LIPPER'S 2011 SUBADVISOR RESEARCH SERIES—PART 1:

SUBADVISOR FEES & EXPENSES

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PART 1: SUBADVISOR FEES & EXPENSES

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Subadvised funds, or funds whose portfolios are managed by an outside investment company, have taken center stage this year in part because of excessive fee lawsuits sought by investors. Generally speaking, these suits allege that the advisors in question maintain excessive fees in relation to the amount of work delegated to the subadvisor. The plaintiffs contend that while almost all fund management duties of the advisor are delegated to the subadvisor, in some instances the advisor is retaining over 80% of the total management fee charged. As a result, the plaintiffs argue it is not feasible that the advisory contracts are the result of arm's length bargaining. Due to the increased interest in and scrutiny of subadvised fund expenses and management fees, this paper will examine the fees and expenses of subadvised funds with two main objectives. First, it will discern if the subadvisor fee is an additional fee tacked onto the management fee or if other expenses decrease to compensate for the cost of the subadvisor. Second, the paper will examine how much of the management fee is retained by the advisor and/or administrator. Finally, recommendations regarding 15(c) report content for subadvised mutual funds are made.

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Please note that the views expressed in this document are intended as non-consultative and do not constitute legal advice.

INTRODUCTION

Currently, the majority of funds underlying variable insurance products (VIPs) have a subadvised fee structure, while less than half of open-end funds have a subadvised fee structure (Figures 1 & 2). For VIPs, 62% of funds are subadvised, accounting for 60% of average net assets of all VIPs (Figure 2). On the other hand, the percentage of subadvised open-end funds is 35%, accounting for 17% of open-end assets (Figure 1). Historically speaking, the industry saw a rise in the percentage of mutual funds and VIPs that utilize a subadvisor; however, those numbers have not grown tremendously over the last five years. The percentage of open-end funds increased 3% and the percentage of VIPs increased 5%.

FIGURE 1 PERCENTAGE OF OPEN-END FUNDS

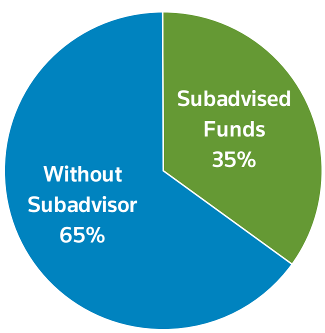


Figure 1 displays the percentage of open-end funds with and without subadvisors. The exclusions for Lipper's methodology apply. Please see footnote 1 on page 4.

FIGURE 2 PERCENTAGE OF VIPs

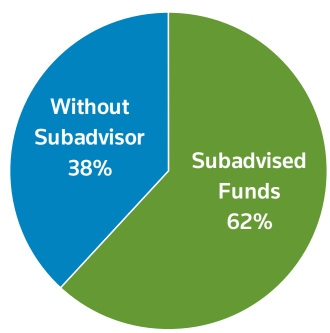


Figure 2 displays the percentage of VIP funds with and without subadvisors. The exclusions for Lipper's methodology apply. Please see footnote 1 on page 4.

TABLE 1 TOP 10 SUBADVISORS BASED ON ASSET UNDER MANAGEMENT

Rank	Subadvisor	Number of Funds	Assets Managed (Mil)	Average 1 Yr Performance Quintile	Average 3 Yrs Performance Quintile
1	Wellington Management Company LLP	428	$101,513.7	2.8	3.1
2	Geode Capital Management LLC	31	$79,533.4	2.2	2.3
3	PIMCO	101	$76,569.1	2.9	1.8
4	BlackRock*	164	$65,416.1	3.1	3.5
5	T Rowe Price Associates Inc	125	$51,305.8	3.1	2.4
6	Research Affiliates LLC	31	$47,347.9	3.2	1.7
7	Northern Cross LLC	4	$35,654.6	2.0	2.3
8	Mellon Capital Management Corporation**	127	$33,469.5	3.0	2.7
9	Jennison Associates LLC	27	$22,356.9	2.3	1.1
10	SSgA Funds Management Inc	52	$22,296.0	2.8	2.9

* BlackRock Includes BlackRock Advisors LLC, BlackRock Capital Management Inc, BlackRock Financial Management Inc, BlackRock Fund Advisors, BlackRock Inc, BlackRock Institutional Management Corp, & BlackRock Investment Management LLC.

** Mellon Capital Management Corporation includes Standish Mellon Asset Mgmt Co LLC.

The performance quintile is calculated against the funds' Lipper classification.

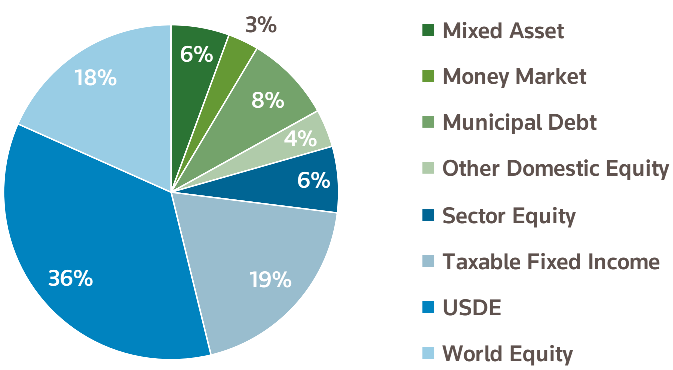
Funds with more than one subadvisor were excluded from this analysis.

INTRODUCTION

For both open-end funds and VIPs, US diversified equity and taxable fixed income funds are the asset classes with the highest percentage of subadvised funds (Figures 3 & 4). World equity funds compose the third largest component for open-end funds, while mixed-asset VIPs make up the third largest component for VIPs.

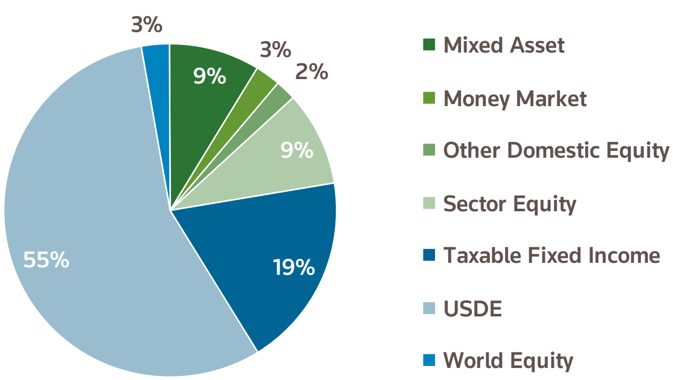
A subadvisor arrangement can be mutually beneficial to both the advisor and subadvisor. The advisor is able to hire a firm with investment expertise in an area in which they may not have expertise, or subadvisors may specialize in specific types of investments and may be able to offer superior investment management. This type of arrangement is also beneficial to subadvisors because they earn a percentage of the assets of the mutual fund without incurring the costs of advertising and distributing. Table 1 lists the top ten subadvisors by asset size. The average performance quintile is also displayed. Subadvised fund performance will be covered in Part 2 of the subadvisor series.

FIGURE 3 PERCENTAGE OF SUBADVISED OPEN-END FUNDS BY ASSET CLASS



Figures 3 and 4 display the percentage of subadvised funds by asset class. The exclusions for Lipper's methodology apply. Please see footnote 1 on page 4.

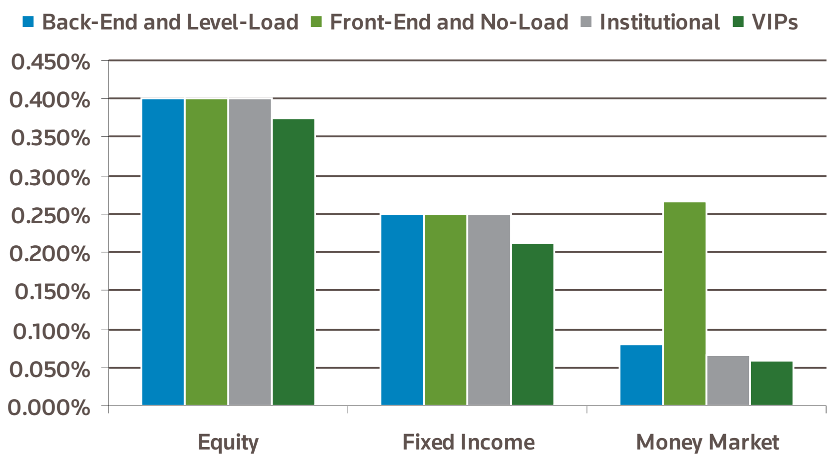
FIGURE 4 PERCENTAGE OF SUBADVISED VIPs BY ASSET CLASS



EXPENSES OF SUBADVISED FUNDS

There are two different hypotheses regarding the expenses of subadvised funds. The first posits that subadvisor fees are counterbalanced elsewhere in the expense ratio, and the second is that subadvised funds are more expensive than funds that are not subadvised. Subadvisors provide a service that is charged as part of the management fee. For disclosed subadvisor fees [1], median fees range from six basis points (bps) for Money Market VIPs to 40 bps for back-end/level-load, front-end/no-load, and institutional equity funds (Figure 5) [2].

FIGURE 5 **MEDIAN SUBADVISOR FEE BY LOAD TYPE AND ASSET CLASS**



[1] Approximately 50% of funds currently disclose subadvisor fees.

[2] In this analysis, we exclude funds with the following fee attributes: all-inclusive management fee structures, at-cost funds, funds of funds, index funds, exchange-traded funds, and funds whose management fees are in net reimbursement.

EXPENSES OF SUBADVISED FUNDS

The evidence is clear that subadvised funds are more expensive than funds that are not subadvised, but not dramatically so. Figure 6 displays the difference in the median between total expenses for funds with subadvisors versus total expenses for funds without subadvisors. For 10 of the 12 groups of funds in this analysis, subadvised funds are more expensive. Front-end/no-load equity funds (10 bps) have the largest difference, followed by back-end/level-load equity funds (9.5 bps). The lowest positive difference is for front-end/no-load money market funds— 1.3 bps. Subadvised funds are less expensive for fixed income VIPs and institutional money market funds, the differences being -2.5 basis points and -2.7 basis points, respectively.

The pattern demonstrates that subadvised funds' median total expense ratios are larger than median total expense ratios for funds that are not subadvised; however, they are not significantly larger. For example, consider the ten basis point difference for front-end/no-load equity funds. Median total expenses for subadvised front-end/no-load equity funds is 135 basis points (Table 2). Ten basis points accounts for only 7% of the median total expenses. In addition, the median subadvised fee presented above was 40 bps, but the total expense difference between subadvised funds and funds without subadvisors is only 10 bps (this example is from the front-end/no-load equity funds). Therefore, we can conclude that some of the subadvisor cost to investors is counterbalanced by management and nonmanagement expenses.

FIGURE 6 DIFFERENCE IN MEDIAN TOTAL EXPENSES

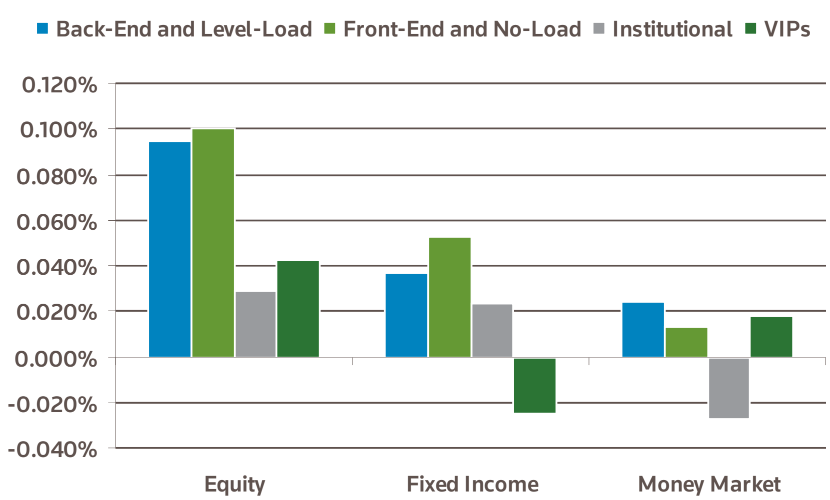


Figure 6 displays the difference between median total expenses for subadvised funds and funds without a subadvisor. A positive difference indicates that the median total expense ratio for subadvised funds is greater, while a negative difference indicates that the median total expense ratio for funds without a subadvisor is greater. The closer the bar is to zero, the less the difference between median total expenses.

EXPENSES OF SUBADVISED FUNDS

Some of the subadvisor expense is compensated for within the total expense ratio, but not all of it; therefore, it is important to discern where the amount of the subadvisor fee is counterbalanced. One of the logical places for this to occur is within the management fee. Lipper defines the management fee as the total of the advisor, administrator, and subadvisor fees. If the subadvisor is hired to do part of the work of the advisor, theoretically, the advisor's portion of the fee should decrease proportionately to the amount of duties delegated to the subadvisor. If this decrease is taking place, then management fees should be the same for subadvised funds and funds without subadvisors. Figure 7 displays the difference between the median management fees by load type. In all cases, the median management fee for subadvised funds is higher than the median management fee for funds that are not subadvised. The largest difference exists for equity VIPs (10 bps), and the smallest difference exists for back-end/level-load and institutional money market funds (a fraction of a basis point).

FIGURE 7 **DIFFERENCE IN MEDIAN MANAGEMENT FEES**

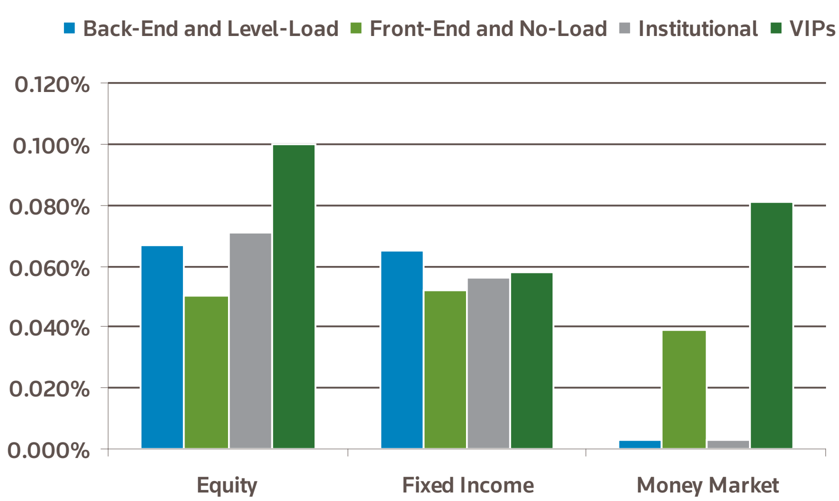


Figure 7 displays the difference between median management fees for subadvised funds and funds without a subadvisor. A positive difference indicates that the median management fee for subadvised funds is greater, while a negative difference indicates that the median management fee for funds without a subadvisor is greater. The closer the bar is to zero, the less the difference is for median management fees.

EXPENSES OF SUBADVISED FUNDS

Table 2 summarizes the findings of the median total expenses and the median management fees. This table shows that the differences in the median total expenses are not the same as the differences in the median management fees. This means that the management fee is not the only portion of the total expense ratio that is absorbing the extra cost of the subadvisor. The findings are mixed. In some cases, the median total expense difference is greater than the median management fee difference, but in other cases the relationship is reversed. Despite the adjustment, from an aggregate view subadvised funds are more expensive than funds without a subadvisor.

TABLE 2 DIFFERENCE BETWEEN MEDIAN TOTAL EXPENSES & MANAGEMENT FEES

	Equity		Fixed Income		Money Market	
	Total	Management	Total	Management	Total	Management
Back-End and Level-load	0.09%	0.07%	0.04%	0.07%	0.02%	0.00%
Front-End and No-load	0.10%	0.05%	0.05%	0.05%	0.01%	0.04%
Institutional	0.03%	0.07%	0.02%	0.06%	-0.03%	0.00%
VIPs	0.04%	0.10%	-0.02%	0.06%	0.02%	0.08%

Table 2 displays the difference of the total expense median and the management fee median for funds with and without subadvisors by equity/fixed income/money market and by load type. For example, for institutional equity funds, subadvised fund's median total expense was three basis points higher than funds without.

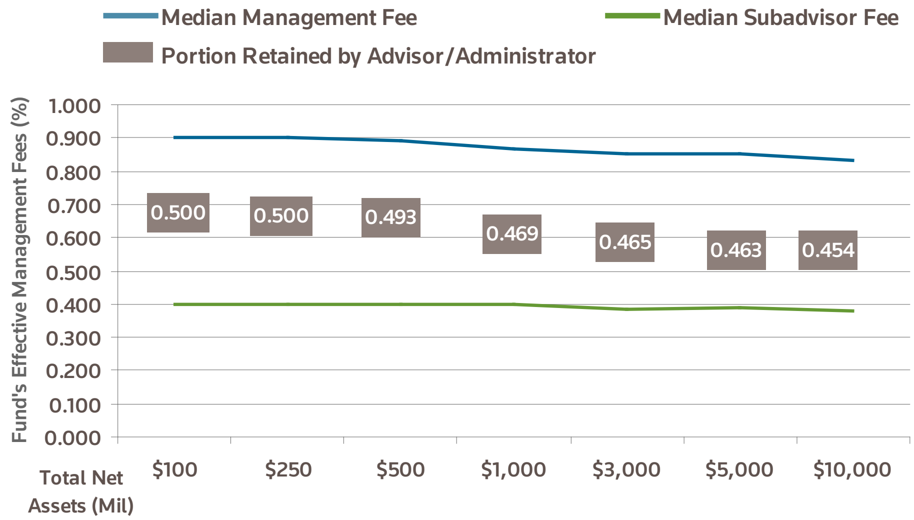
AMOUNT OF MANAGEMENT FEE RETAINED BY THE ADVISOR

From our research, Lipper concludes that subadvised funds are more expensive than funds without a subadvisor, on average. This finding held true from both a total expense ratio and a management fee perspective, although the difference is not the same for median total expenses and median management fees. From the management fee perspective, we will next explore what amount of the management fee is retained by the advisor and/or administrator for subadvised funds. The advisor hires the subadvisor, and the subadvisor is delegated investment management duties from the advisor. In most advisor/subadvisor relationships, the advisor still maintains some of their original duties. Therefore, the subadvisor and advisor are both paid from the management fee.

To examine this relationship, the data is stratified by equity/fixed income/money market, then separated by open-end funds and VIPs. Next, all subadvised funds with disclosed subadvisor fee schedules are narrowed down to one share class per portfolio to ensure a particular subadvisor fee schedule is not overweighed. The results are displayed in Figures 8-13 [3]. The following discussion focuses on the "percentage retained" portion of the figures because that is one of the focal points in the previously mentioned litigation. Equity funds have the lowest percentage of the management fee retained by the advisor, followed by fixed income funds and money market funds. This pattern is seen for both open-end funds and VIPs. Generally speaking, the percentage retained also tends to decrease as assets increase, although this is not true in all circumstances. For open-end equity funds, the median percentage retained ranges from 53.9% to 55.6%, depending on the asset level. The percentage retained for open-end fixed income funds is a little higher, ranging from 54.0% to 58.3%, and the percentage retained for open-end money market funds is higher still, ranging from 72.2% to 80.0%. The findings are almost identical for VIPs.

[3] This analysis is conducted for subadvised funds that disclose their subadvised fee.

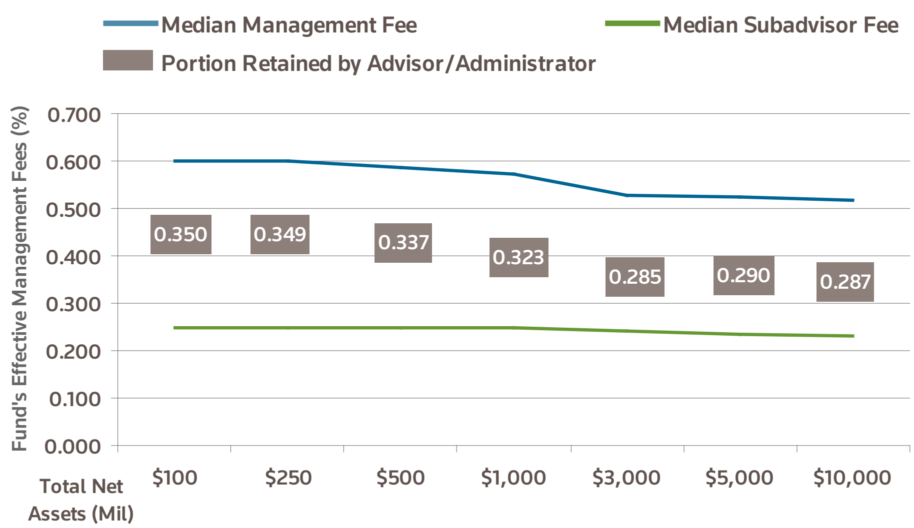
FIGURE 8 OPEN-END EQUITY FUNDS—AMOUNT OF MANAGEMENT FEE RETAINED



The blue line is the median management fee, the green line is the median subadvisor fee, and the amount in the gray box is the difference between these lines, which is also the portion retained by the advisor. All of this information can be found in the table below along with the percentage of the median management fee retained by the advisor. Each of these data points is shown at seven hypothetical asset levels ($100 million, $250 million, $500 million, $1 billion, $3 billion, $5 billion, and $10 billion).

Subadvised Expense Group							
Median Management Fee	0.900	0.900	0.893	0.869	0.850	0.850	0.831
Median Subadvisor Fee	0.400	0.400	0.400	0.400	0.385	0.387	0.378
Portion Retained by Advisor/Administrator	0.500	0.500	0.493	0.469	0.465	0.463	0.454
% Retained	55.6%	55.6%	55.2%	53.9%	54.7%	54.5%	54.6%

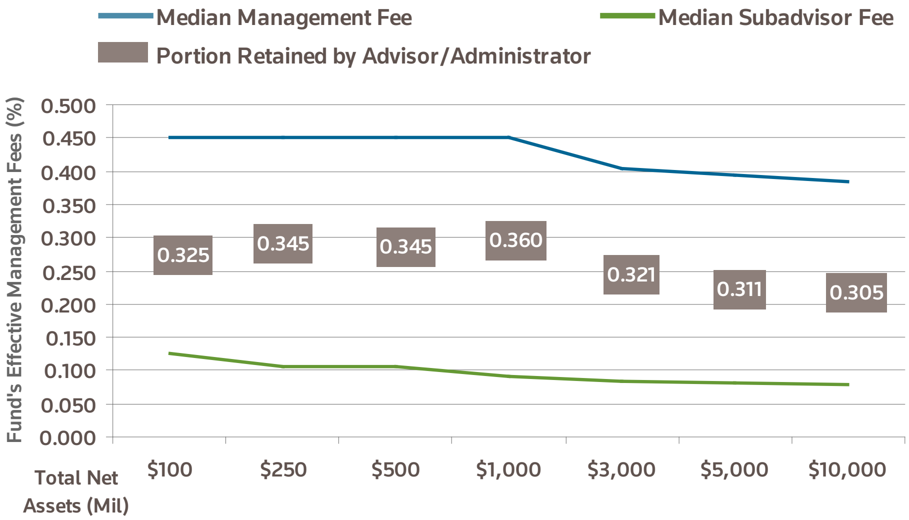
FIGURE 9 OPEN-END FIXED INCOME FUNDS—AMOUNT OF MANAGEMENT FEE RETAINED



The blue line is the median management fee, the green line is the median subadvisor fee, and the amount in the gray box is the difference between these lines, which is also the portion retained by the advisor. All of this information can be found in the table below along with the percentage of the median management fee retained by the advisor. Each of these data points is shown at seven hypothetical asset levels ($100 million, $250 million, $500 million, $1 billion, $3 billion, $5 billion, and $10 billion).

Subadvised Expense Group							
Median Management Fee	0.600	0.599	0.587	0.573	0.528	0.523	0.517
Median Subadvisor Fee	0.250	0.250	0.250	0.250	0.243	0.233	0.230
Portion Retained by Advisor/Administrator	0.350	0.349	0.337	0.323	0.285	0.290	0.287
% Retained	58.3%	58.3%	57.4%	56.3%	54.0%	55.4%	55.5%

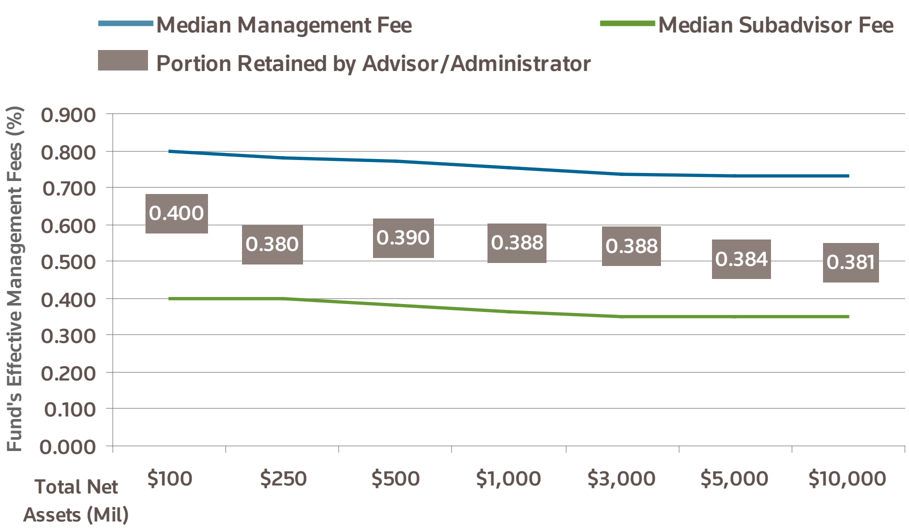
FIGURE 10 OPEN-END MONEY MARKET FUNDS—AMOUNT OF MANAGEMENT FEE RETAINED



The blue line is the median management fee, the green line is the median subadvisor fee, and the amount in the gray box is the difference between these lines, which is also the portion retained by the advisor. All of this information can be found in the table below along with the percentage of the median management fee retained by the advisor. Each of these data points is shown at seven hypothetical asset levels ($100 million, $250 million, $500 million, $1 billion, $3 billion, $5 billion, and $10 billion).

Subadvised Expense Group							
Median Management Fee	0.450	0.450	0.450	0.450	0.404	0.393	0.384
Median Subadvisor Fee	0.125	0.105	0.105	0.090	0.083	0.082	0.079
Portion Retained by Advisor/Administrator	0.325	0.345	0.345	0.360	0.321	0.311	0.305
% Retained	72.2%	76.7%	76.7%	80.0%	79.5%	79.1%	79.4%

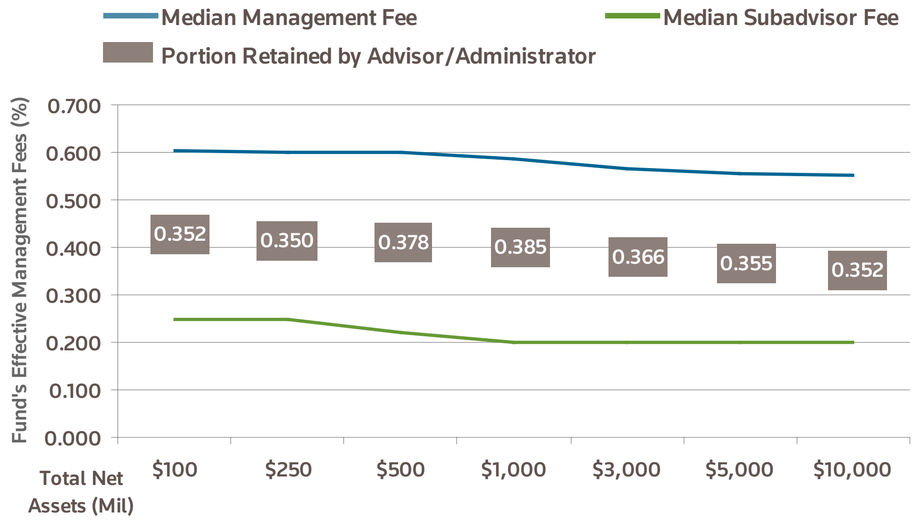
FIGURE 11 EQUITY VIPs—AMOUNT OF MANAGEMENT FEE RETAINED



The blue line is the median management fee, the green line is the median subadvisor fee, and the amount in the gray box is the difference between these lines, which is also the portion retained by the advisor. All of this information can be found in the table below along with the percentage of the median management fee retained by the advisor. Each of these data points is shown at seven hypothetical asset levels ($100 million, $250 million, $500 million, $1 billion, $3 billion, $5 billion, and $10 billion).

Subadvised Expense Group							
Median Management Fee	0.800	0.780	0.770	0.753	0.738	0.734	0.731
Median Subadvisor Fee	0.400	0.400	0.380	0.365	0.350	0.350	0.350
Portion Retained by Advisor/Administrator	0.400	0.380	0.390	0.388	0.388	0.384	0.381
% Retained	50.0%	48.7%	50.6%	51.5%	52.6%	52.3%	52.1%

FIGURE 12 FIXED INCOME VIPs—AMOUNT OF MANAGEMENT FEE RETAINED



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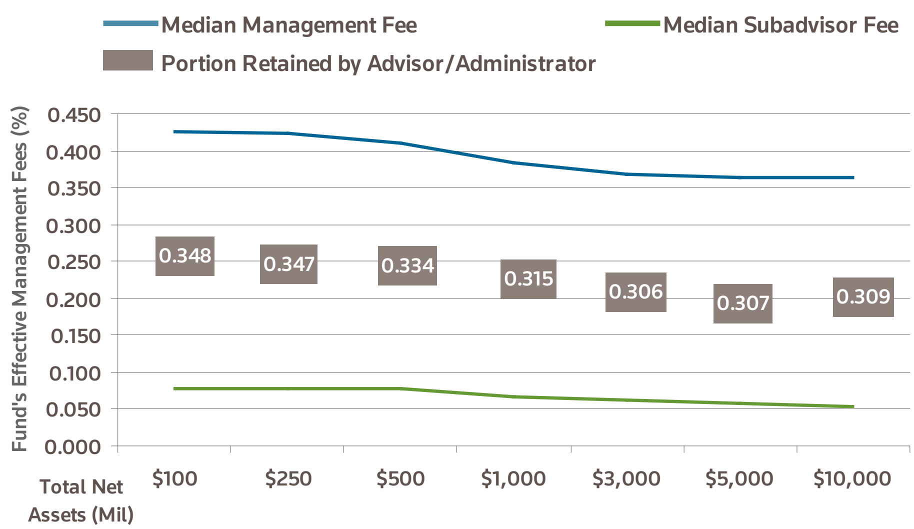
Subadvised Expense Group							
Median Management Fee	0.602	0.600	0.600	0.585	0.566	0.555	0.552
Median Subadvisor Fee	0.250	0.250	0.222	0.200	0.200	0.200	0.200
Portion Retained by Advisor/Administrator	0.352	0.350	0.378	0.385	0.366	0.355	0.352
% Retained	58.5%	58.3%	63.0%	65.8%	64.7%	64.0%	63.8%

FIGURE 13 MONEY MARKET VIPs—AMOUNT OF MANAGEMENT FEE RETAINED



The blue line is the median management fee, the green line is the median subadvisor fee, and the amount in the gray box is the difference between these lines, which is also the portion retained by the advisor. All of this information can be found in the table below along with the percentage of the median management fee retained by the advisor. Each of these data points is shown at seven hypothetical asset levels ($100 million, $250 million, $500 million, $1 billion, $3 billion, $5 billion, and $10 billion).

Subadvised Expense Group							
Median Management Fee	0.425	0.425	0.411	0.383	0.368	0.365	0.363
Median Subadvisor Fee	0.078	0.078	0.078	0.068	0.062	0.058	0.054
Portion Retained by Advisor/Administrator	0.348	0.347	0.334	0.315	0.306	0.307	0.309
% Retained	81.8%	81.7%	81.1%	82.4%	83.3%	84.1%	85.1%

LIPPER'S PERSPECTIVE

What do these findings mean from Lipper's perspective and in light of impending lawsuits? Lipper believes that despite the small difference in subadvised funds versus those that are not subadvised, the two should not be separated when evaluating expense comparison groups. There are two reasons for this decision. Hiring a subadvisor is a business decision that is made by the mutual fund company; the company has the option to incur the costs of entry for the creation of a mutual fund, but instead it chooses to hire a subadvisor. In addition, the higher expenses of subadvised funds may be justified because of the expertise offered by the subadvisor. Second, both types of funds may be the same from the standpoint of the investor. For example, if an investor wants to hold a technology mutual fund, typically their main concern is not the organization of the management of funds but the philosophy of the investment and the overall total expense ratio.

For 15(c) purposes, Lipper recommends that subadvised fund boards consider their expenses in conjunction with those of funds that are not subadvised. In addition, boards may consider reviewing a subadvised expense group against their subadvised fund to ensure their additional expenses related to the subadvisor are in line with other subadvised funds. Finally, boards should closely examine the portion of the fee reserved by the advisor in light of the duties of the subadvisor, as compared to the advisor.

In addition to fund expenses, boards should study the performance of the subadvised fund in relation to funds without a subadvisor. Part 2 of Lipper's subadvised series will provide an in-depth examination and explanation of subadvised fund performance. The report will be released at the beginning of October. Part 3 of the Subadvisor Research Series will address flows of subadvised funds.