

2016

Study on Expense Ratios for Mutual Funds



FOUNDATION OF INDEPENDENT FINANCIAL ADVISORS



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STUDY ON EXPENSE RATIOS FOR MUTUAL FUNDS:

1. OVERVIEW:

There is a general perception of the industry that the TER (Total Expense Ratio) of Mutual Funds in India is extremely high.

The 2015 edition of the Morning Star study “Global Fund Investor Experience Study June 2015” (hereinafter referred to as GFIE Report) covers fees and expenses for funds for 25 countries including India. This report was created to encourage a dialogue about global best practice for mutual funds from the perspective of fund shareholders.

The objective of the study is to analyse the fees and expense ratios for the asset classes prevalent in India as compared to the global market for the domiciled funds.

Studies have compared the annual costs of investing in mutual funds across countries. However, many times the costs are not meaningfully comparable. The GFIE Study 2015 has compared cost of bundled funds (embedded funds) and unbundled funds without taking into consideration the fact that in case of unbundled funds the annual costs are not the total cost of ownership of funds. The following extract from the report clearly brings this out:

“One of the difficulties in comparing Annual Expense Ratios across countries has been development of unbundled fee arrangements, whereby an advisor is not paid sales commission by the Fund Company in the traditional model but rather is paid a separate fee by the Fund Investor. When taken, this action has the effect of lowering official fund expense ratios because funds no longer need to collect money from share holders to make advisor payments. It also has the effect of complicating expense ratio comparisons, because an investor in a lower cost fund may pay an additional fee to an advisor which is not considered in Morning Star calculations.”
(Page 21 of the GFIE Report)

Conclusions that TER in India is indeed high are drawn going by the reports of research agencies such as Morning Star without giving due consideration to all ingredients of the cost of ownership to the investor.

An in depth perusal of the Global Fund Investor Experience Study, the 2015 edition of Morning Star destroys the myth of India being one of the high T.E.R. countries.



Our study indicates:

- (i) According to the GFIE Report the Average Median Expense Ratio for money market funds in India is 0.18%. **India is ranked as the 3rd least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 2**
- (ii) According to the GFIE Report the Average Median Expense Ratio for Fixed Income funds in India is 0.53%. **India is ranked as the 6th least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 2**
- (iii) **Money Market and Fixed Income Funds comprise of 9.14 trillion that is almost 2/3rd of the total assets managed by the Indian Mutual Fund Industry which is being managed at a weighted average cost of 0.40%.**
- (iv) **In the GFIE Report, the TER for Equity Funds is shown as 2.65% for India. However, we carried out an independent study which indicates TER for Equity Oriented Funds as 2.07% (1.81% before Service Tax).**

According to AMFI classification of assets, our study indicates the average weighted expense ratio for Equity Oriented Funds for March 2016 is 2.07%. If service tax of 14.50% is reduced from Total Cost of 2.07%, the TER before service Tax in India is 1.81%. The detailed analysis of the same is given in TABLE 3.

In our interaction with Morning Star, we were informed that they have classified Balanced Funds, Fund of Funds (FOF) and Arbitrage Funds as Allocation Funds. But according to AMFI classification they have been classified as Equity Oriented Funds. **To make TER comparable with GFIE Report, If we were to exclude the Balanced Funds, Fund of Funds (FOF), Arbitrage Funds from Equity Oriented Funds, the average weighted expense ratio for Equity Funds for March 2016 is 2.14%. If service tax of 14.50% is reduced from Total Cost of 2.14%, the TER before service Tax in India is 1.87%.**

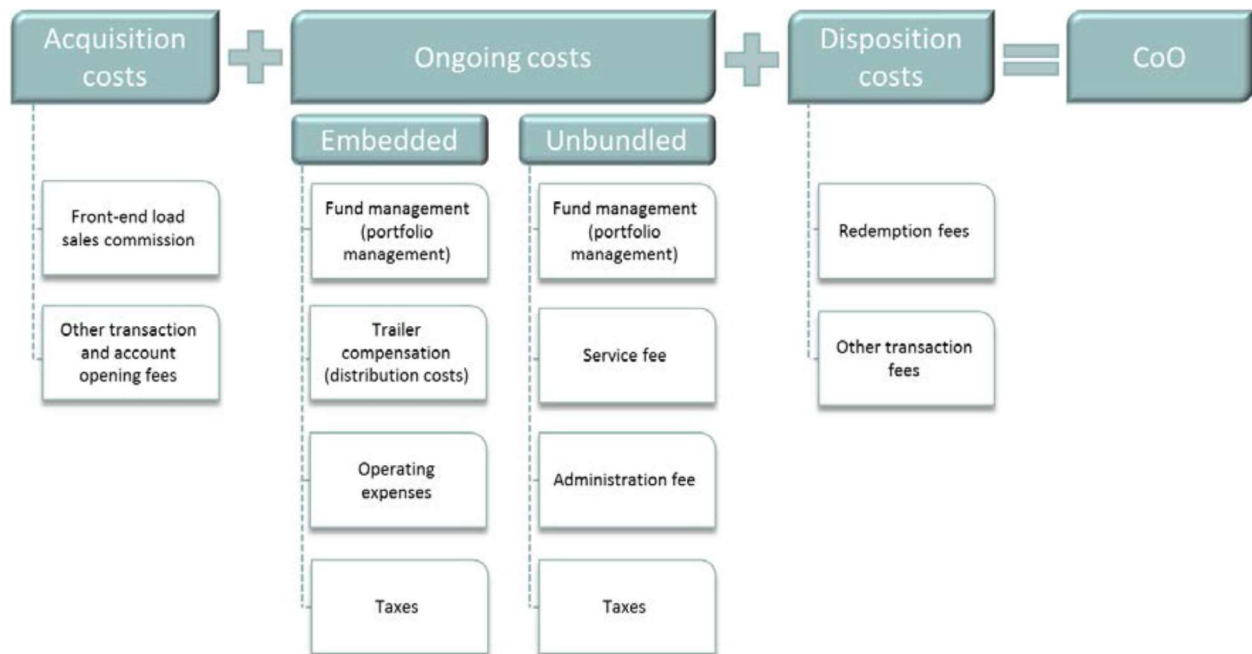
We have written to Morning Star about the discrepancy observed in expense ratio for Equity Funds in India. The response from Morning Star has not been received till the time of writing this report.

In case of equity funds, if the total cost of ownership i.e. front load charges + annual expense + advisory fees + platform access charges + performance fees, is considered then **India is ranked as the 5th least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 3.**



2. COST OF OWNERSHIP (CoO) OF FUNDS TO INVESTORS:

Before an exercise is undertaken to decipher the expense ratios and rankings it would be pertinent to define the Cost of Ownership of Mutual Funds. The cost of ownership of Mutual Fund is described as:-



Source: Investors Economies and Strategic Insight of Canada the Cost of Ownership framework

Typically Total Cost of Ownership for the investor comprises of following costs:

- i) Front-end Loads charged at the time of investment.
- ii) Asset Management fees, charged by Asset Management Companies (AMC).
- iii) Trailer fees charged by AMC and paid to distributors for their services.
- iv) Operating expenses such as custodian, trustee, audit, legal, filing record keeping etc.
- v) In case of unbundled services, Investment Advisory Fees charged by Investment Advisors, where the investors avail their services.
- vi) Platform Charges.
- vii) Taxes such as service tax, HST and GST.
- viii) Deferred Loads.



3. DIFFERENT GLOBAL PRACTICES:

Broadly the investors are charged following expenses:

a. Annual Expense Ratios:

Annual Expense Ratios refer to the fees charged by the AMCs to the unit holders for investments managed by them. There is a practice of bundled fee and unbundled fee arrangements in different markets. In Unbundled fee arrangements an advisor is not paid a sales commission by the fund company as in the traditional model but rather is paid a separate fee by the fund investor.

b. Front load charges:

There is a practice of charging front end load charges which are sales commissions paid at the time of purchase of fund. Front Load charges range between 0%-5%.

“Specifically, in two thirds of the countries, front loads are negotiable with the advisor. In other markets they are fixed on a specific break point schedule, giving investors little room to negotiate price. In China and Finland loads are negotiable but only for large investments.” (Page 21 of the GFIE Report). **Front loads are banned in India**

c. Deferred loads:

Deferred loads are paid when the investors exit the fund.

d. Performance Fees:

“In addition to ongoing stable expense ratios, fund investors sometimes are charged performance fees based on the returns of the fund.” (Page 21 of the GFIE Report). Performance fees are not paid in India

e. Advisor Fees:

These are fees paid by the unit holders to Investment Advisors where they avail the services of the Investment Advisors. This is mainly in cases of unbundled fee arrangements.



4. ASSETS MANAGED BY THE INDIAN MUTUAL FUND INDUSTRY:

We have tabulated below the details of Average AUM for Assets managed by the Indian Mutual Fund Industry as on 31.03.2016:

Asset Class	AAUM Amount (Rs. Trillion)	AAUM Amount (Rs. Trillion)	%
MONEY MARKET		3.27	24.15%
DEBT			
Income	5.70		
Gilt	0.17	5.87	43.38%
EQUITY ORIENTED FUNDS			
Growth and Balanced	3.79		
ELSS	0.39		
Fund of Funds – Overseas	0.02		
Other ETFs	0.13	4.33	32.00%
GOLD ETF's		0.06	0.47%
		13.53	100.00%

Source: AMFI India



5. OUR ANALYSIS:

The GFIE Report covers fees and expenses for funds available for sale in market place and funds which are locally domiciled. The GFIE Report breaks up the market into 4 groups of funds –Fixed Income, Money Market, Equity and Allocation.

The objective of the study is to analyse the fees and expense ratios for the asset classes prevalent in India as compared to the global market for the domiciled funds.

We have collated the data appearing in the GFIE Report 2015 and prepared following tables to give a meaningful comparison of fees and expenses and country wise rankings:

- (i) Summary of Overall Grade and Expenses for Mutual Funds for 25 countries: TABLE 1;
- (ii) Summary of Fees and Expenses for Money Market and Fixed Income- Domiciled Funds for 25 countries with Ranking : TABLE 2;
- (iii) Summary of Cost of Ownership of Equity Funds for 25 countries. This report considers the cost of bundled funds and in case of unbundled funds the Total cost of ownership i.e. front load charges, fees for unbundled services + cost of advisory/services and platform charges with Rankings: TABLE 3;

As per GFIE Report, the TER for Equity Funds in India is 2.65%. However, we carried out an independent study which indicates TER for Equity Oriented Funds as 2.07% (1.81% before Service Tax). To make TER comparable with GFIE Report, we have considered expenses for Equity Funds in India @ 2.14% in the tables 1 and 3.



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TABLE 1

Summary of Overall Grade and Expenses for Mutual Funds for 25 Countries:

Country	OVERALL GRADE					Fees & Expenses- Average Median Expense Ratio							
	Overall Grade	Regulation and Taxation	Disclosure	Fees and Expenses	Sales and Media	DOMICILED FUNDS				AVAILABLE FOR SALE			
						Fixed Income	Equity	Allocation	Money Market	Fixed Income	Equity	Allocation	Money Market
Australia	B-	D	D+	A	A-	0.58	1.18	0.82	0.40	0.00	0.00	0.00	0.00
Belgium	C	B-	C	C	B	0.22	1.30	1.10	0.51	1.16	1.90	1.43	0.33
Canada	C+	C	A-	D-	B	1.51	2.35	2.16	0.60	0.00	0.00	0.00	0.00
China	D+	B-	C+	D+	C-	0.89	1.76	1.76	0.63	0.00	0.00	0.00	0.00
Denmark	B-	B-	B	B	C-	0.73	1.54	0.84	0.30	1.05	1.82	1.43	0.15
Finland	B-	B-	B	B-	C	0.65	1.61	1.21	0.30	1.24	1.90	1.45	0.12
France	C	B-	C-	C+	C+	0.77	1.65	1.63	0.29	1.07	1.81	1.65	0.15
Germany	C+	C+	C+	C	B	0.76	1.44	1.54	0.27	1.06	1.81	1.63	0.15
HongKong	C	B	C	D+	B+	0.96	1.52	1.69	0.48	1.40	1.90	1.69	0.18
India (Note1)	C+	B-	C+	B-	B-	0.53	2.14	2.38	0.18	0.00	0.00	0.00	0.00
Italy	C-	B-	C	C	C	1.09	2.31	1.58	0.36	1.15	1.86	1.65	0.15
Japan	C-	B	C	D+	B-	1.51	1.65	1.40	0.59	1.51	1.65	1.40	0.26
Korea	A	A-	B	B+	B	0.41	1.60	1.05	0.15	1.39	1.83	1.38	0.15
Netherlands	A-	C+	C+	A	B	0.50	0.80	1.11	0.35	1.12	1.76	1.49	0.15
New Zealand	C+	C	C+	B	C+	0.64	1.46	1.41	0.63	0.64	1.57	1.41	0.63
Norway	B-	B	B-	B-	C-	0.50	2.00	1.12	0.40	1.31	1.90	1.49	0.15
Singapore	C	B+	C-	C-	B	0.79	1.73	1.43	0.50	1.39	1.90	1.69	0.27
SouthAfrica	C	C+	D+	B	C+	0.64	1.43	1.63	0.57	0.83	1.85	1.63	0.57
Spain	C	B-	C+	B-	C-	0.85	2.01	1.34	0.60	1.10	1.82	1.56	0.12
Sweden	B	C+	B+	B	C	0.70	1.56	1.60	0.30	1.24	1.83	1.50	0.13
Switzerland	B-	B-	C+	B-	B	0.80	1.32	1.30	0.20	1.06	1.73	1.50	0.15
Taiwan	A-	C+	A	D+	A-	1.36	1.76	1.33	0.20	1.46	1.83	1.67	0.21
Thailand	C+	B-	B-	C+	C	0.44	1.83	1.35	0.49	0.00	0.00	0.00	0.00
United Kingdom	B+	B	C+	B	A-	1.05	1.65	1.43	0.40	1.11	1.75	1.50	0.12
United States	A	C-	A	A	B-	0.59	0.84	0.61	0.14	0.00	0.00	0.00	0.00

Source: GFIE Report- June 2015, Morningstar Inc.

Note 1:

According to GFIE Report, TER for Equity Funds in India was 2.65%. Our study indicates, the TER for Equity Funds @ 2.07% for Equity Oriented Funds as per AMFI's classification. To make TER comparable with the classification of assets in GFIE Report, we have considered expenses for Equity Funds in India @ 2.14%. Detailed reasons are discussed in the report.



TABLE 2

Summary of Fees and Expenses for Money Market and Fixed Income- Domiciled Funds for 25 countries with Ranking:

Country	DOMICILED FUNDS			
	Money Market		Fixed Income	
	Expense Ratio	Rank	Expense Ratio	Rank
Australia	0.40	13	0.58	7
Belgium	0.51	19	0.22	1
Canada	0.60	22	1.51	24
China	0.63	24	0.89	19
Denmark	0.30	8	0.73	13
Finland	0.30	8	0.65	11
France	0.29	7	0.77	15
Germany	0.27	6	0.76	14
HongKong	0.48	16	0.96	20
India	0.18	3	0.53	6
Italy	0.36	12	1.09	22
Japan	0.59	21	1.51	24
Korea	0.15	2	0.41	2
Netherlands	0.35	11	0.50	4
New Zealand	0.63	24	0.64	9
Norway	0.40	13	0.50	4
Singapore	0.50	18	0.79	16
SouthAfrica	0.57	20	0.64	9
Spain	0.60	22	0.85	18
Sweden	0.30	8	0.70	12
Switzerland	0.20	4	0.80	17
Taiwan	0.20	4	1.36	23
Thailand	0.49	17	0.44	3
United Kingdom	0.40	13	1.05	21
United States	0.14	1	0.59	8

Source: GFIE Report- June 2015, Morningstar Inc.



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TABLE 3
 Summary of Cost of Ownership of Equity
 Funds for 25 countries.

Fees & Expenses- Average Median Expense Ratio

Country	Morning Star Report					Total Cost of Ownership				Revised Ranking
	Funds Reporting Front Load %*	Expense Ratio for Equity*	Less: Service Tax (Note i)	Expense Ratio for Equity Funds Before Service Tax (Note i)	Rank	Expense Ratio for Equity Funds Before Service Tax (Col 5)	Front Load Charges (Col 2 x 0.50%) (Note ii)	Advisory+ Platform Charges for Unbundled Funds (Note iii)	Total Cost (Col 7+8+9)	
1	2	3	4	5	6	7	8	9	10	11
Australia	15	1.18		1.18	3	1.18	0.08	1.25	2.51	19
Belgium	87	1.30		1.30	4	1.30	0.44		1.74	3
Canada	4	2.35	0.21	2.14	24	2.14	0.02		2.16	13
China	66	1.76		1.76	18	1.76	0.33		2.09	12
Denmark	94	1.54		1.54	10	1.54	0.47	1.25	3.26	25
Finland	69	1.61		1.61	13	1.61	0.35		1.96	7
France	86	1.65		1.65	14	1.65	0.43		2.08	10
Germany	85	1.44		1.44	7	1.44	0.43		1.87	4
HongKong	71	1.52		1.52	9	1.52	0.36		1.88	6
India (Note iv)	0	2.14	0.27	1.87	21	1.87	0.00		1.87	5
Italy	43	2.31		2.31	25	2.31	0.22		2.53	20
Japan	81	1.65		1.65	14	1.65	0.41		2.06	8
Korea	11	1.60		1.60	12	1.60	0.06		1.66	2
Netherlands	59	0.80		0.80	1	0.80	0.30	1.25	2.35	18
New Zealand	37	1.46		1.46	8	1.46	0.19	1.25	2.90	22
Norway	48	2.00		2.00	22	2.00	0.24		2.24	17
Singapore	88	1.73		1.73	17	1.73	0.44		2.17	15
South Africa	28	1.43		1.43	6	1.43	0.14	1.25	2.82	21
Spain	15	2.01		2.01	23	2.01	0.08		2.09	11
Sweden	14	1.56		1.56	11	1.56	0.07		1.63	1
Switzerland	81	1.32		1.32	5	1.32	0.41	1.25	2.98	23
Taiwan	95	1.76		1.76	18	1.76	0.48		2.24	16
Thailand	46	1.83		1.83	20	1.83	0.23		2.06	9
United Kingdom	52	1.65		1.65	14	1.65	0.26	1.25	3.16	24
United States	15	0.84		0.84	2	0.84	0.08	1.25	2.17	14

*Source: GFIE Study- June 2015, Morningstar Inc. except for India



Notes for Table 3:

- (i) In India, TER includes service tax @ 14.50% as on March 2016. We have worked out the expense ratio before Service Tax. We have done the same adjustment for Canada where the rate of tax is considered @ 10%. In USA the TER does not include service tax/ HST.
- (ii) The GFIE Report has indicated the Funds Reporting Front Load %. Funds Reporting Front Load % indicates % of cases where front load charges have been paid by investors. For eg. In Belgium Front Load charges have been reported in 87% of the funds sold and in Singapore in 88% cases.

The Front Load % paid by the investor has not been mentioned in the Report. Internationally Front Load charges are in the range of 0% to 5%. We have assumed Front Load charges @ 1.50% and amortised it over a period of 3 years being average holding period of the funds. The annual front load charges have therefore been taken to be 0.50%.

In col 8 to arrive at the Front Load Charge, we have multiplied Front Load Charges assumed @ 0.50% with Funds Reporting Front Load %.

- (iii) *"In 2013, the US was the main exception to the dominant position of bundled fee arrangements worldwide. As a part of this study, we have also identified Australia, South Africa and the Netherlands as markets where the fees are also typically unbundled. There are no of other markets where unbundling is a growing trend, including New Zealand, UK, Denmark and Switzerland."* (Refer Pg 21, GFIE Report).

In Unbundled fee arrangements an advisor is not paid a sales commission by the fund company in the traditional model but rather is paid a separate fee by the fund investor.

"What is the total cost of owning an unbundled fund? We specifically looked at information available from the U.S., Australia, the U.K., and South Africa to answer this question. If an investor has accessed the fund directly, without the help of an advisor, then there are no more costs. Where an advisor is involved, there is no one number but typically a range. Broadly, ongoing fees paid to advisors range from 0.5% to 1.2% per annum, with 0.75% quoted as an average. These ranges were similar in each of the four markets. When using a platform to gain access to a range of unbundled funds, there is typically a fee for this service as well. The range here is 0.00% to 0.75%. These costs are typically very low or bundled elsewhere, in the case of the U.S., and tend to be in the order of 0.3% to 0.4% in other markets. If paying for both advice and an administration platform, the total cost of owning the fund could be an additional 1.0% to 1.5%." (Refer Pg 22, GFIE Report).

We have assumed Advisory and Platform Charges @ 1.25%.

- (iv) According to GFIE Report, TER for Equity Funds in India was 2.65%. Our study indicates, the TER for Equity Funds @ 2.07% for Equity Oriented Funds as per AMFI's classification. To make TER comparable with the classification of assets GFIE Report, we have considered expenses for Equity Funds in India @ 2.14%. Detailed reasons are discussed in the report.



Our Observations for various asset classes are:

I. MONEY MARKET:

- i) According to the GFIE Report the Average Median Expense Ratio for money market funds in India is 0.18%. **India is ranked as the 3rd least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 2**
- ii) The Indian investments yield a return of almost 8% per annum, so even after the expense ratio the Investors earn a good yield. As against this in case of Japan and USA the expense ratio for this class is 0.59% and 0.14% respectively inspite of the yields being significantly lower.
- iii) Thus, out of the total funds under management in India (AAUM) as on 31st March 2016, Rs. 3.27 trillion- 24.15% of the funds are being managed within an expense ratio of 0.18%.

II. FIXED INCOME:

- i) According to the GFIE Report the Average Median Expense Ratio for Fixed Income funds in India is 0.53%. **India is ranked as the 6th least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 2**
- ii) The Indian investments yield a return of almost 8% per annum, so even after the expense ratio the Investors earn a good yield. As against this in case of Japan and USA the expense ratio for this class is 1.51% and 0.59% respectively inspite of the yields being significantly lower.
- iii) Thus out of the total funds under management in India (AAUM) as on 31st March 2016, Rs. 5.87 trillion- 43.38% of the funds are being managed within an expense ratio of 0.53%.
- iv) **Money Market and Fixed Income Funds comprise of 9.14 trillion that is almost 2/3rd of the total assets managed by the Indian Mutual Fund Industry which is being managed at a weighted average cost of 0.40%.**



III. EQUITY:

In the GFIE Report, the TER for Equity Funds is shown as 2.65% for India.

We have carried out an independent study to analyse the TER for Equity Oriented Funds in India. We have taken the Average AUM for March 2016 scheme wise from AMFI India website. We have worked out the weighted average expense ratios for all schemes in the category Equity Oriented Funds.

According to AMFI classification of assets, our study indicates the average weighted expense ratio for Equity Oriented Funds for March 2016 is 2.07% as per table below:

In Crs		
Expense Ratio for Equity Oriented Funds	Avg AUM for March 16	Total Expense Ratio (%)
Growth	302120	2.21%
ELSS	38788	2.24%
Balanced	51784	2.21%
Other ETFs	12926	0.25%
Arbitrage	26157	0.76%
Fund of Funds - Overseas	1918	1.79%
Grand Total	433694	2.07%

If service tax of 14.50% is reduced from Total Cost of 2.07%, the TER before service Tax in India is 1.81 %.



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In our interaction with Morning Star, we were informed that they have classified Balanced Funds, Fund of Funds (FOF) and Arbitrage Funds as Allocation Funds. But according to AMFI classification they have been classified as Equity Oriented Funds. **To make TER comparable with GFIE Report, if we were to exclude the Balanced Funds, Fund of Funds (FOF), Arbitrage Funds from Equity Oriented Funds, the average weighted expense ratio for Equity Funds for March 2016 is 2.14% as per table below:**

In Crs		
Expense Ratio for Equity Oriented Funds	Avg AUM for March 16	Total Expense Ratio (%)
Growth	302120	2.21%
ELSS	38788	2.24%
Other ETFs	12926	0.25%
Grand Total	353834	2.14%

If service tax of 14.50% is reduced from Total Cost of 2.14%, the TER before service Tax in India is 1.87%.

We have written to morning star about the discrepancy observed in expense ratio for Equity Funds in India by emailed dated 10/5/2016 and 11/6/2016. The response from Morning Star has not been received till the time of writing this report.

As acknowledged by the Report itself while compiling the tables and categorizing countries based on expense ratios, front loads, exit loads, adviser fees, platform fees etc. have not been taken into account.

Our analysis indicate:

- i) According to the Report the Weighted Average Expense Ratio for Equity Funds in India is 2.07% and 1.81% before Service Tax.
- ii) **India is ranked as the 5th least expensive country out of 25 countries reviewed in GFIE Report. Refer–TABLE 3.**
- iii) The long term returns post expenses earned by investors in Indian equity funds are far superior to returns earned in funds in other countries. An analysis of the TER as a percentage to the returns earned would be the best in India.