

# Mutual Funds and Institutional Accounts: A Comparison

## 1. INTRODUCTION

The SEC recently directed mutual funds to provide additional disclosure about factors that fund boards consider during advisory contract renewals.<sup>1</sup> Fund documents must now disclose whether in renewing the fund's advisory contract the board relied on a comparison of fees and services of other funds or other types of clients such as institutional investors or pension funds.

Mutual funds and institutional accounts are very different investment products.<sup>2</sup> Mutual funds are primarily retail products, which gather assets from vast numbers of individuals who have limited balances to invest. Institutional accounts gather assets from a limited number of clients who have millions or even billions of dollars to invest. Mutual funds and institutional accounts are distributed differently, operate under different legal and regulatory structures, and have different business risks. In addition, the advisory contracts of institutional accounts typically cover portfolio management but little else, whereas the advisory contracts of mutual funds are usually broad-based, covering portfolio management and a range of other services. Even portfolio management can differ importantly between the two products.

Recent analyses have made much of the fact that mutual fund advisory fees tend to be higher than those of institutional accounts (as illustrated in Figure 1). Such comparisons can be highly misleading because of the dissimilarities between mutual funds and institutional accounts. This paper highlights key differences between the two products. A wide range of factors influences the relative advisory fees of the two products. Thus, there are no simple rules by which fund boards can compare the fees of such products. When assessing mutual fund fees, there is no substitute for the considered business judgment of fund boards.

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<sup>1</sup> *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies; Final Rule*, SEC Release Nos. 33-8433; 34-49909; IC-26486 (June 23, 2004); 69 Fed. Reg. 39798 (June 30, 2004).

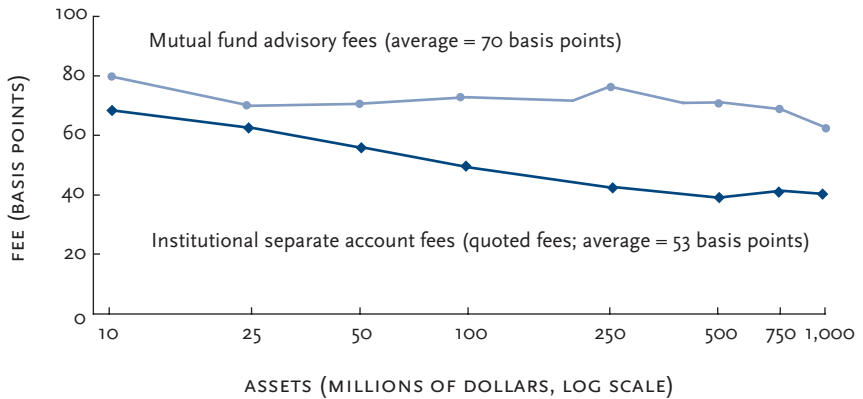
<sup>2</sup> Throughout this paper, "institutional account" is taken to mean an institutional separate account or an institutional commingled trust, but excludes institutional share classes of mutual funds. Institutional share classes of mutual funds have some features in common with institutional separate accounts, such as sizable average account balances, but also share many common attributes with retail share classes of mutual funds. For the sake of brevity, institutional share classes of mutual funds are not discussed separately from other share classes of mutual funds.

FIGURE 1:

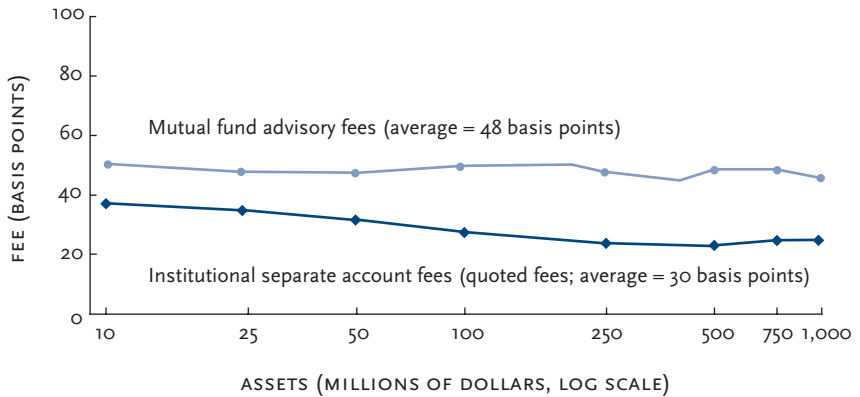
**Advisory Fees of Mutual Funds and Institutional Separate Accounts**

*(fees for active management; annual percent of assets in basis points)*

*Large-Cap Domestic Equity Portfolios\**



*Domestic Fixed-Income Portfolios\**



*\*Fees for separate accounts are those quoted by asset managers for actively managing a portfolio while advisory fees for mutual funds are those actually incurred on actively managed funds.*

*Sources: Lipper for mutual funds; Callan Associates for institutional separate accounts*

## 2. MUTUAL FUNDS AND INSTITUTIONAL ACCOUNTS: DIFFERENT PRODUCTS, DIFFERENT COSTS

Asset managers generally agree that mutual funds and institutional accounts are inherently different products. To be sure, mutual funds and institutional accounts have in common the need for portfolio management, including security selection, research, securities trading, and asset allocation. But the similarities largely end there. Figure 2 summarizes some of the major differences that can influence the advisory fees of the two products.

FIGURE 2:

### Major Differences between Mutual Funds and Institutional Accounts

Mutual Funds	Institutional Accounts*
Primarily serve retail investors	Primarily serve corporations, state and local governments, foundations, and endowments
Serve thousands to millions of investors who typically have small average account balances	Serve one to at most a few hundred investors with high average account balances
Adviser must provide considerable service due to volume of investors	Adviser provides service, but to a limited number of client contact points
Subject to Investment Company Act of 1940	Not subject to Investment Company Act of 1940
Frequent (usually daily) and less predictable cash flows	Infrequent and more predictable cash flows
Significant tax reporting burden	Limited or no tax reporting burden
Higher distribution costs per dollar of assets	Lower distribution costs per dollar of assets
Fund has few assets at inception but offers growth potential to adviser	Size of an account is large at inception, but offers relatively less growth potential for adviser; account may shrink over time to cover benefits or required payouts
Advisory contracts cover investment management, as well as a broad array of business and administrative activities, and sometimes transfer agency and custody	Advisory contracts primarily cover investment management

\*institutional separate accounts and commingled trusts

## Clientele

Mutual funds primarily serve retail investors while institutional accounts serve foundations, endowments, defined benefit pension plans, trusts, corporations, state and local governments, or wealthy individuals. This fundamental difference influences in many ways the features and costs of providing mutual funds and institutional accounts and, as a result, their respective fees.

## Numbers of Investors or Clients

Mutual funds gather and pool small investments from thousands or even millions of (mostly) retail investors. An institutional separate account manages the investments of a single client whose investments may total millions to several hundreds of millions of dollars. Commingled trusts manage a pool of assets of at most several hundred clients.

FIGURE 3:

### Average Account Balances of Mutual Funds and Institutional Separate Accounts

	Assets (trillions of dollars)	Number of Accounts	Average account balance (dollars)
Long-term mutual funds	\$6.2	229,458,597	\$26,993
Institutional accounts	\$2.2	53,300	\$41,048,780

Sources: Investment Company Institute for mutual funds; Morningstar for institutional accounts

This difference means that mutual funds have much lower average account balances than institutional accounts. For example, as of December 2004, long-term mutual funds had net assets of \$6.2 trillion in roughly 230 million accounts, for an average account balance of about \$27,000 (Figure 3).<sup>3</sup> According to one source, institutional accounts had assets of about \$2 trillion, but that was held in just 53,300 accounts, resulting in an average account balance of about \$41 million. This is very important because, as a rule, if two portfolios have equal assets, the one with more accounts (*i.e.*, a lower average account balance) will be more costly to operate per dollar of assets.

<sup>3</sup>The average account balance of \$26,993 in Figure 3 likely overstates by a fair margin the average account balance in a typical mutual fund because it includes balances in all institutional share classes, omnibus accounts, and variable annuities (VA), all of which tend to have very high average account balances and thus skew the average. Account level data collected by ICI indicate that the typical balance in a (non-VA) long-term retail mutual fund, as indicated by the median account balance, may be less than \$10,000. Moreover, ICI data indicate that about one-fourth of all mutual fund complexes have average account balances of roughly \$12,000 or less in non-VA accounts.

Fund advisers bear the cost and risk of setting up and maintaining the infrastructure needed to accommodate the large number of investors their mutual funds serve. For example, if a fund offers investors 24/7 access to phone representatives, the fund's call center must have sufficient round-the-clock staff to support such operations. In addition, in order to provide the services that the large numbers of shareholders demand, advisers must make ongoing capital investments in computer hardware and software, Internet websites, telephone systems, recordkeeping and accounting systems, legal and compliance systems, trading systems, and, for some advisers, brick-and-mortar walk-in retail stores.

In contrast, while institutional investors demand service, the total amount of service the adviser must provide is more limited, in part because there are fewer accounts per dollar of assets, but also because the adviser may have to deal with only one or a few client representatives per account.

### *Client Demand for Services*

Most fund investors make retail-sized purchases and select funds on the basis of performance and fees and are free to “vote with their feet.” Retail mutual fund investors also select funds on the basis of services and features that funds offer, such as the availability of a website, 24/7 phone contact, ability to exchange among funds in the same complex, checking account features on bond funds, and minimum account balances and account maintenance fees.

Institutional investors are motivated by performance and fees. However, they do not need or demand many of the services and features demanded by retail mutual fund investors.

### *Legal structure*

Institutional accounts are subject to many state and federal regulations. For example, defined benefit pension plans are subject to ERISA. Asset managers generally agree, however, that mutual funds operate under more, and more complex, laws and regulations than do institutional accounts. Most significantly, mutual funds and their advisers operate under both the Investment Company Act of 1940 ('40 Act) and the Investment Advisers Act of 1940, whereas advisers to institutional separate accounts and commingled trusts are subject to the Investment Advisers Act of 1940 but not the '40 Act.

The '40 Act and other federal securities laws impose numerous obligations uniquely on mutual funds. For example, a fund must:

- be priced daily,
- provide shareholders with detailed prospectuses and semiannual reports,
- have a board of directors or trustees,
- comply with a range of portfolio limits or restrictions, and
- comply with a myriad of other SEC rules, regulations, and pronouncements; recent examples are the greater attention paid to fair valuing securities, the need to comply with Sarbanes-Oxley, and the requirement to disclose proxy votes.

The obligations imposed on mutual funds by the '40 Act can add materially to the cost of operating a mutual fund relative to that of an institutional account.

### *Tax Status of Investors in Mutual Funds and Institutional Accounts*

Investors in mutual funds must pay taxes on capital gains and dividends, either now or, in the case of tax-deferred vehicles such as IRAs and 401(k) accounts, at some point in the future. In contrast, many institutional investors (*e.g.*, foundations and state and local governments) have tax-exempt status. Mutual funds must therefore maintain significant tax reporting capabilities that are not required for institutional accounts.

### *Portfolio management*

To some extent, portfolio management is similar for mutual funds and institutional accounts. Portfolio managers of both engage in research to help identify underpriced equities or assess the credit worthiness of bond issuers. Both buy and sell securities on the basis of that research. Both may engage in asset reallocations from time-to-time.

But portfolio management does differ importantly between the two kinds of products. Investors can purchase or redeem mutual fund shares on a daily basis. Most funds also allow investors to make exchanges at no cost between funds in the same complex. As a result, mutual funds may experience frequent and potentially large and uncertain cash flows. In contrast, flows to institutional accounts may occur only monthly, quarterly, and in some cases not for a number of years. In addition, portfolio managers of institutional accounts are often forewarned about the dates and dollar amounts of expected cash flows.

To support frequent and potentially uncertain cash flows from thousands to millions of investors, mutual fund portfolio managers may carefully time purchases and sales of securities and may use financial derivatives such as equity market futures to “equitize” cash flows. In addition, in order to allow investors to purchase or redeem shares on a daily basis, fund advisers make substantial capital investments in infrastructure such as accounting and recordkeeping systems, telephone response systems, and Internet websites, or must contract with third parties for these kinds of services.

Legal arrangements also matter. Institutional accounts may have portfolio restrictions imposed by clients because of legal restrictions on the clients themselves (*e.g.*, state law may prevent a given defined benefit pension fund from investing in the stock of particular companies), because clients wish to meet certain portfolio goals (*e.g.*, a given level of credit quality), or other reasons.

Advisers of mutual funds must comply with the requirements that the '40 Act imposes on the fund portfolios. These include requirements for portfolio diversification, limits on portfolio holdings of illiquid assets, restrictions on transactions with affiliated parties, and restrictions on investments outside of stated prospectus objectives. These requirements are intended to help to reduce financial risks or limit conflicts of interest. All else equal, however, they make portfolio management more difficult and therefore more costly for mutual funds relative to institutional accounts because the latter are not subject to the '40 Act.

### *Marketing and distribution*

Asset managers indicate that ongoing marketing and distribution costs are greater for mutual funds than for institutional accounts, at least in terms of expenditures per dollar of assets managed. This, to some extent, owes to the fact that mutual funds gather smaller investments from vast numbers of individuals through a variety of distribution channels, whereas institutional accounts collect large investments from a relatively small numbers of clients.

### *Differences in Product Life Cycles*

An institutional account usually begins life when an institutional investor makes a large initial investment of millions to hundreds of millions of dollars or more with an investment adviser. An institutional account may therefore achieve economies of scale immediately. The adviser expects assets in the account to remain relatively stable. While assets may remain in the account for a number of years, they may be withdrawn quickly if the client becomes dissatisfied with performance or service, if the investment style is no longer a good match, or for other reasons.



In contrast, a mutual fund seldom has a group of investors who make a large investment at the fund's creation. A mutual fund typically starts small and may require significant subsidies from its adviser for a number of years until the fund reaches a critical mass. To achieve this critical mass, the mutual fund's sponsor must build (or hire the services of third-party contractors who have) an infrastructure that can accommodate large numbers of shareholders in the hope that the fund will grow and eventually return a profit. If the fund eventually achieves a viable size, it may continue to attract additional shareholders and assets and return greater profits down the road.

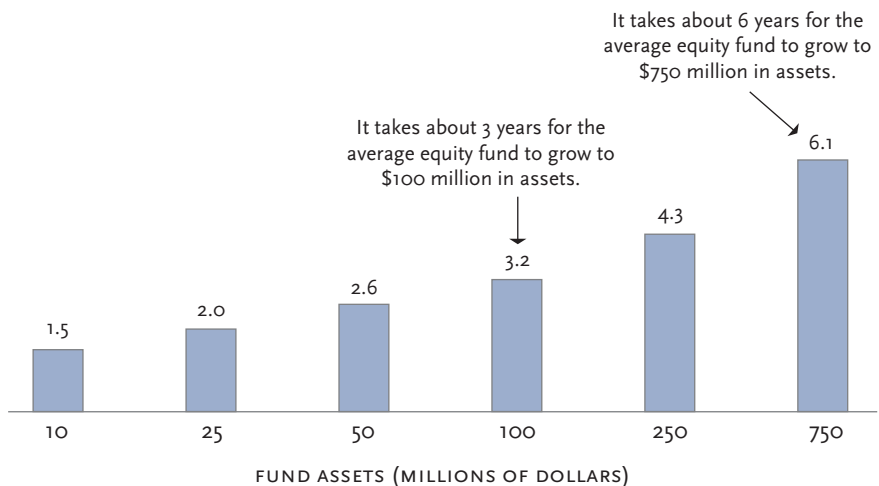
It can take several years for a fund to achieve a viable size. For example, among newly created equity funds that survive, it takes about three years for fund assets to reach \$100 million (Figure 4). Achieving a critical mass is not a given, however. Advisers not infrequently initiate funds that must eventually be closed or merged because they fail to attract sufficient shareholders and assets.

As a result, a given mutual fund and a given institutional account offer an adviser different growth prospects and, consequently, different expected profit streams and business risks. Other things the same, near-term profits are preferable to more distant, and therefore more risky, profits. The higher advisory fees of mutual funds and their greater potential for future asset growth help compensate a fund's adviser for the fact that newly created mutual funds may incur losses during their early years, may never reach viable size, and may ultimately need to be closed or merged.

FIGURE 4:

#### Years Required for an Equity Fund to Reach a Given Size

*(average years to grow to a given level of assets among surviving equity funds)*



Source: Investment Company Institute

## *Differences in Pricing*

The fees paid by a given institutional separate account client may reflect unique circumstances. For example, a given institution may incur lower advisory fees for a given account if it maintains other accounts with the same adviser. Advisers may also offer lower fees to attract high-profile clients likely to be seen by other potential clients as a “seal of approval.”

In comparison, all of the shareholders in a given mutual fund by law incur identical advisory fees, regardless of the size of their account balances or whether they invest in a number of other mutual funds in the same complex. Advisers frequently offer fee waivers — like coupons or discounts on other retail products — to attract investors, especially to new, small funds that would otherwise have high expense ratios.

## *Differences in Advisory Contracts of Mutual Funds and Institutional Accounts*

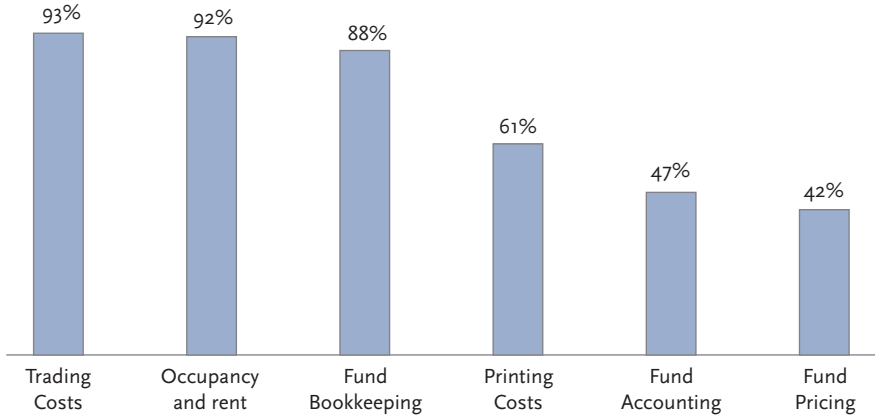
Advisory contracts for institutional accounts generally cover a narrow range of services that are directly related to portfolio management (*e.g.*, security selection, research, securities trading, and asset allocation). For instance, if an institutional investor such as a defined benefit pension plan offers beneficiaries an Internet website or a call center to handle inquiries, the costs of providing those services are not encompassed in the advisory fees that the institution pays for investment management.

In contrast, mutual fund advisory contracts are normally broad-based, covering portfolio management, as well as a range of services and features that funds need to operate. A fund’s adviser typically manages the fund’s business affairs overseeing the fund’s custodian, transfer agent, any subadviser, or other third-party service providers. The adviser typically must ensure that the fund’s operations comply with federal and state laws and regulations and may provide general accounting services; may prepare and file SEC, tax, shareholder, and other reports; and may provide the legal services required to prepare these reports. In addition, the advisory fees of some funds are “all-in,” encompassing not just portfolio management and business and administrative expenses, but also the costs of transfer agency and custody.

FIGURE 5:

**Services in Addition to Portfolio Management that May Be Covered by Mutual Fund Advisory Contracts**

*(percent of funds citing a particular service as being covered by advisory fees in their N-SAR reports; asset-weighted average)\**



*\*excludes any funds that report having paid administrative fees on their N-SAR; represents 1,867 funds comprising \$3.2 trillion in assets*

*Sources: Strategic Insight; Investment Company Institute calculations*

Figure 5 details some of the services besides portfolio management that are covered by mutual fund advisory contracts. The great majority of fund advisory contracts cover trading costs (93 percent) and occupancy and rent (92 percent). Most fund advisory contracts cover fund bookkeeping (88 percent), more than half (61 percent) cover printing costs for things like prospectuses and annual reports, and about half cover fund accounting (47 percent) and daily NAV pricing (42 percent).

In short, the advisory contracts of mutual funds often cover much more than just portfolio management, whereas the advisory contracts of institutional accounts primarily cover portfolio management.

### 3. SUMMARY

Meaningfully and directly comparing the advisory fees of mutual funds and institutional accounts may pose significant challenges for fund boards. Mutual funds and institutional accounts are different products, operate under different legal and regulatory structures, and are distributed through different channels to different clienteles. These differences generally mean that mutual funds can be more risky to start and more costly to operate and distribute than institutional accounts. In addition, the advisory contracts of mutual funds are typically broad-based while those for institutional accounts are narrow in scope. The combination of these factors helps to explain why the advisory fees of mutual funds tend to be higher than those of institutional accounts.



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