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The coming fee famine

On the Tuesday before the Thursday before the long Labor Day weekend, Fidelity Investments laid an ax to the fees it charges on five of its equity index funds. So doing, the Boston behemoth opened a new phase in the commoditization of investing. Following is a speculation on the meaning of this development for the sprawling, highly capitalized, fabulously remunerative money-management business.

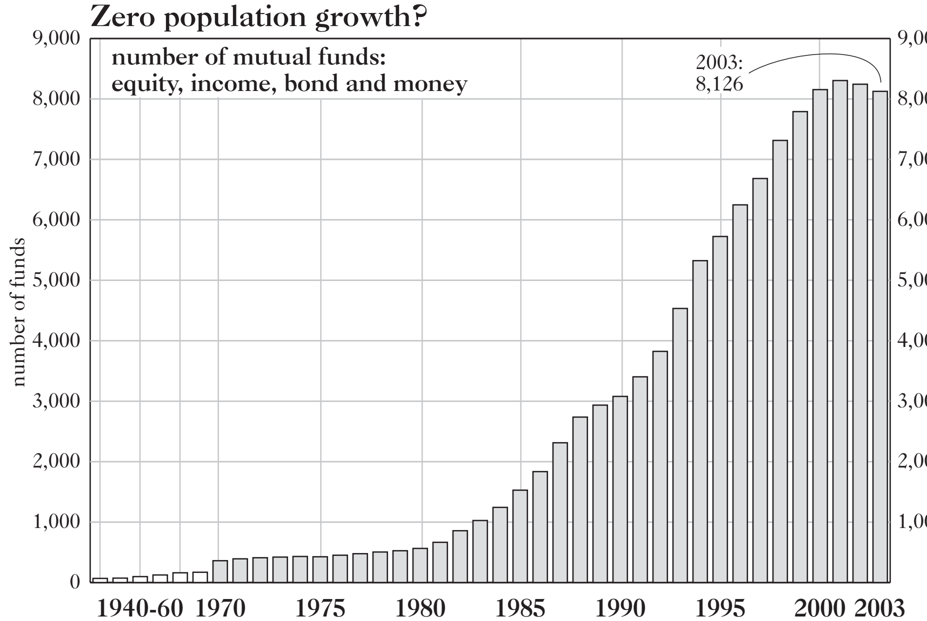
The Fidelity news surprised no faithful readers of the financial press. Last week's reduction in fees was the company's fourth in 18 months. No fewer than 500 mutual funds cut their fees in the year to July 31, according to Lipper Inc., more than twice the number of a year ago. Avenging angel Eliot Spitzer has signed agreements with seven offending mutual fund companies stipulating fee reductions of $800 million over five years. According to a February study by the Investment Company Institute, "the cost of sales loads and annual expenses paid by mutual fund shareholders has dropped sharply since 1980."

Contrary to evidence that you sometimes see before your very eyes, the laws of supply and demand do apply on Wall Street. Twenty years of titanic returns in financial assets led an immense expansion in money-management capacity. People, office space, computing power and distribution chains were assembled to service the surging demand for double-digit investment returns. "Over the past two decades," observes the ICI, "the growth in investor demand and low barriers to entry have prompted the formation of many new fund companies. These new companies, along with existing fund companies, have created thousands of new funds." And not only mutual funds but also a vast array of tradable options and indices, many competing directly with managed funds. But now that returns have dwindled, so has the demand for investment management. Drooping demand overlaid on generous supply points in the direction it usually does--to lower margins for the redundant vendors.

Which vendors? Investors are, and long have been, free to choose. At the extreme of cost consciousness, they may pick a Fidelity index fund at 10 basis points a year or a Vanguard index fund at 12 basis points a year. They may buy an exchange-traded fund with no management fee, only the brokerage expense. All the way over at the extreme of cost obliviousness, they may choose a hedge fund, or a fund of hedge funds, or a fund of funds of hedge funds, at 1% or more in management fees and 20% or more of the profits, if any.

"The world is a big place," the April 9 issue of Grant's observed, "but whether it is big enough to accommodate both the Vanguard idea (low fees) and the Man idea (high fees) may be doubted." Subsequently, the price of a share of the London-listed Man Group, the biggest public hedge-fund purveyor, has fallen by 25%. However, assets under hedge-fund management have continued to climb. (What percentage of the hedge funds that you respect are closed to new money? a friend asked a successful investor the other day. Eighty percent was the answer. Incred-

Zero population growth?



source: Investment Company Institute

Man Group—tradable hedge fund

source: The Bloomberg

ibly, our friend reflects, at this moment the demand for hedge funds outstrips the supply--or at least the supply of funds you'd want to invest in.) At first glance, the hedge-fund boom would seem to provide a pricing umbrella for any and every branch of the money-management business. Looking more closely, however, we see no such umbrella, only an echo of the bubble years, when Old Economy stocks could look cheap at 25 times earnings because New Economy stocks traded at 50 or 100 times. It turned out there was no New Economy, only the Old Economy sitting in front of a computer terminal.

"I view index funds as a commodity," Jeff Carney, president of Fidelity's retail group, tells The Boston Globe, "and we need to offer a competitive price in order to attract the kind of flows we'd like to see." If index funds are a commodity, what should we call equity mutual funds? Corporate and tax-exempt bond funds? What should we call the managed funds that don't manage to beat the relevant index--indeed, that, after fees and expenses, return less than nothing? Tuesday's Financial Times contained a relevant paragraph: "Fidelity's Magellan Fund lost an average of 5.4% a year from mid-1999 to mid-2004," the paper said. "Over that time, the fund charged investors more than $2 billion in fees. However, if it had left its portfolio untouched it would have lost only 2% a year, according to Morningstar." In uttering the word "commodity," Carney opened a can of worms.

For the three-decade collapse in investment-transaction costs, historians will credit technology and deregulation. To explain the broad-based decline in investment-management fees, they should cite, among other things, new SEC restrictions on so-called soft dollar payments, a rise in mutual-fund distribution costs and--not least--Mr. Bear. In a disappointing stock market, every basis point--even the prevailing measly dividend yield on the S&P 500 or the superficially inconsequential difference in cost between index funds--makes a difference. "Shareholders have always been very sensitive to fees, in the sense that the bulk of industry flows go into lower-cost funds," Brian Reid, deputy chief economist at the ICI, tells Grant's. "I think, if anything, it's heightened in the last several years."

What does professional equity management cost? Charles T. Munger, of Berkshire Hathaway fame, puts it at 3%, all in (mutual funds claim 1%, but Munger knows more, and has been around longer, than most mutual funds). He deplores this spending, likening it to a particular kind of embezzlement: the owners have been victimized, but they don't know it yet. Adapting the verbal invention of John Kenneth Galbraith, Munger calls the commandeered billions the "febezzle"--the prefix, of course, derived from "fee."

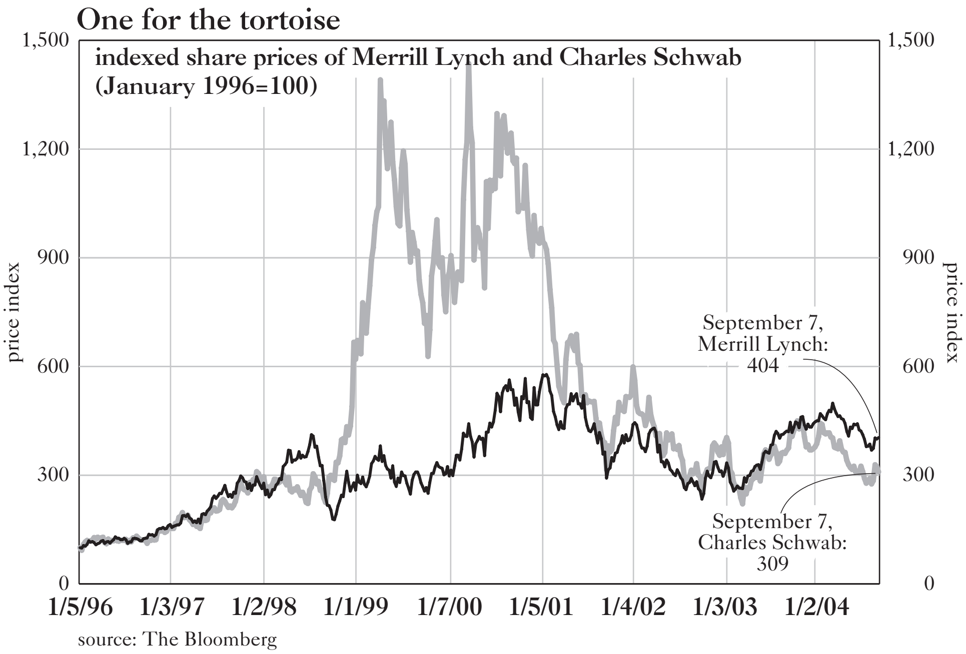
"If a foundation, or other investor, wastes 3% of assets per year in unnecessary nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3%, 'febezzlers' though they are, think they are virtuously earning income," Munger explained in a 2000 speech. "The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself"--until a bear market, mutual-fund scandals and angry politicians force the febezzle to shrink.

The threat of further shrinkage is a dark cloud hanging over the likes of Franklin Resources, T. Rowe Price, BlackRock Inc., Federated Investors, Eaton Vance et al. It is a cloud that a bull market could easily dispel. But, pending the restoration of dependable and effortless double-digit returns in passive investment portfolios, the downward pressure on fees and margins is likely to weigh on the stocks of the money managers. This is, we recognize, a large and bold generalization: There are equity managers, debt managers and variations on each. Nearby, we show the trend in revenues and assets under management for the biggest of the money managers (measured by market cap), Franklin Resources. If we are right about the unfolding bear market in fees and margins, it has only just begun.

Study after study underscores the validity of a message long identified with the founder of Vanguard Group. Don't

Franklin Resources—the trend is no friend

	2003	2002	2001	2000	1999	1998	1997	1996	1995
Avg. assets under mgmt. (bil.)	$ 269.8	$ 263.2	$ 243.4	$ 227.7	$ 219.8	$ 213.4	$ 217.3	$ 188.8	$ 141.2
Revenue (mil.)	2,624.4	2,518.5	2,354.8	2,340.1	2,262.5	2,577.3	2,163.3	1,519.5	1,253.3
Revenue/avg. assets	0.97%	0.96%	0.97%	1.03%	1.03%	1.21%	1.00%	0.80%	0.89%



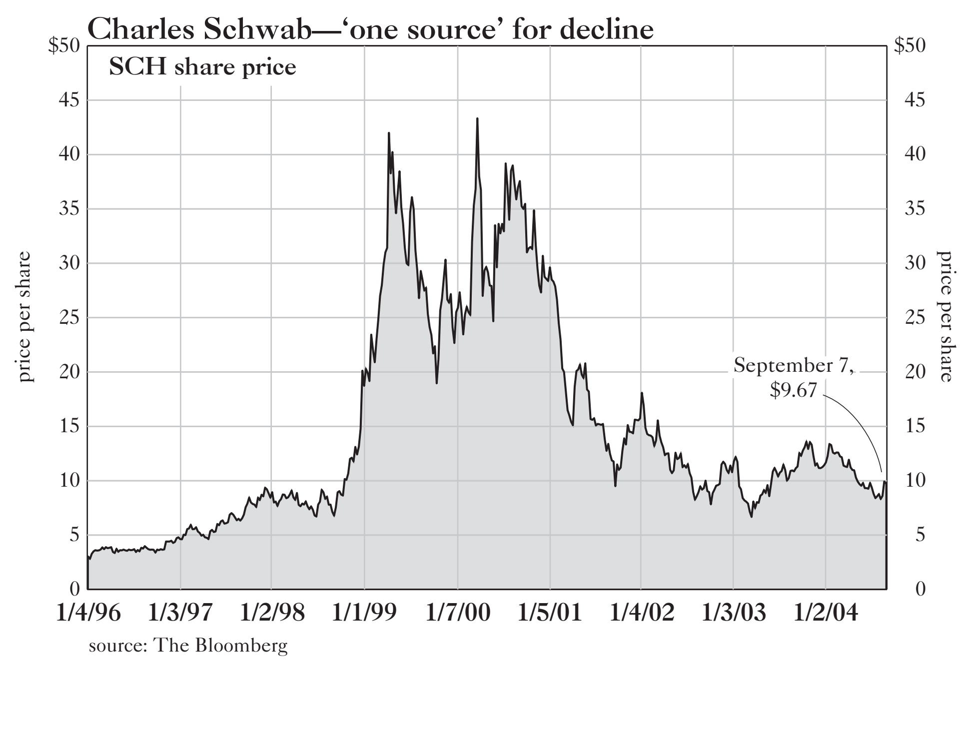
overpay for investment "management," Jack Bogle likes to say. In a recent comparison of fund performance, Standard & Poor's found that fees make the difference: Funds charging below-average fees outperform those charging above-average fees. The finding holds for almost every category and at almost every interval (a year, three years, five years or 10 years). "Few, if any, fund characteristics can be linked to performance more so than the level of expenses," Phil Edwards, an S&P managing director, was quoted as saying in the July 12 issue of Investment News.

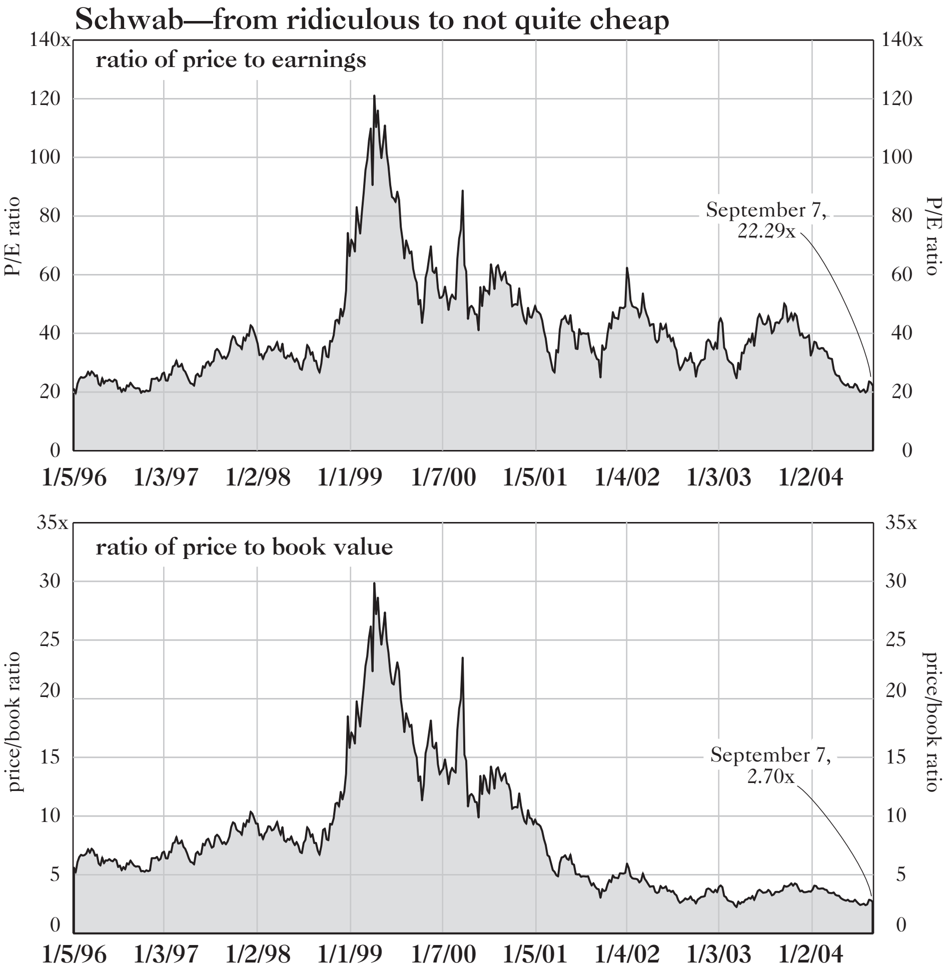
Edwards has the compound interest tables on his side. According to a study by the benefits consulting firm of Hewitt Associates (as reported in The Boston Globe), "$50,000 invested in a 401(k) plan with average fees of 0.5% would grow to $437,748 over 30 years, assuming an 8% annual gain. With a 1% fee, the account would grow to $380,613." The Hewitt study apparently did not probe the 1%-and-20% hedge-fund compensation model.

Many judge that, in ponying up these immense fees, the smart money is only demonstrating its storied intelligence. We doubt it (although some of our best friends are hedge-fund managers and your editor is on the receiving end of a 1%-and-20% compensation scheme). The runaway popularity of the hedge-fund model supports the most basic truth of Wall Street. We mean that professional investors will believe anything. Not so many years ago, the pros broadly agreed that Charles Schwab Corp. was invincible, worth any conceivable price, even 40 times earnings and 10.6 times book value (at a time when Merrill Lynch was quoted at 14 times earnings and two times book value). The professionals were mistaken, as Grant's pointed out in an exposé-analysis dated Oct. 23, 1998. "When the individual investor decides to leave the scene of the accident (whatever it is and whenever it happens)," we wrote, "Schwab will demonstrate the truism that leveraged financial institutions are different from P&G [then trading at a mere 30 times earnings]. They are irreducibly cyclical." One flaw only marred this brilliant production, and the flaw was this: The price of a share of SCH proceeded to climb by fourfold after we published.

"Anything can happen in markets," says the great Richard Russell, editor of Dow Theory Letters. Yet, over the long run, arithmetic is what always happens. If the stock and bond markets continue to serve up returns significantly below the Lucullan averages of the 1990s, the clients will notice. It won't be lost on them how little they accrue in comparison to the payments directed to money managers, fund distributors and the tax man. They will begin to pay attention to numbers compiled by the Bogle Financial Markets Research Center, which show, for example, that equity mutual funds collectively trade in and out of their portfolios every 10 months. The clients will rise up, or opt out, and the competitive pressure on fees will intensify. That the mushroomlike growth of the U.S. hedge-fund industry continues unabated is, to us, a fact of the kind that whipped the Schwab share price to the Nasdaq finish line a few years back. It is a red herring.

A short Schwab refresher course is a useful aid for understanding both the vagaries of investment behavior and the coming erosion in the margins of money-management organizations. For those not paying attention in the late 1990s, Schwab was the evident winner in the financial services





source: The Bloomberg

evolutionary sweepstakes. In January 2000, only days after AOL announced its New Economy-at-the-gate merger with Time Warner, Schwab disclosed its purchase of U.S. Trust Co., the eminent old-line asset manager. The cost was $2.5 billion, which Schwab was prepared to pay (and did) in the currency of its own stock, by then quoted at 52.2 times trailing earnings and 14 times book. At that price--38.3 times trailing 12-month earnings and 9.6 times book value--the U.S. Trust acquisition was accretive to Schwab. U.S. Trust's earnings had grown at 24% a year for the three previous years, and--in the way of deals and bankers--it was assumed, of course, that those earnings would continue to grow for the next three years. They did not. Synergies were promised. They were not discovered. "Our merger is about fulfilling our commitment to our most affluent investors," declared Chuck Schwab, founder and strategist. "The affluent category happens to be one with the most growth, growing at about 40% a year for the next five years."

In fact, affluence was then receding, although that truth was not immediately revealed. In August 2000, Schwab was honored with a place in Fortune magazine's newly erected pantheon of "10 Stocks to Last the Decade." By March 2001, Schwab himself could see that something was wrong. "We've come through a highly speculative technology bubble," the founder admitted on a conference call. "Maybe I should have been more emphatic about understanding that this was a temporary phenomenon." By the end of 2002, as Roger Lowenstein has pointed out in his book, "Origins of the Crash," Fortune's portfolio (unluckily called the "buy and forget portfolio") was down by a cool 80%, SCH by a mere 70%.

Schwab is a business enterprise. Hedge funds are a "compensation scheme" (to quote the New York investor Paul J. Isaac). If there is a bubble in hedge funds, it is a different kind of bubble than the one in which Schwab was borne up. All the same, the enthusiasm for the 1%-and-20% model is contagious. To many, or perhaps most, investors, hedge funds are money machines sharing a common knack for excelling in all market seasons. They are the alleged solution to the problem of how to live well in a 5% world.

How deeply this view has penetrated the retail investment cortex is revealed by the news that Schwab, too, has tossed its hat in the fund-of-hedge funds ring. "Charles Schwab Corp. is starting to see progress in its largely unpublicized effort to replicate with hedge funds its success in hawking mutual funds through its One Source no-transaction-fee supermarket," reports the July 12 Investment News. The article quotes a demurer from a financial planner: Only a tiny portion of the Schwab customer base even knows what hedge funds do. Besides, the critic pointed out, a prospective hedge-

U.S. Trust and peers at Jan. 11, 2000
(in $ millions)

	market cap	—price-to-earnings multiples— LTM	1999e	2000e	price/ book
Bank of New York	$ 25,986	21.4x	20.9x	18.6x	5.4x
Mellon Financial	15,099	16.4	16.3	14.6	3.6
Northern Trust	10,629	28.4	27.6	24.6	5.5
State Street	11,733	25.0	24.6	21.8	4.9
Peer group averages	**15,862**	**22.8**	**22.4**	**19.9**	**4.9**
Peer average plus 30% premium	20,620	29.6	29.1	25.9	6.3
U.S. Trust					
at market on Jan. 11, 2000	1,461	22.4	21.4	18.9	5.6
at 71% premium proposed	2,498	38.3	36.7	32.3	9.6
at 87% actual premium paid	2,731	41.9	40.0	35.3	10.5

sources: The Bloomberg; fairness opinion dated Jan. 12, 2000, in Schwab/U.S. Trust merger proxy fund investor must be a so-called qualified investor, meeting (among other qualifications) a $1 million net worth. In this particular, however, the critic was mistaken: "Schwab is allowing non-accredited investors to buy funds of hedge funds if a registered investment adviser advises them," according to Investment News, which, citing trade sources, reports that Schwab is charging a 60 basis-point fee on top of the other layers of fees borne by its fund-of-funds clientele.

For perspective, the entire hedge fund universe (as estimated) is only as big as Fidelity, which has $1 trillion under management and serves 21 million fee-conscious customers. "Over the past 18 months," said the Fidelity release disclosing reductions in fees on equity index funds, "Fidelity has eliminated front-end charges on dozens of mutual funds, making Fidelity's entire product line of funds sold directly to investors load-free; lowered commissions for certain online equity trades; and guaranteed one-second trade execution at National Best Bid or Offer."

Fidelity is in it for the money. Presumably, it is forgoing fees because it feels it must. Some observers--including professional Fidelity-watcher James Lowell--speculate that the company is using its index funds as a kind of loss leader. Certainly, the losses lead. The immediate out-of-pocket expense to Fidelity of the announced cuts in index-fund fees totals $40 million. The company has $41 billion in index funds, a pittance (of the $1 trillion under management, $680 billion is in stocks and bonds, the balance mainly in money funds). Magellan Fund, though shrunken by years of subpar investment performance, has assets of $62 billion. At 70 basis points a year, Fidelity generates annual fees and expenses of $433 million. Repositioning Magellan in the "commodity" department of the mutual-fund showcase, with a concomitant reduction in fees and expenses to, say, 35 basis points a year, would mean a $217 million annual hole in Fidelity's pocket.

"Fidelity's move suggests that the mutual-fund industry, historically resistant to competing on cost, increasingly is recognizing that investors are paying more attention to how much they are paying for professional money management," reported the September 1 Wall Street Journal.

"Never have so many been paid so much for so little," Christopher C. Davis, of Davis Selected Advisers, likes to say about his brothers and sisters in the money-management industry. Maybe, they're going to be paid a little less.

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U.S. Trust's peers today (in $ millions)

	market	—price-to-earnings	multiples—		price/
	cap	LTM	2004e	2005e	book
Bank of New York	$ 23,552	$16.7x	$15.7x	$13.9x	$2.7x
Mellon Financial	12,478	16.6	16.1	14.2	3.3
Northern Trust	9,505	19.2	18.4	16.6	3.0
State Street	15,481	16.9	17.2	15.3	2.6
Peer group averages	**15,254**	**17.4**	**16.8**	**15.0**	**2.9**
Peer average plus 30% premium	19,830	22.6	21.9	19.5	3.8

sources: The Bloomberg; fairness opinion dated Jan. 12, 2000, in Schwab/U.S. Trust merger proxy

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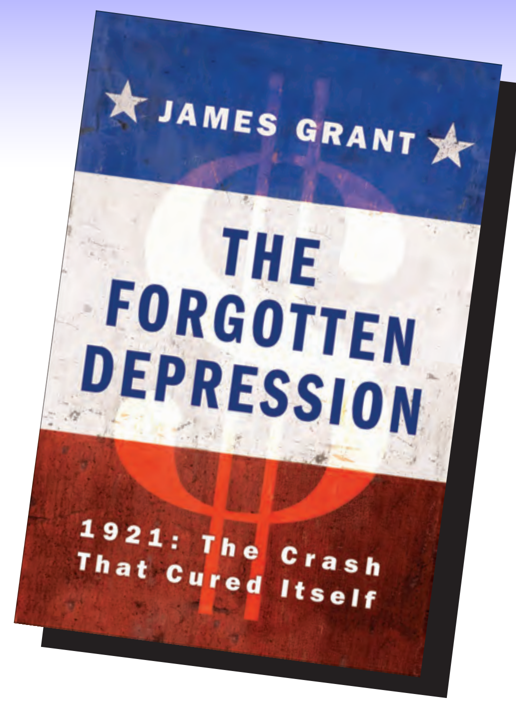

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