

# 2021 Mid-Year Survey of Investment Firm Profitability and Influences on Director Oversight Responsibility

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A Mutual Fund Directors Forum Webinar



**MUTUAL FUND DIRECTORS FORUM**

*The FORUM for FUND INDEPENDENT DIRECTORS*

# Today's Speakers



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*(Moderator)*



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# Agenda

- Trailing 12-month industry environment
- Product and strategy demand
- Impact to investment firm profitability
- Influences on individual fund profitability
- Changes and impacts to director oversight

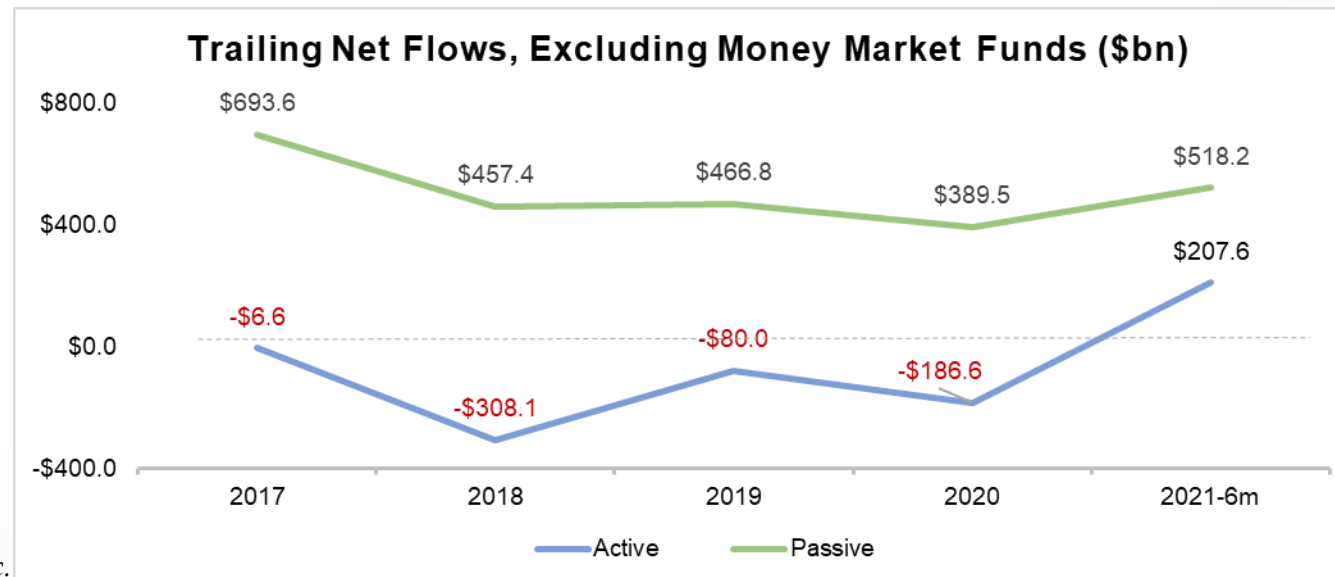
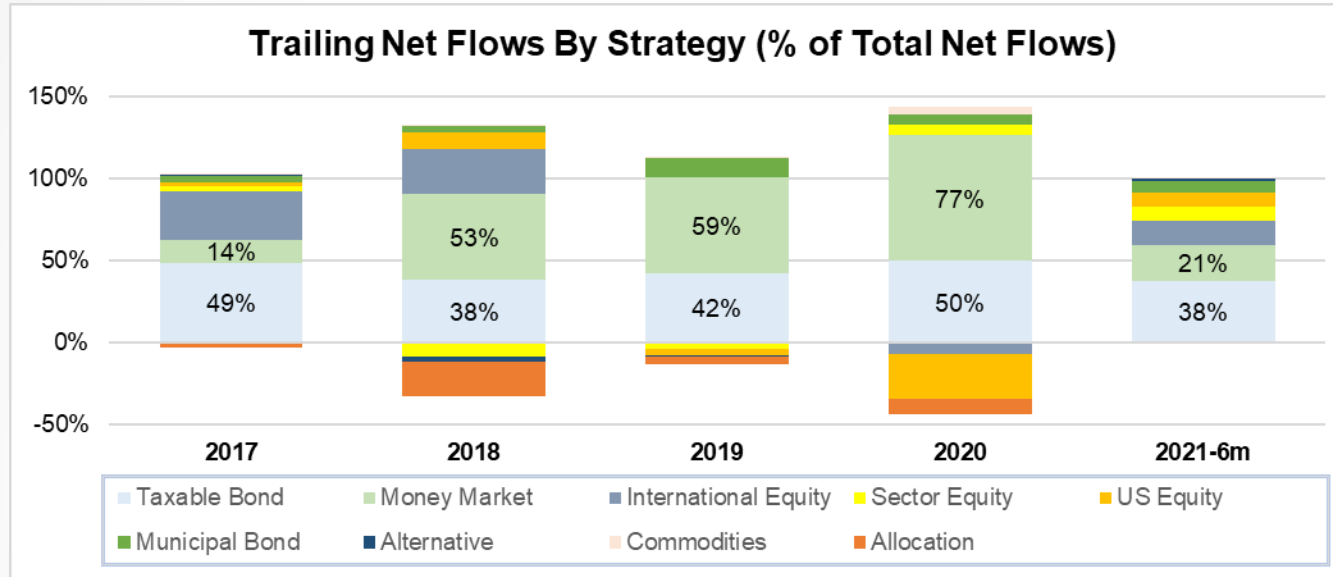
# Industry Environment Impacting Profitability

Influences possibly influencing market performance:

- Pandemic volatility and economic responses:
  - Rebound to new market highs by the end of 2020 from the crash of March
  - Congress passed \$3.8 trillion in stimulus packages in 2020
  - Federal Reserve stepped in with a broad array of actions including lowering the interest rate to almost 0%
  - Money market funds attempted to control expenses and maintain a \$1 NAV and 30% liquidity requirements in a high volume, low interest environment leading to higher voluntary waivers
  - Trailing impact with Delta variant
- Clarity on the outcome of the U.S. presidential election
- Day traders became more present, influencing trading and pricing
- Ongoing trade wars with China and resulting tariffs

# Product Demand

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



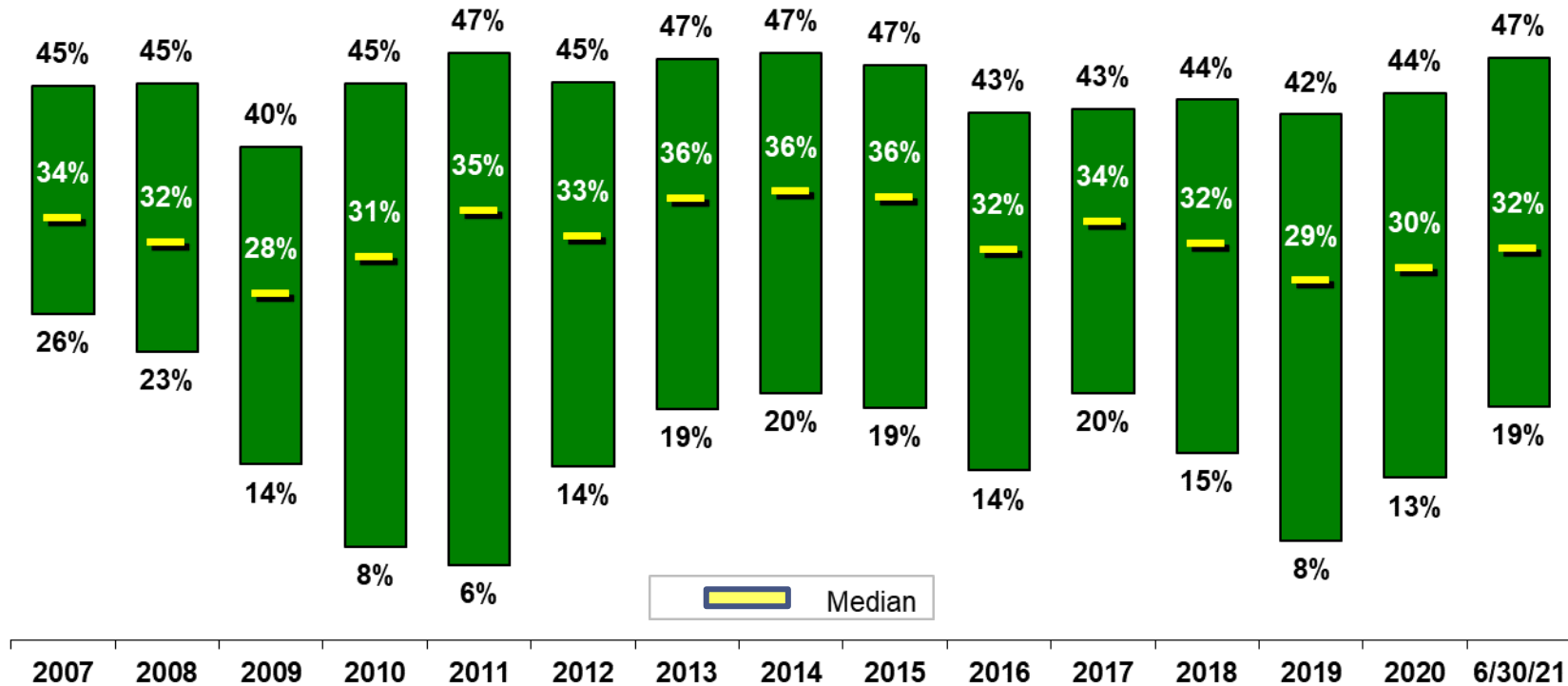
Flow data reported by Morningstar, Inc.

# Audience Poll

- 1) What are the total assets under management of your firm?
  - a. Under \$10bn
  - b. Between \$10bn and \$150bn
  - c. Greater than \$150bn
  
- 2) Did the assets under management increase or decrease during the 12 months ending 06/30/2021?
  
- 3) Did the mix in asset strategy (equity vs. fixed income) change significantly during the same period?

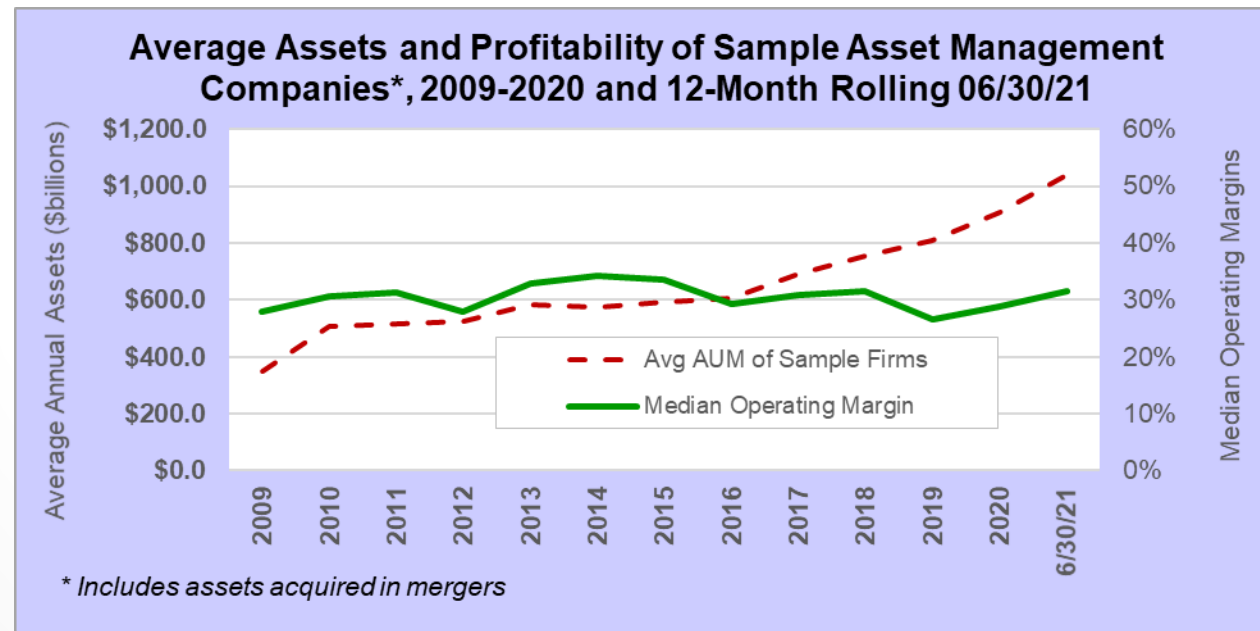
# Summary of Pre-tax Operating Margins of Publicly-reported Firms Significantly Engaged in Mutual Fund Management

Range and Median of Total Firm Pre-tax Operating Margins;  
2007 - 2020 12/31 and 12-month Rolling 06/30/21



# Margin and Asset Trends

- Average assets of sample firms continued to grow
- Operating margins have remained relatively flat
- Expense structures have impacted margins:
  - Variable expenses such as sales and investment compensation and distribution
  - Increasing technology and risk mitigation expenses
  - Reinvestment in business





# Audience Poll

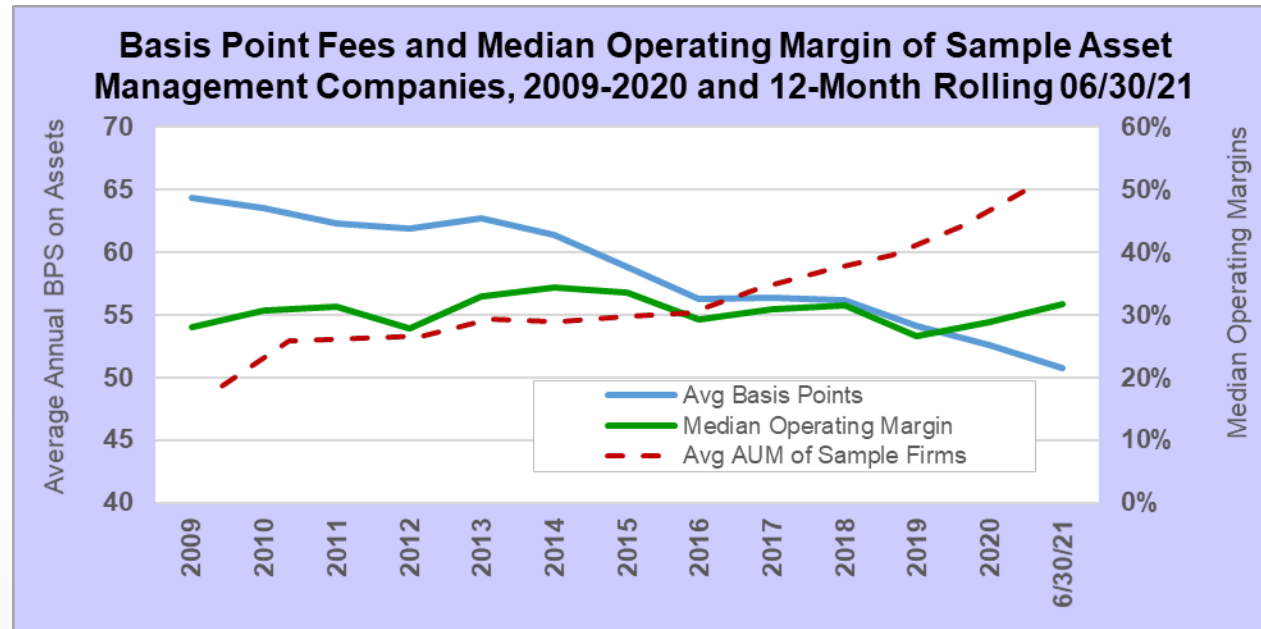
- 1) During the twelve months ending 06/30/21, did your firm launch any new funds or products?
- 2) Did you undergo any mergers or acquisitions of externally managed funds or products?

# Director Considerations

- Considerations regarding profitability for Directors when reviewing:
  1. Proposed new funds or products
  2. Proposed mergers of in-house funds
  3. Acquisitions of external funds

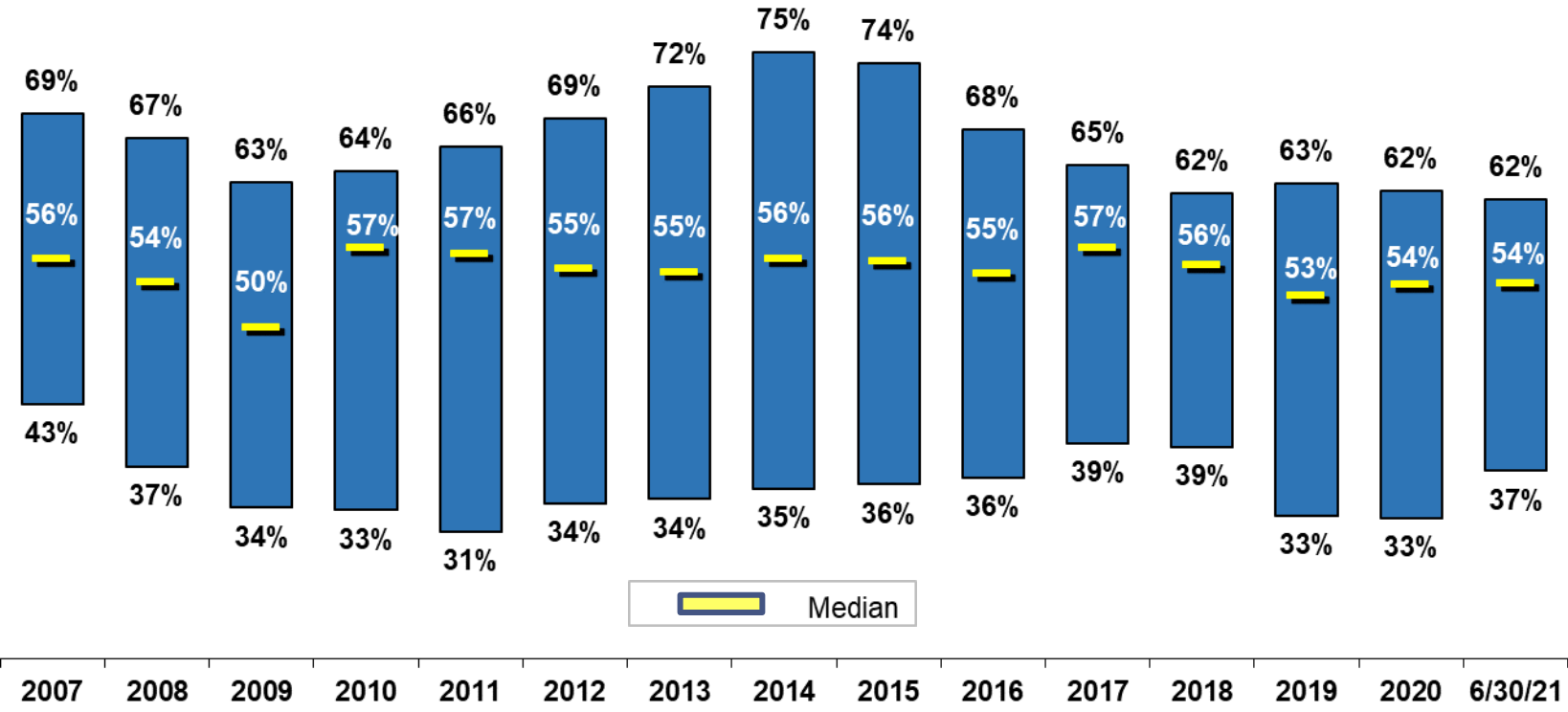
# Margin and Fee Trends

- An essential impact to margins has been the trend of lower average basis points collected on advisory fees
- Asset growth has influenced operating margins, but declining average basis points collected on fees has kept profits in check



# Summary of Pre-tax Operating Margin from **Advisory Activities** of Selected Publicly-reported Companies Significantly Engaged in Mutual Fund Management

**Range and Median of Advisory Channel Pre-Tax Advisory Margins;  
2007 - 2020 12/31 and 12-month Rolling 06/30/21**



# 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

# 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 never 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

# 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
- But fund directors also need to demonstrate oversight of other factors including profitability and factors that may be correlated to profitability:
  - economies-of-scale and
  - “fall-out” or “ancillary” benefits received by the adviser or its affiliates

# 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



# The Future of Profitability

- Market performance
  - COVID continues
  - Federal support of monetary stimulus
  - Debt ceiling
  - China property market impact
- Dependent on each firm:
  - Product mix
  - Firm structure
    - Private or Public
    - Scale
    - Variable vs. Fixed
  - Firm functions
    - Investments
    - Advisory
    - Servicing
    - Distribution

# Questions?



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