

kpmg



## Retail Registered Schemes Fees and Charges

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*This report contains 22 pages*

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## 1 Executive Summary

This report is the first of a three-part report issued to IFSA in conjunction with the brief outlined in section 2. This part specifically focuses on the results of our analysis of the fees and charges an investor incurs through investing in registered managed investment schemes.

Our study identified the fees and charges incurred by an investor for access (entry), and advice investment management and administration.

With respect to investor advice and access fees we noted there exists a large variety of structures available to the investor. The publicly available data provides a guide as to the range of fees paid by an investor as a result of their entry to a scheme. What is actually paid by an investor cannot be determined since the exact entry fee paid by an investor depends on a number of factors. These factors include:

- extent of advice received by the investor from their respective adviser;
- nature of any fee rebates provided by the adviser to their respective investors ; and
- method of access into the scheme by the investor (ie. whether the investor has invested through a discount broker).

The data available therefore did not permit a quantitative analysis to be performed of access and advice fees. In spite of the above variables, we are still able to conclude that over the past five years the potential cost to an investor of entering a scheme has reduced as a result of widespread rebating by fund distributors and the evolution of low cost distribution channels such as discount brokers.

Fees for investment management and administration are bundled and included as part of the registered scheme's MER. For the period 1996 to 2000 we found there has been an overall reduction in the weighted average MER of 3.92% (or 6 basis points). This reduction translates to an annualised cost saving of approximately \$53.5m. The weighted average MER excluding cash assets decreased over the same period by 6.25% (or 12 basis points).

Since the introduction of MIA on 1 July 1998, we found there has been an overall decline in the total weighted average MER of 2% (or 3 basis points). This reduction in MER translates to an annualised cost saving of approximately \$26.8m.

With respect to the size of the MER, we noted that:

- MER's are asset class specific;
- asset classes which produced a higher range of expected return (and therefore arguably a higher risk premium) attracted a higher MER; and
- schemes that were actively managed attracted a higher MER than schemes that were passively managed.

## 2 IFSA Brief

This report has been prepared by KPMG who were engaged by IFSA to conduct an analysis of the levels and trends in fees and charges for retail managed investments products. In accordance with the agreed IFSA brief, KPMG were specifically engaged to:

- identify the fees and charges structures that operate in the Australian market for managed investments, superannuation, master trusts and wrap accounts, including their interaction with the advisory/access industry. Report on the development and trends of these fee structures over the past 5 years;
- identify fees and charges levels for managed investment products over the past 1, 3, and 5 year periods;
- report on future trends re the fees for managed investments, superannuation and master trusts & wrap accounts, including their interaction with the advisory industry;
- report on levels of fees in Australia relative to fees and charges in other overseas markets for comparable products over a 1, 3, and 5 year period;
- draw conclusions from the data in regard to “What drives fee levels?”. Specifically, considering, funds under management, product value and performance;
- identify fee structures for competitive products such as DIY super and IDPS.

### 2.1 Research background

#### 2.1.1 Overview

This report is the first part of a three part report issued to IFSA in conjunction with the brief outlined in section 2. This part specifically focuses on the results of our analysis of the fees and charges an investor incurs through investing in registered managed investment schemes (“registered schemes”).

#### 2.1.2 Products selected

Our analysis of schemes was undertaken on the basis of asset class. The following asset classes were separately identified:

- Domestic equity (both active and passive management)
- International equity
- Cash
- Domestic bond
- International bond

- Diversified funds

With respect to diversified funds, three categories were separately analysed using ASSIRT criteria. These categories were:

- Multi-sector 30 – Diversified income funds
- Multi-sector 70 – Diversified balanced funds
- Multi-sector 70+ - Diversified growth funds

For all asset classes selected, with the exception of international bonds, KPMG were able to obtain data for products, which in aggregate covered between 75-80% of the FUM<sup>1</sup> of that particular class. For the international bond asset class, the data obtained represented 50% of FUM<sup>1</sup> for that class.

### **2.1.3 Sources of data**

Data was acquired through researching publicly available information over the past 5 years. With respect to registered schemes, the data was sourced from a combination of prospectuses and individual registered scheme financial statements.

### **2.1.4 Time horizon**

Our analysis of registered schemes covered the five year period from 1996 to 2000.

### **2.1.5 Disclaimer**

The statements and analysis in this report are provided in good faith but rely upon the information obtained as outlined above.

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<sup>1</sup> Using FUM per ASSIRT Market Share Report – December Quarter 2000

### 3 Overview of all fees and charges

As is shown by the following diagram consumers are charged fees for the following services:

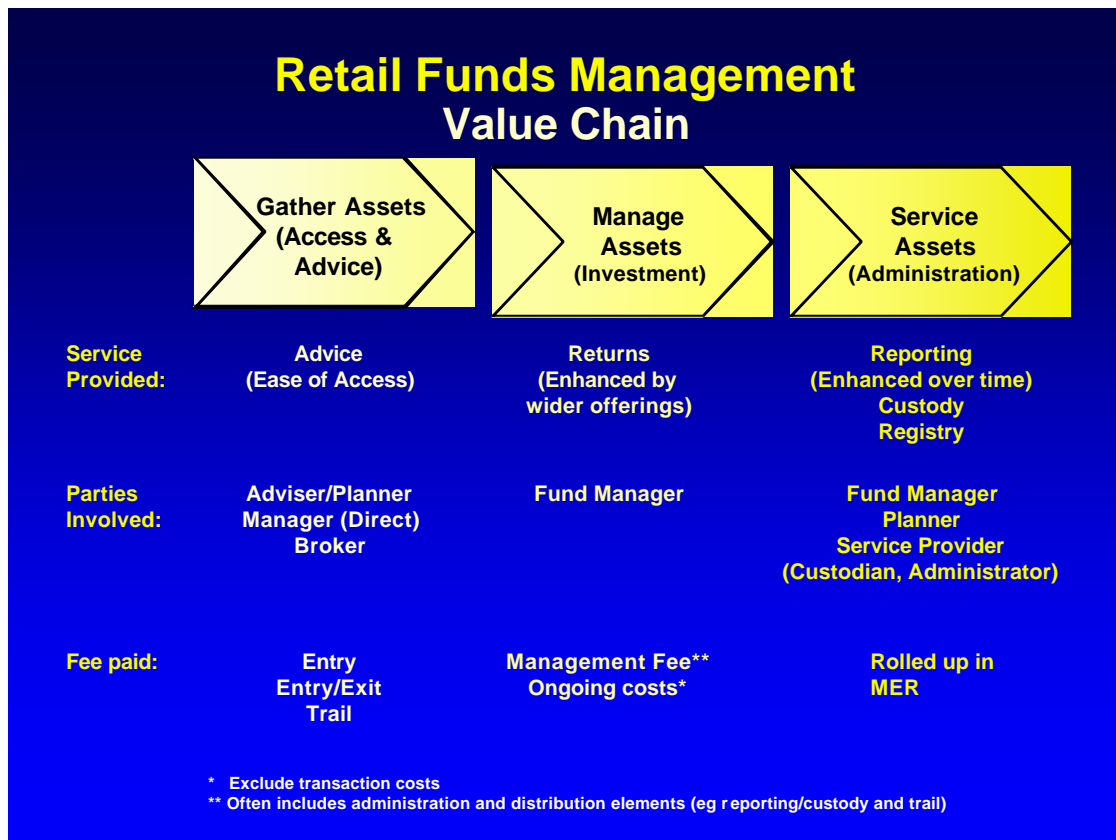
- access and advice;
- investment management; and
- administration.

The level of total fees that a consumer pays is dependent upon the method and type of access and advice, investment management and scope of service that the consumer or their product demands.

It is also relevant to note that fees are received by more than one participant in the managed investments value chain.

The following diagram illustrates the nature of fees charged for each product and services offered and identifies the parties involved.

The products and services provided may be sourced either from within the one organisation or from different organisations.



### 3.1.1 Access and advice

Access and advice fees are paid to the party that introduces the investor to the scheme (eg: financial planner, discount broker, etc).

Access and advice fees are applied in one of two ways:

- up-front fees: or
- on-going (“trail”) fees.

Up-front fees are levied once only at the date the initial investment is made. Trail fees are applied during the term of the investment.

An alternative to an upfront fee may be to charge an exit fee should the investor withdraw from the product within a specified time. The exit fee is stepped to reduce to nil over time, should the investor remain in the fund for greater than the specified time.

### 3.1.2 Investment management

Investment management fees are paid to the party which manages or invests the scheme property. The fees incurred for investment management are included as part of a scheme’s management expense ratio (“MER”).

The IFSA definition of MER and its inclusions is contained in Appendix 1. These fees are calculated as a percentage of the scheme’s net assets and are quoted in annualised terms. The MER excludes all up-front and exit fees.

### 3.1.3 Administration

The range of administration services provided for investors in registered schemes includes:

- periodic consolidated and detailed investor level reporting;
- investor access to internet platforms for to up to date investment information and/or transactional facilities;
- comprehensive taxation reporting at the individual investor level;
- timely processing of investor transactions and/or enquires.

In the case of registered schemes, the cost of administration services is generally included in the scheme’s MER, irrespective of which party provides the service.

## 4 Registered schemes

### 4.1 Overview

The fees and charges paid by an investor in a registered scheme for access and advice, investment management and administration are embodied in the entry fee and the MER.

As outlined below, depending upon the election made by the investor, entry fees may be paid separately at the time of initial investment or “wrapped up” in the MER. Fees for investment management are included in the MER. In addition, the cost of administering a registered scheme is generally bundled and included in the MER without separate disclosure to the investor.

### 4.2 Access and advice

Investors pay a fee for access and advice when initially investing in a registered managed investment scheme. This fee can be paid through one of two options:

- up front fee levied on the initial investment; or
- on going fee levied over the life of the investment.

Historically, the most common manner of entry for an investor into a registered scheme has been via a financial adviser. The service provided at this time was generally paid “up front” by the investor, based either on the time and expertise involved in the advice provided (“fee for service”) or on the value of the investment (“upfront fee”).

More recently, fee structures have been amended to provide investors and advisers with the option to lower (to nil in many instances) up front entry fees, and to replace this with a trail over the life of the investment. Where this “dial up” option is utilised the investor will usually incur a higher MER than an investor that has elected an entry fee option. The difference between the MER’s in each case approximates the fee.

Where this alternative has been made available, the trail fee has been in the range of 0.33 to 0.60%, with the average being 0.44%.

The payment of a trail by the manager of a scheme to an adviser/broker may also take place without an election being made by the investor. In these instances the manager bears the cost of the trail, without a corresponding increase in the MER. This scenario has become increasingly evident with the evolution of new distribution channels, for example, the introduction of discount brokers.

#### 4.2.1 Historical trends

The data which is publicly available provides a guide as to the range of fees paid by an investor as a result of their entry to a scheme. What is actually paid by an investor cannot be determined from these sources as, for example:

- upfront fees may be rebated;
- an adviser's fee for service will vary from situation to situation;
- where offered, the combination of entry fee and trail will vary from investor to investor.

The types and structure of the various fee options which are available to a retail investor are summarised in the following table.

Method of access and advice	Type of fee	Levy base	Term of fee	Access and advice fee paid by	Range of fee
Financial adviser	Fee for service	Time	Provision of advice	Investor	Various
	Up-front	Initial investment	Levied once only	Investor	Nil to 5%
	Trail (included in MER)	Investment value	Term of investment	Manager/ Trail may be dialled up by investor	0.33 to 0.60
Broker	Up-front	Initial investment	Levied once only	Investor	Nil to 5%
	Trail (included in MER)	Investment value	Term of investment	Manager	0.33 to 0.60
Direct	Up-front	Initial investment	Levied once only	Investor	1 to 5%

#### **4.2.2 Buy/Sell spread**

The price at which an investor enters or exits a scheme is usually subject to a buy/sell spread, typically in the range of 0.15 to 0.50%. This spread is designed to meet the costs incurred by the scheme in acquiring or selling investments at the time of entry or exit of an investor to or from the scheme. As a consequence, the spread is “retained” within the scheme and is not paid to any party involved in its operation. Investors of the scheme are therefore not disadvantaged by other scheme investors purchasing or redeeming their respective investments in the scheme.

## 4.3 Investment management and administration

The fees an investor pays for investment management and administration are bundled together and included as part of the management expense ratio (MER). KPMG's analysis of investment management and administration fees was performed by reviewing the trend in the MER<sup>1</sup> for registered schemes.

### 4.3.1 Historical trends

We performed an analysis of the historical trend in the size of the MER from 1996 to 2000 for all core asset classes of registered schemes, the results of which are contained in the following table.

Asset Class	Weighted Average MER <sup>2</sup>				
	1996	1997	1998	1999	2000
Domestic equity - active	1.88	1.87	1.84	1.81	1.78
Domestic equity – passive	N/A	N/A	N/A	1.29	1.15
International equity	2.05	2.04	2.02	2.01	1.95
Cash	1.08	1.08	1.07	1.06	1.04
Domestic bond	1.60	1.50	1.39	1.37	1.38
International bond	1.87	1.84	1.82	1.83	1.74
Diversified funds – Income	1.62	1.54	1.48	1.45	1.47
Diversified funds - Balanced	2.02	1.95	1.92	1.88	1.86
Diversified funds – Growth	2.00	1.96	1.89	1.91	1.85
<b>Total weighted average MER</b>	<b>1.53</b>	<b>1.53</b>	<b>1.50</b>	<b>1.49</b>	<b>1.47</b>
<b>Total weighted average MER (ex cash)</b>	<b>1.92</b>	<b>1.89</b>	<b>1.86</b>	<b>1.84</b>	<b>1.80</b>

<sup>1</sup> To maintain comparability where entry and nil entry fee alternatives were offered which resulted in a different MER for the same product, the entry fee option was used in the analysis.

<sup>2</sup> Weighted Average MER has been calculated using relative FUM weightings of the products in our sample for the respective asset class.

The results of our analysis indicate that MER's have declined by between 3.70% to 13.75% from 1996 to 2000. The total weighted average MER across all asset classes has declined by 3.92% or 6 basis points. This translates to annualised cost saving of approximately \$53.5m.<sup>3</sup>

The total percentage decline per asset class from 1996 to 2000 is detailed in the following table.

<b>Asset class</b>	<b>Percent decrease</b>
Domestic equity – Active	(5.32)
Domestic equity – Passive	(10.85)
International equity	(4.88)
Cash	(3.70)
Domestic bond	(13.75)
International bond	(6.95)
Diversified funds – Income	(9.26)
Diversified funds – Balance	(7.92)
Diversified funds – Growth	(7.50)
<b>Total weighted average MER</b>	(3.92)
<b>Total weighted average MER (ex cash)</b>	(6.25)

As noted from the above table the size of the percentage decline in MER from 1996 to 2000 is not consistent across all asset classes.

It is important to note that the decline in passive domestic equity products was largely due to the introduction of a large foreign passive fund manager mid way through 1999. The MER for their suite of index products has only been reflected in 2000 data, which was their first full year of operation in the Australian market.

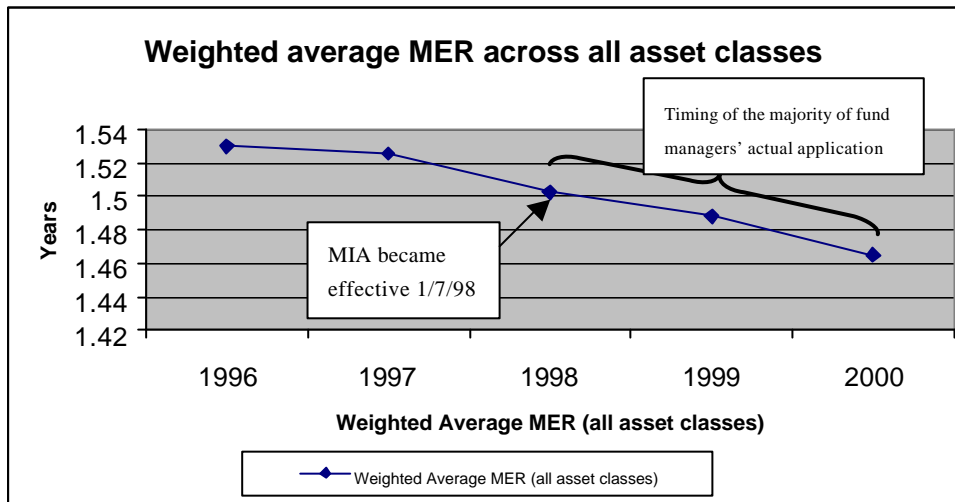
#### **4.3.1.1 Introduction of MIA**

The Managed Investment Act reforms became effective on 1 July 1998. However, transitional provisions provided a two year period from this date to register schemes with ASIC.

<sup>3</sup> Based on ASSIRT FUM data as at 31 December 2000

The more significant aspects of the introduction of the MIA were the removal of the trustee's responsibilities with respect to retail unit trusts and their replacement with a more rigorous compliance regime for responsible entities.

The following graph plots the timing of the introduction of MIA and the observed decline in total weighted average MER over time.



The table below indicates the fall in MER by asset class in the period subsequent to the introduction of the MIA.

Asset class	Weighted Average MER		Basis point decrease
	1998	2000	
Domestic equity - active	1.84	1.78	6
International equity	2.02	1.95	7
Cash	1.07	1.04	3
Domestic bond	1.39	1.38	1
International bond	1.82	1.74	8
Diversified funds - Income	1.48	1.47	1
Diversified Funds - Balanced	1.92	1.86	6
Diversified Funds - Growth	1.89	1.85	4
<b>Total weighted average MER</b>	<b>1.50</b>	<b>1.47</b>	<b>3</b>

As seen from the above table there has been a 3 basis point fall in the total weighted average MER since 1998. This translates to annualised cost savings of approximately \$26.8m<sup>5</sup>.

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<sup>5</sup> Based on ASSIRT FUM data as at 31 December 2000

## 4.4 Drivers of management expense ratio

In addition to the factors considered in section 4.3 in relation to the observed decline in MER's, our brief also required consideration be given to factors such as performance and product value as potential drivers of fee levels.

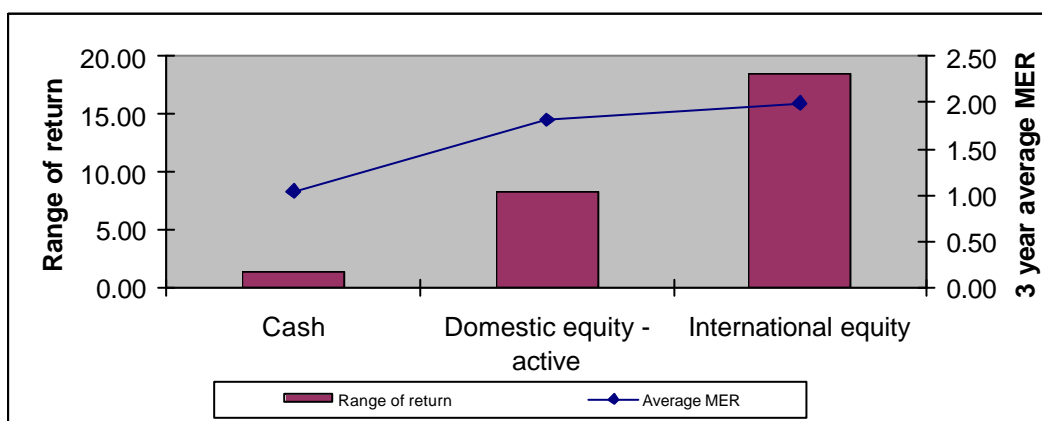
### 4.4.1 Range of expected return

The following graph compares the size of the MER to the range of expected return for the following asset classes:

- cash
- domestic equity – active ; and
- international equity

The range of expected return is defined as the percentage difference between return earned by the product within the sample that achieved the highest three year return and the return earned by the product within the sample that achieved the lowest three year return. Effectively, the range of expected return is a measure of the volatility in returns for the products included in the sample.

**MER v Range of return over 3 years**

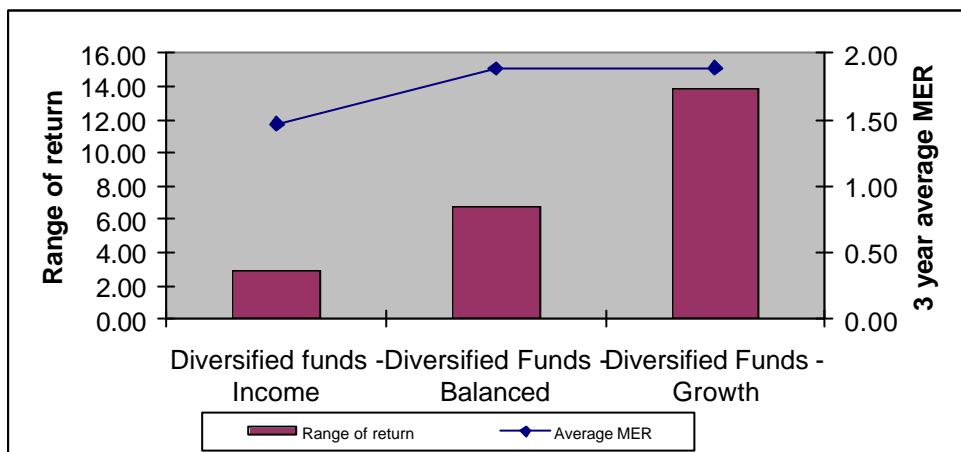


The above graph provides some evidence that there is a relationship between the MER and the range of expected return. This may suggest that the size of the MER for a particular asset class is in part related to the relative risk premium for the relevant class of asset.

For instance the above graph illustrates that the international equity asset class has demonstrated a greater volatility in returns than cash. The higher MER of this class is consistent with an argument that the higher risk asset classes command a higher degree of management expertise and effort in executing the investment management function. This translates into higher management costs associated with these classes of assets which have been passed onto the investor through the MER.

The following graph plots the range of expected return to MERs for diversified funds.

**MER v Range of return over 3 years**



In the above graph, the correlation between MER and range of return for diversified funds is less clear between balanced and growth asset classes. The reasons for this are uncertain and do not appear to relate to the strength of the product gradings between diversified balanced and diversified growth (as they appear to be supported by the relative range of expected returns).

#### 4.4.2 Investment management style

The impact of management style on the MER is clearly evident by comparing the MER for actively managed products to passively managed (or index) products.

	<b>Actively managed domestic equity</b>	<b>Passively managed domestic equity</b>
<b>Average weighted MER - 2000</b>	1.78	1.15

This variance in MER may be attributed to the higher cost associated with monitoring and executing an active investment management style compared to the passive management style.

It is important to note also that the passive market in Australia is at a much earlier point in its product life cycle than the much more established actively managed equities products. Furthermore the introduction of established foreign passive fund managers into the index market has significantly reduced the MERs for passively managed investment products.

#### **4.4.3 Goods and Services Tax (GST)**

The review covers the periods 30 June 1996 to 30 June 2000. Given that the introduction of GST occurred on 1 July 2000, the study did not include the impact of GST.

The goods and services (including the management fee) consumed by a scheme are generally subject to GST. Schemes are generally permitted to claim a credit of 75% of the GST they incur.

The majority of current prospectus' reviewed disclosed that managers anticipated MER's to increase by approximately 2.5% as a result of GST. The increase in basis points from the impact of GST is therefore dependent on the respective MER. For example, applying this increase percentage to our weighted average MER data (from section 4.3.1), the implementation of GST would result in an increase in the total weighted average MER of approximately 4 basis points.<sup>6</sup>

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<sup>6</sup> Calculated as 2.5% of 147 basis points.

## **A Appendix 1 - MER**

IFSA defines the management expense ratio in IFSA Standard 4.00 as:

$$\text{MER} = \left( \frac{\text{Fees} + \text{Recovered expenses} - \text{ITC}}{\text{Average Scheme Size}} \right) \times 100$$

Fees include the following:

- management fee (excluding up-front and exit fees);
- fees of the trustee; and
- other fees which include:
  - local and overseas manager fees;
  - custodian fees;
  - audit fees;
  - trail commissions; and
  - amounts paid to ATO under GST reverse charge provision.

Recovered expenses are expenses incurred by the operation of the scheme, these include:

- transaction costs;
- brokerage;
- repair, maintenance and refurbishment costs;
- GST; and
- Government taxes and charges for transacting on investors account if paid out of the scheme;

But exclude the following expenses:

- Government taxes and charges for purchases and sales of securities (FID and BAD);
- income and other tax (excluding capital gains tax); and
- interest expense on specific borrowings.

ITCs are input tax credits received or receivable from the Australian Taxation Office.

## B Appendix 2 - Detailed Asset Class Data

Domestic equity - active	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	1.88	1.87	1.84	1.81	1.78	7.77	13.14	16.76
<b>Low</b>	1.71	1.76	1.73	1.66	1.66	(3.36)	8.30	11.20
<b>High</b>	2.08	2.00	2.00	2.00	2.00	21.16	16.62	21.11
<b>Spread</b>	0.37	0.24	0.27	0.34	0.34	24.52	8.32	9.91

Domestic equity - passive	Weighted average MER		Return (years)
	1999	2000	1
<b>Weighted average MER</b>	1.29	1.15	7.75
<b>Low</b>	1.15	0.75	2.98
<b>High</b>	1.38	1.25	10.36
<b>Spread</b>	0.23	0.50	7.38

International equity	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	2.05	2.04	2.02	2.01	1.95	16.85	21.26	21.42
<b>Low</b>	1.50	1.50	1.50	1.50	1.50	(15.00)	8.00	14.30
<b>High</b>	2.40	2.34	2.36	2.36	2.23	51.83	26.54	24.03
<b>Spread</b>	0.90	0.84	0.86	0.86	0.73	66.83	18.54	9.73

Cash	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	1.08	1.08	1.07	1.06	1.04	5.06	4.37	4.55
<b>Low</b>	0.98	0.98	0.83	0.81	0.86	3.97	3.37	4.30
<b>High</b>	1.20	1.20	1.24	1.22	1.19	5.40	4.70	5.08
<b>Spread</b>	0.22	0.22	0.41	0.41	0.33	1.43	1.33	0.78

Domestic bond	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	1.60	1.50	1.39	1.37	1.38	6.58	5.94	8.25
<b>Low</b>	1.25	1.16	1.16	1.12	1.10	-3.36	4.90	5.46
<b>High</b>	1.83	1.77	1.88	1.88	1.83	12.71	14.99	14.14
<b>Spread</b>	0.58	0.61	0.72	0.76	0.73	16.07	10.09	8.68

International bond	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	1.87	1.84	1.82	1.83	1.74	12.02	7.08	8.58
<b>Low</b>	1.54	1.60	1.55	1.63	1.50	8.11	4.51	7.00
<b>High</b>	1.94	1.97	2.37	2.35	2.42	15.36	10.54	10.90
<b>Spread</b>	0.40	0.37	0.82	0.72	0.92	7.25	6.03	3.90

Diversified - Income	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	1.62	1.54	1.48	1.45	1.47	8.39	6.49	6.77
<b>Low</b>	1.44	1.3	1.17	1.12	1.09	5.91	5.40	6.10
<b>High</b>	2.11	2.09	2.06	2.09	2.04	10.22	8.35	8.92
<b>Spread</b>	0.67	0.79	0.89	0.97	0.95	4.31	2.95	2.82

Diversified - Balanced	Weighted average MER					Returns (years)		
	1996	1997	1998	1999	2000	1	3	5
<b>Weighted average MER</b>	2.02	1.95	1.92	1.88	1.86	8.60	9.24	10.11
<b>Low</b>	1.93	1.83	1.71	1.62	1.60	3.10	5.60	7.73
<b>High</b>	2.22	2.12	2.12	2.09	2.04	13.98	12.40	13.29
<b>Spread</b>	0.29	0.29	0.41	0.47	0.44	10.88	6.80	5.56

<b>Diversified - Growth</b>	<b>Weighted average MER</b>					<b>Returns (years)</b>		
	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>1</b>	<b>3</b>	<b>5</b>
<b>Weighted average MER</b>	2.00	1.96	1.89	1.91	1.85	14.64	14.19	9.35
<b>Low</b>	1.64	1.63	1.65	1.65	1.54	1.20	5.80	7.27
<b>High</b>	2.23	2.17	2.15	2.25	2.23	21.50	19.62	13.30
<b>Spread</b>	0.59	0.54	0.50	0.60	0.69	20.30	13.82	6.03