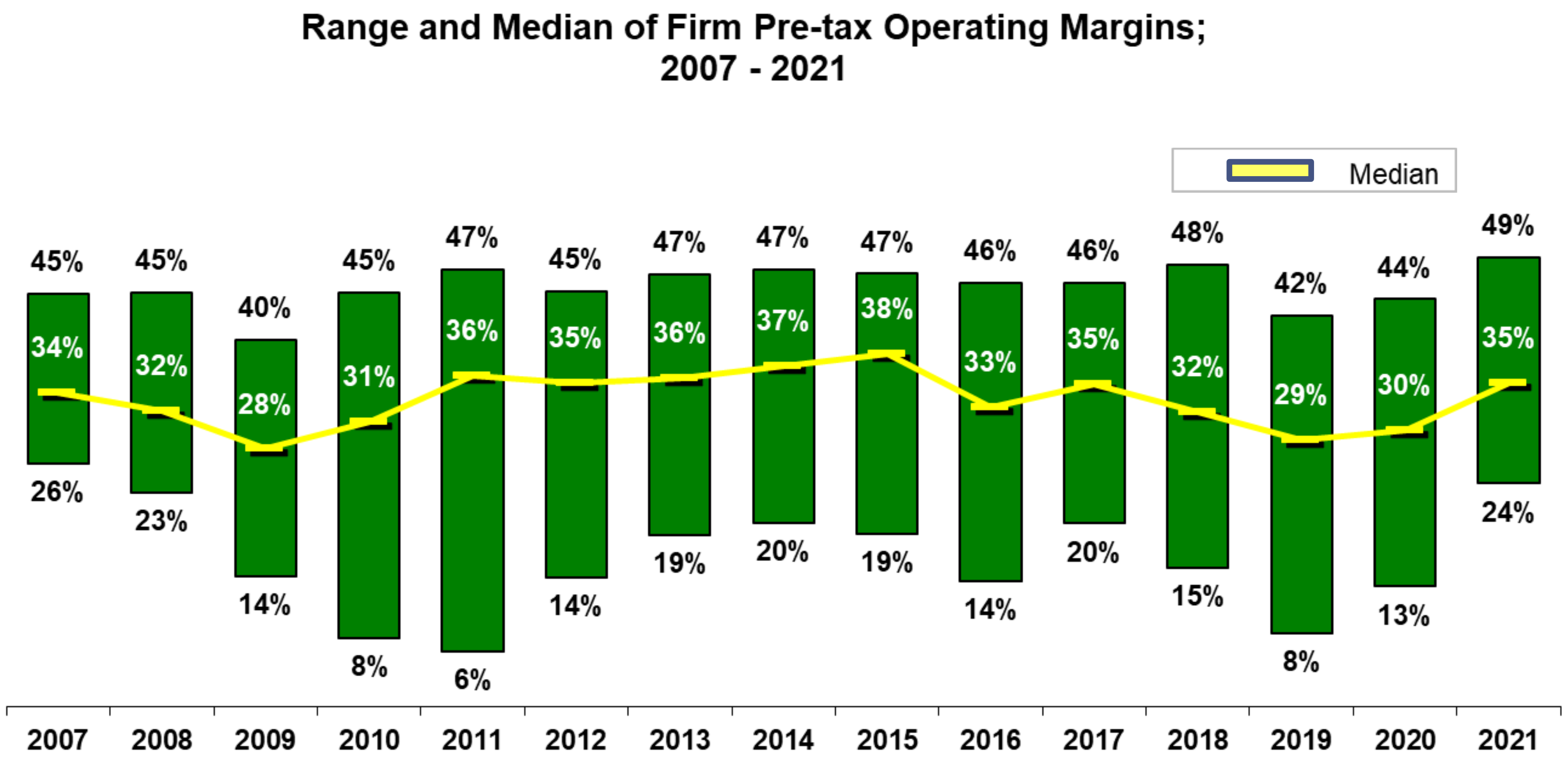
2021 Industry Environment Impacting Profitability

- Another year-over-year market gain:
  - S&P 500: 26.9%; DJIA: 18.7%; Nasdaq Composite: 21.4%
- Lingering impact of Covid-19 and variants, including supply chain disruptions and labor market shortages
- Fed kept interest rates near zero and invested billions of dollars into markets each month
- Increasing inflation
- Day traders became more present, influencing trading and pricing
- The total market capitalization of the cryptocurrency market tripled during the year
- Ongoing trade wars with China and resulting tariffs

2022 has started as a very different year – longer-term impact to average industry AUM and profits is unclear

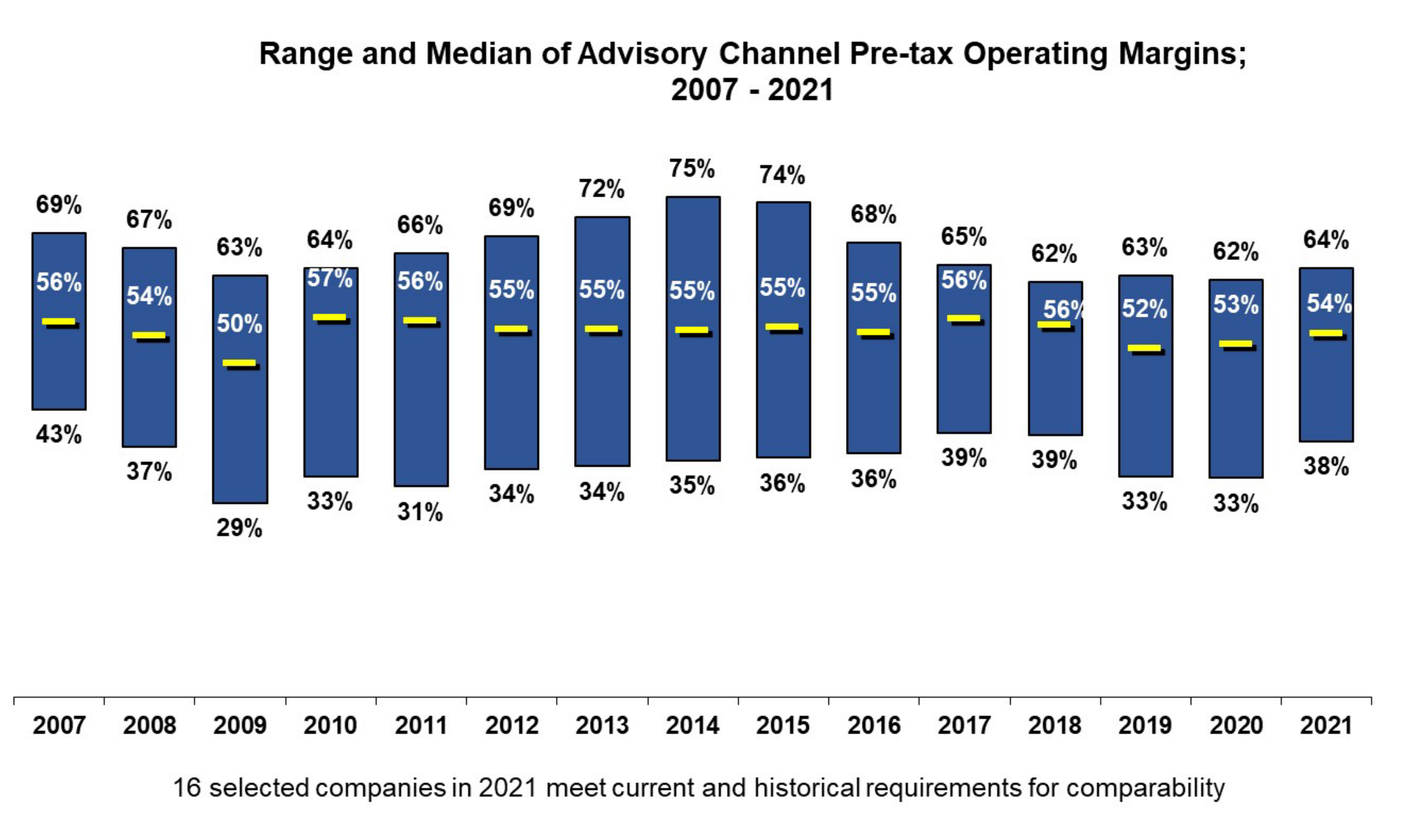
- Possible market "correction" and drop in leading indices year-to-date
- Russian invasion of Ukraine
- Record high inflation and rising prices
- Expectation for rising interest rates and tightening monetary policy

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



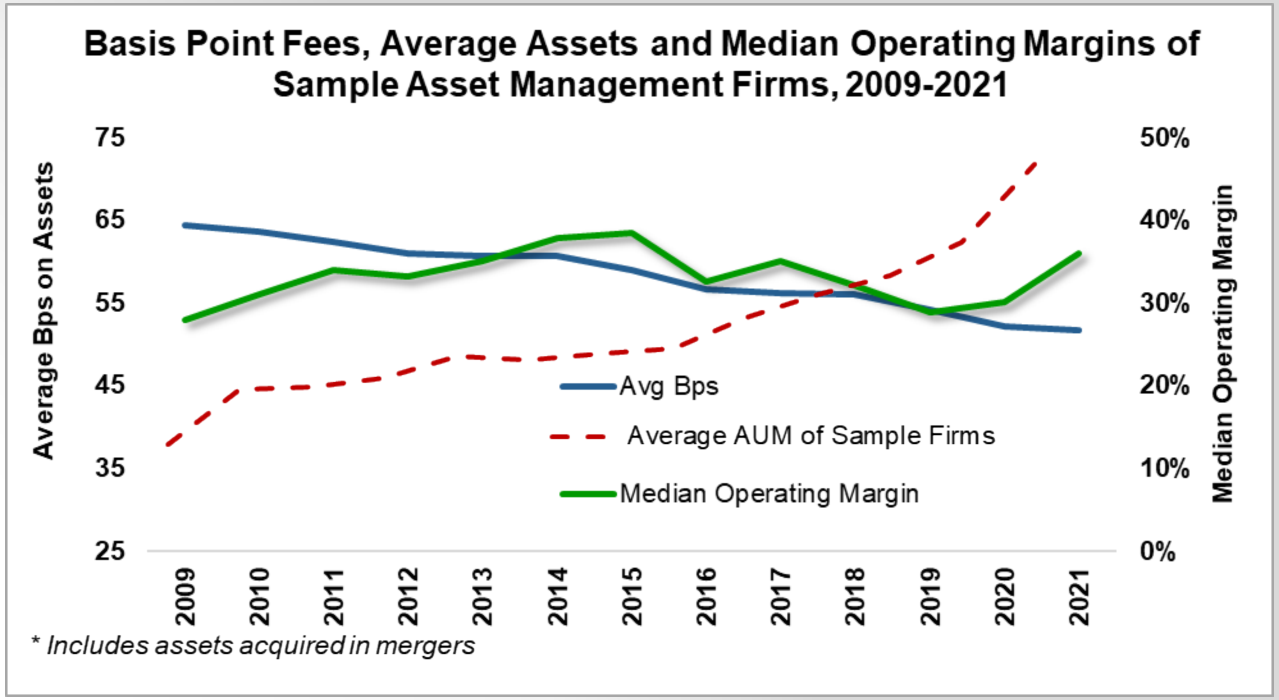
16 selected companies in 2021 meet current and historical requirements for comparability

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



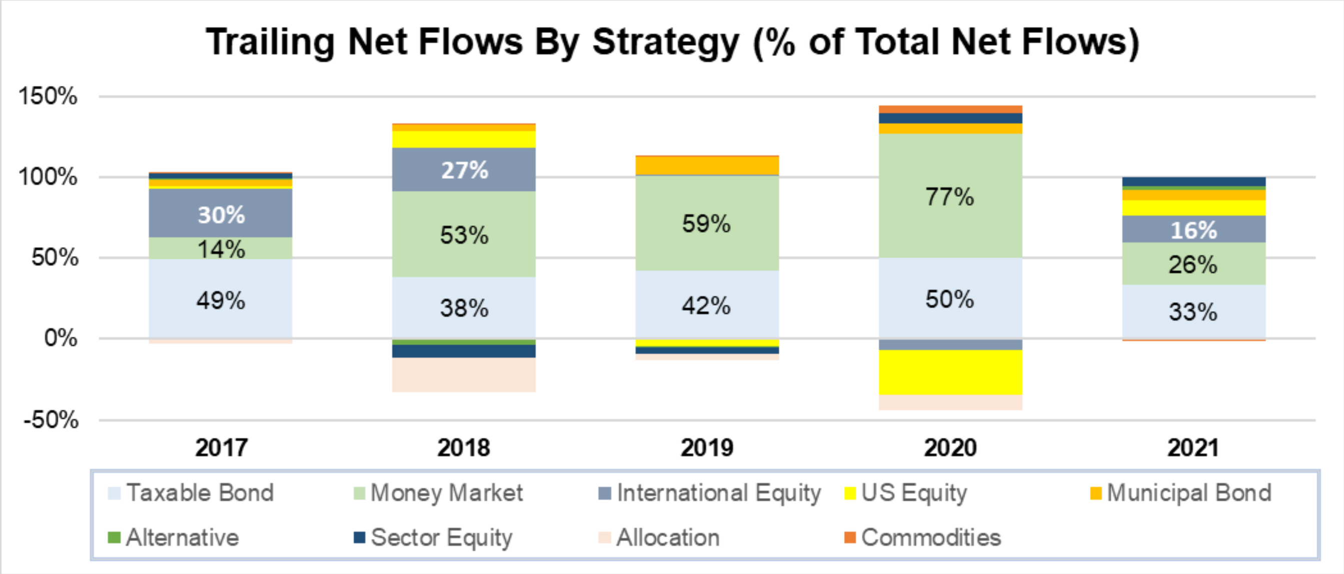
Margin and Asset Trends

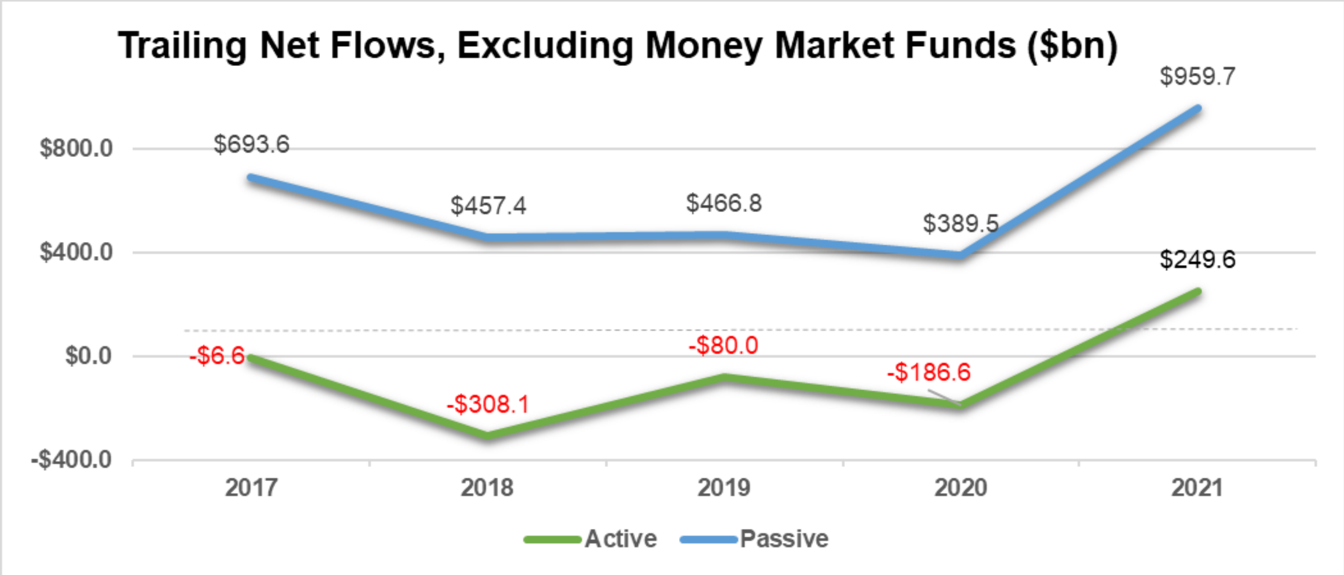
- Sample firms' AUM continued to grow significantly
  - Average firm AUM grew 25% from 2020 to 2021
  - 60% AUM growth over the last five years
- Offsetting greater economies of scale:
  - Variable expenses
  - Increasing fixed expenses
  - Declining average basis points; from 64 to 51 between 2009 and 2021



Product and Strategy Demand

Assets continued to flow to lower fee funds in both strategies and products





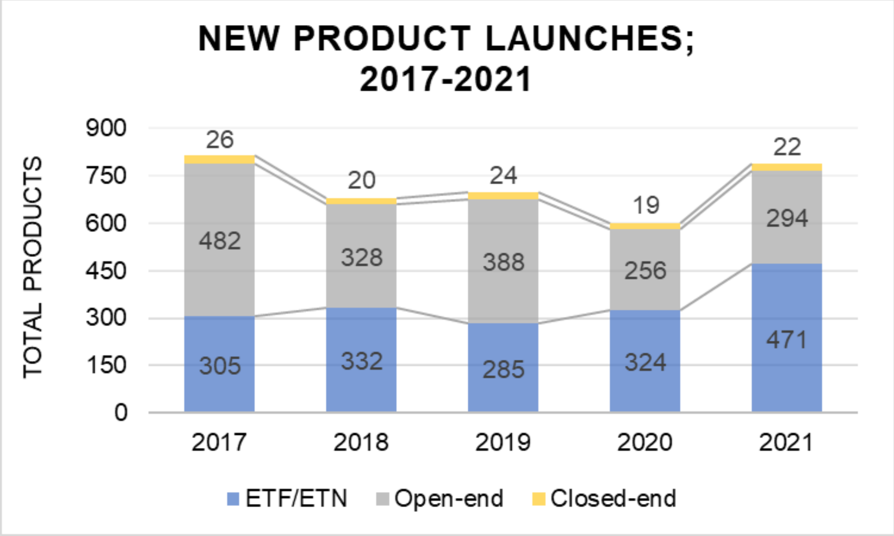
Flow data reported by Morningstar, Inc.

Expenses Influencing Margins

- 2021 expense trends impacting margins:
  - Variable expenses related to asset and revenue growth: sales and investment compensation and distribution expenses
  - Returning to pre-covid spend for travel and marketing
  - Small decreases in occupancy spending
  - Increases in recruitment spending and compensation of specific positions to compete
  - Significant amount of reinvestment in the business

Firms Reinvested in Business

- New funds launched



- New strategies developed and released:
  - ESG
  - Digital assets
  - Blockchain
  - Inverse and leveraged equity

- New products:
  - Branch to other '40 Act fund type
  - Interval funds
  - UCITS for non-U.S investors
  - Private investing

- Continued industry consolidation through acquisitions and mergers

- Expenses increased related to business development efforts:
  - Additional investment and trading staff
  - Technology upgrades and data acquisition
  - Increased compliance, legal and risk mitigation
  - Marketing and education efforts

Impact on Director Oversight Responsibilities

Director Considerations

- General guidelines surrounding existing responsibilities and processes remain unchanged
- Specific oversight discussions in the board room in 2022 may include:
  - Newly acquired funds
  - Newly launched and small funds
  - Growth and related economies of existing funds
- Early 2022 events yet to be reflected in profitability – and is it short-lived?
  - Have assets declined?
  - Has volatility impacted flows?
  - Have newly launched products failed to gain traction?
  - Has the geopolitical environment impacted certain emerging market products?

Guidance Available to the Board

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
- Because there are no standards on allocation models, there is also no comparable fund-by-fund data

Oversight Responsibilities of the Board

Supporting materials that help demonstrate the board's process can include:

- Documentation of the methodology for calculating an adviser's profitability

- 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

Helpful board discussion topics can include:

- Assessing the correlation of cost drivers and business activities
- Management's discussion of significant changes in methodology or profitability, as well as outliers
- Trending profitability (year-over-year)

A board should not hesitate to request further information and ask follow-up questions until the members believe their questions have been adequately addressed

Oversight of New Products

- Profitability considerations for newly launched products*:
  - Median AUM at 12/31 of products launched in 2021: $15.1m
  - Median AUM of products launched prior to 2021: $325.7m
  - Advisor’s projected AUM, margins and target date for scale
  - Any needed capital investment for a new strategy or product type

- Acquired and/or merged funds
  - Profitability/fees reasonableness in comparison to existing funds
  - Advisory breakpoint structures reasonableness in comparison to existing funds

- Assess margins excluding any one-time launch or merger expenses

**products include open-end funds, ETFs and ETNs*

Oversight of Growing Funds

- Growth of existing industry products:
  - As a result of market performance in 2021:
    - 85% of funds' average AUM grew between 2020 and 2021
    - The median of a fund's AUM growth was 23%

- Correlation to board oversight:
  - As assets have grown, how has corresponding profitability responded, and why?
  - Typically, won't be an equivalent increase in profits:
    - Variable expenses
    - Shared economies of scale

Understanding the Objectives of Analyzing Fund Profitability

- One of the *Gartenberg* factors is consideration of the profitability of the adviser and the costs incurred by the adviser
- It's important to remember that high profits are not necessarily indicative of an excessive fee
  - Higher profit margins can be justified based on the quality of services provided by a highly qualified and conscientious adviser (*Schuyt*)
- Indeed, 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 an adviser's profitability enables a board to evaluate the financial stability of the adviser

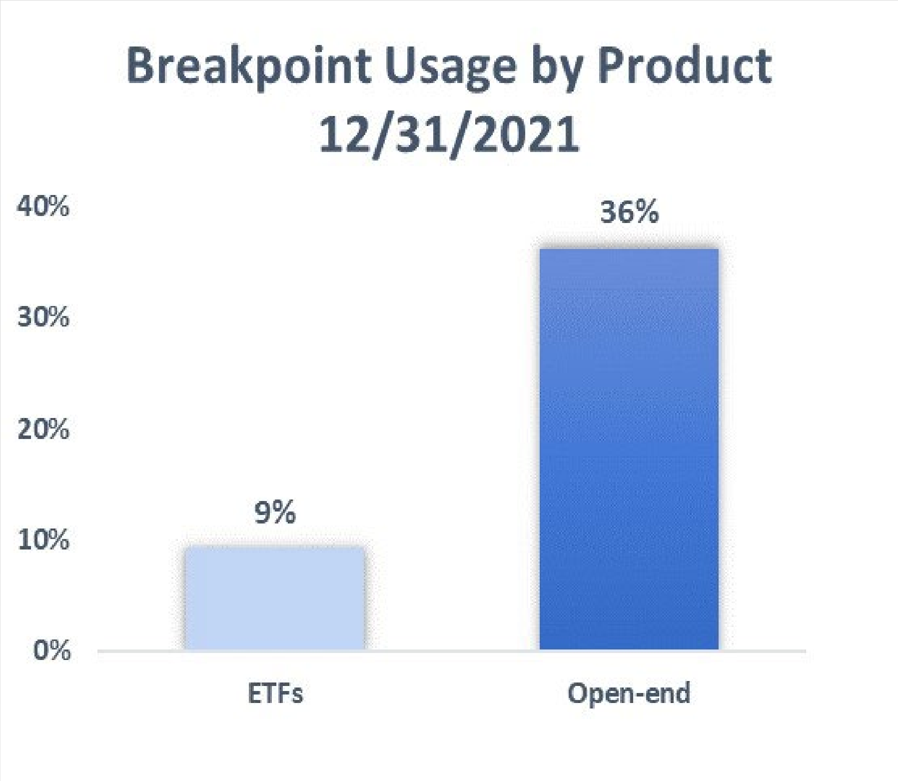
Assessing Economies of Scale

- 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:
    - Waiving sales charges or loads on purchases
    - Waiving distribution and/or service 12b-(1) fees
  - Additional ancillary benefits and *reinvestments in the business* recognized by fund investors (products, marketing, technology, staffing and infrastructure)

Advisory Fee Breakpoint Use

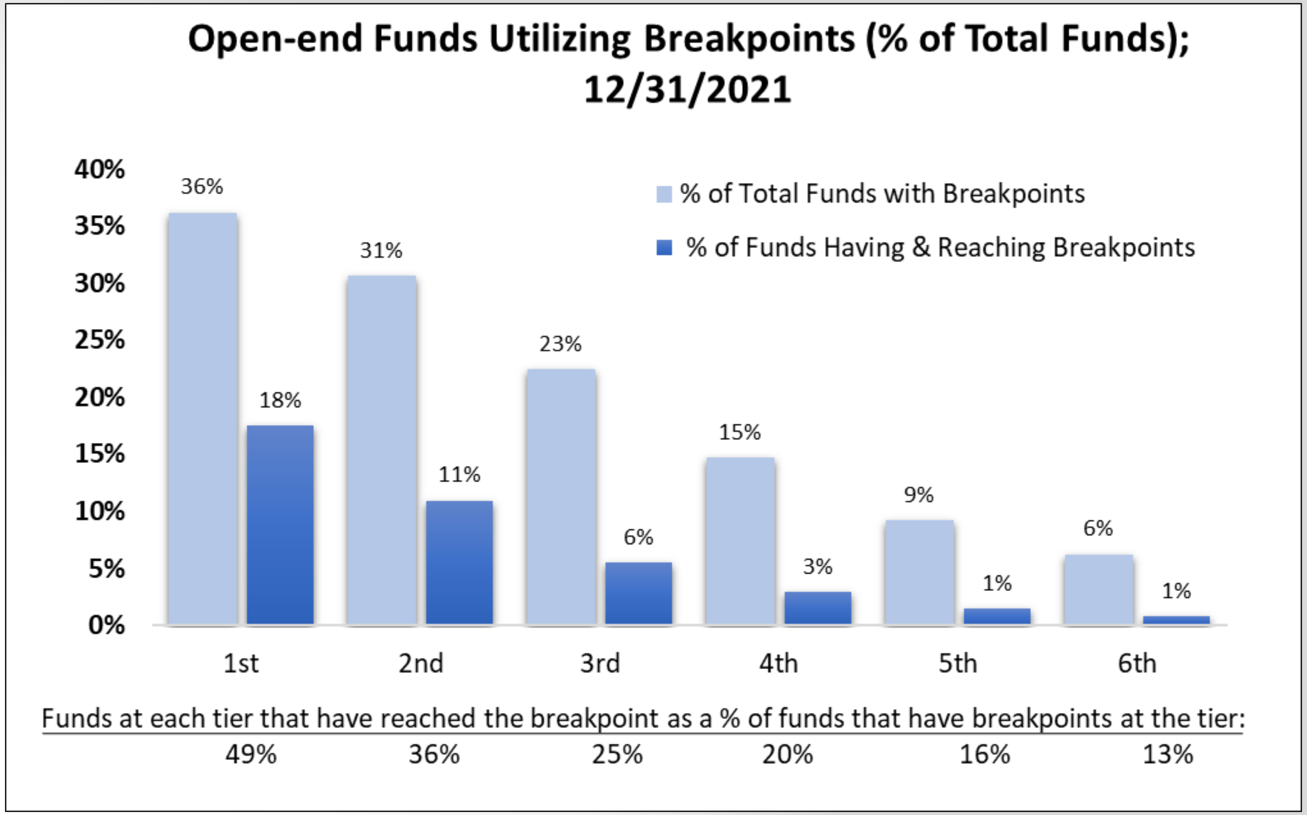
- Breakpoints continue to be used as a tool for sharing possible cost savings as AUM grows, but the rate of use is significantly different depending on product type, fee structure, and strategy, among other factors

- Great variation in the asset levels for breakpoints, reduction amount at each breakpoint, and number of total breakpoints



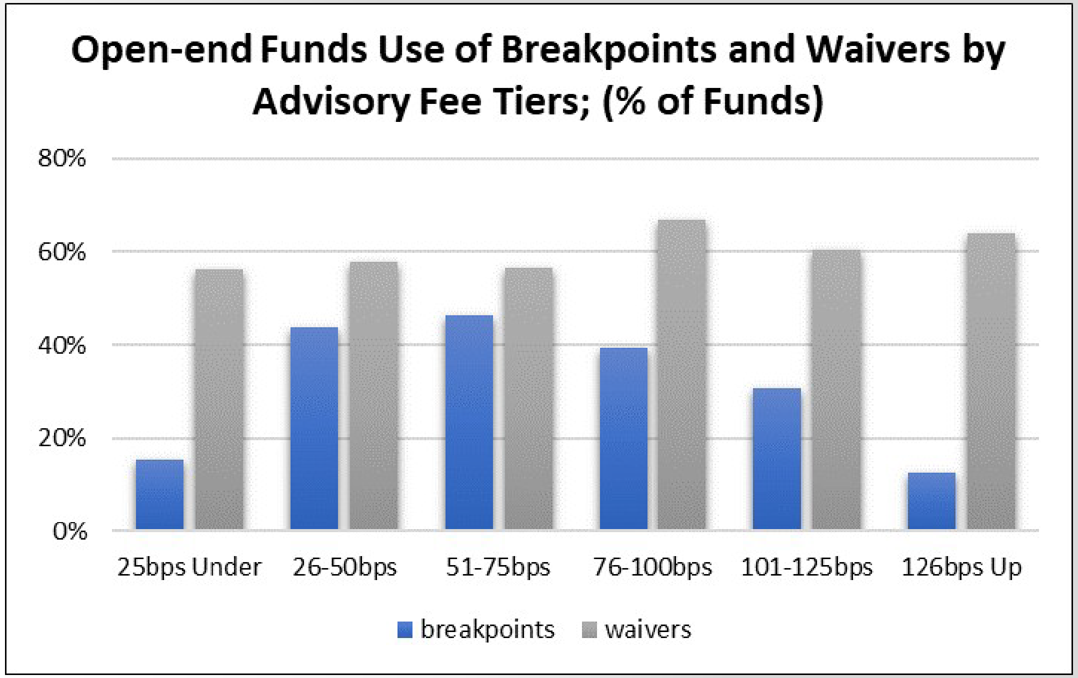
Realization of Breakpoints

- There is a gap between funds having breakpoints in the advisory fee schedule and having scale to reach even the first breakpoint:
  - ETFs: 5% of all funds have breakpoints and reached the 1st tier.
  - Open-end Funds:
    - 36% have breakpoints
    - 18% have breakpoints and have broken the first tier



Use of Fee Waivers

- Another tool firms use for expense sharing is waivers
- This chart shows the use of waivers vs. breakpoints by advisory fee levels
- 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 are relatively the same rate



Analyzing Fund Profitability in the Context of Other Gartenberg Factors

- The Supreme Court has made it clear that a fund board needs to engage in a robust process when evaluating an investment advisory agreement and related fees
- A thorough consideration of all of the *Gartenberg* factors enables a board to demonstrate such a process
- Fund directors tend to spend significant time considering fund performance, fees and total expenses compared to identified peer groups
- Fund directors also need to demonstrated oversight of other factors including profitability and factors that may be correlated to profitability

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