

# Mutual Fund Heterogeneity and Fee Dispersion

JOHN A. HASLEM

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*[Fund] classes that are authorized to have 12b-1 fees have expense ratios that are higher than other classes by an amount equal to about 93% of the maximum authorized 12b-1 fee.*

—SEC [2000]

The purpose of this study is to discuss research that identifies heterogeneous mutual fund and investor attributes and relations that explain dispersion in fund fees. One might think there is a short list of attributes and relations, such as high versus low expense ratios, that tells the full story of fund fee dispersion, but the story is much more complicated and nuanced. The research topics discussed are not inclusive of heterogeneous fund and investor attributes and relations that generate dispersions in fund fees, but they do provide this depth within their particular research domains.

The topics discussed related to this research are as follows: 1) disproportionate fee spreads and fund agency conflicts and services; 2) fee dispersion and heterogeneity in decisions concerning fund and investor attributes; 3) fee dispersion and strategic pricing in actively managed funds; 4) fee markups within fee-setting scenarios; 5) fee dispersion and market segmentation; and 6) fee dispersion and heterogeneity in board and sponsor decisions. The final, more traditional discus-

sion reviews factors affecting fund expense ratios over time.

## AGENCY CONFLICTS AND DISPROPORTIONATE FEES

Adams et al. [2012] discuss the long-running debate concerning whether market competition limits mutual funds' ability to charge excessive fees relative to shareholder services. It is posited that excessively high fees are prevalent in funds with multiple share classes and weak governance structures. A comprehensive 1996–2007 sample of index funds finds internal governance mechanisms primarily affect funds with relatively few share classes, where investors often face larger fund search costs and/or restricted access to competitive funds. Further, funds with publicly held fund advisers are related to disproportionately larger fee spreads (28 basis points). Results are also robust to fund board characteristics, multiple share-class structures, and investment objectives. Overall, competition and agency considerations are important determinants of fund fees.

A major unresolved issue is whether mutual fund advisers have the same agency incentives as shareholders. Central to this principal/agent issue is the idea that fund advisers charge fees that are disproportionate relative to the services provided. In

this regard, Section 36(b) was added to the Investment Company Act of 1940 (the Act), which imposes a fiduciary duty on fund advisers regarding compensation.

This article documents the extent to which mutual funds have agency conflicts of interest and whether portions of fees charged to investors are disproportionate to provided shareholder services. Two important issues are the introduction of multiple-share-class structures and the relationship between fund advisers and directors.

The first conflict of interest arises when new mutual fund share classes significantly alter flow characteristics. By appealing to various investor clienteles, fund advisers are motivated to use varying fee structures across multiple share classes. This conflict is also driven by the interaction among other fund and investor attributes variously impacting fees. Among them are: 1) institutional versus retail investors; 2) fee structures and services; 3) investor preferences for service and search costs; 4) level and quality of non-portfolio services; 5) investor fund switching versus search costs; 6) fund competition; 7) multiple share-class pricing strategies; 8) investor and fund adviser conflicts; 9) non-portfolio fund characteristics; 10) publicly held versus privately held fund advisers; 11) costs of share classes; and 13) effectiveness of governance.

The second conflict of interest is related to the structure of mutual funds and focuses on the relation between fund advisers and shareholders regarding compensation. Funds are independent legal entities owned by shareholders with voting rights and governed by boards of directors. Funds are externally managed by investment advisers, who create and operate the funds and appoint the initial board of directors. Directors frequently outsource all necessary services to the fund adviser. The interlocking relationship of fund advisers and directors jeopardizes the independence and effectiveness of directors in negotiating fees.

This second conflict of interest is engendered by the interaction of several other mutual fund adviser and shareholder attributes that variously impact fee competitiveness. Among them are 1) shareholder ability to buy/sell fund shares at net asset value; 2) shareholder sensitivity and fund cash inflows from prior returns; 3) competition and marginal costs; 4) optimality of shareholder asset allocation decisions; 5) shareholder sensitivity to index fund fees; 6) quality of financial advisor and broker advice; 7) broker incentives to sell

funds and broker fees; and 8) tangible shareholder benefits in direct-sold funds and broker-sold funds.

There are many reasons to analyze index mutual funds. Among them are 1) they are widely held by investors; 2) their investors are more "savvy" and sensitive to fees; 3) they exhibit smaller investment policy differences in tracking indexes; 4) fund return variations are driven by expenses; 5) they combine intense price competition with transparent performance; 6) investor performance concerns are mitigated with "star" portfolio managers; and 7) fund managers have a narrower focus on investment objectives.

In summary, Adams et al. [2012] analyze a basic mutual fund principal/agent problem. That is, do fund advisers charge fees that are disproportionate relative to provided services? There has been a long-standing legal debate concerning "excessive" fund fees. Few investors have prevailed in court, and there have been no public disclosures of fees returned to shareholders. In the most recent Supreme Court case (*Jones v. Harris Associates*), the fiduciary duty of fund advisers was reaffirmed. The Investment Company Act of 1934 also limits the ability of fund advisers to charge unnecessary fees for internally managed funds. However, the issue of how to identify disproportionate fund fees was not addressed.

The research posits that despite intense competition there is dispersion of fees in the mutual fund industry. This finding is due in part to the industry's use of multiple share-class structures, organizational incentives at the fund adviser level, and the apparent close relationship between fund advisers and fund directors. A 1998–2007 sample of index funds finds that funds managed by public fund advisers charge about 28 basis points more in total fee spreads than private fund advisers and that these fee spreads are positively related to the number of share classes. Internal governance mechanisms appear to matter primarily for funds with smaller share classes.

Legal research has documented discrepancies concerning disproportionate mutual fund fees, but this study is the first to provide detailed economic insights. While competition is effective for single-share-class funds, it is less likely to reduce conflicts of interest in multiple-share-class funds. Differences in fund fees should be considered to determine whether fees charged to retail investors are high relative to the services they receive.

## FACTOR RELATIONS AND FEE DISPERSION

Iannotta and Navone [2012] empirically analyze factors impacting the cross-section of equity mutual fund fee dispersion. Fee dispersion is primarily explained by heterogeneity of “products,” investor clienteles, and production functions. Theory also predicts that investor search costs generate fund fee dispersion. By controlling for observable sources of heterogeneity, fee dispersion declines with fund age and size and with fund adviser assets under management. Fee dispersion is also smaller for funds charging marketing and distribution fees. Consistent with theoretical predictions, search costs positively impact dispersion of fund fees.

Economic research finds fee dispersion of homogenous products to be indicators of market inefficiency. Fees are dispersed when market participants charge non-marginal prices for homogenous products. Funds catering to less-sensitive investors can charge higher fees for the same services than funds catering to more performance-sensitive investors. S&P 500 Index fund fee dispersion is due to non-portfolio-related characteristics, such as investor fund switching and search costs.

While equity mutual fund services are not homogenous, price dispersion is not due to ex post portfolio performance. Expense differences explain most variations in after-expense performance, which suggests there is no positive relation between expense ratios and gross portfolio performance. There is a negative relation between fund gross performance and expenses, after controlling for a number of salient fund characteristics. Apart from the “puzzle” of the negative correlation with past performance, significant price dispersions are generally observed.

This study empirically analyzes mutual fund fee dispersion explained by observable heterogeneity in decisions concerning fund and investor attributes. Approximately 40% of fund fee dispersion is so explained. The heterogeneous attributes include 1) portfolio composition, performance, risk, and related portfolio attributes; 2) ability of portfolio managers; 3) “product” differences, clienteles, and production functions; 4) market “agent” ability and willingness to make economic decisions; 5) investor ability to search among funds for lower prices; 6) degree of investor homogeneity; 7) degree of marginal cost pricing; 8) comparability of buy/sell sides of markets; 9) investor search costs; 10) market competitiveness with costly information; 11) investor cost

of information and number of fund suppliers; 12) past performance as investor proxy for fund manager ability; 13) investor performance expectations proxy for fund manager skill; 14) fund size and age and fund advisers assets under management; 15) marketing and distribution fees; and 16) fund adviser characteristics.

In summary, Iannotta and Navone [2012] analyze cross-sectional determinants of mutual fund fees. Past research finds price dispersion of homogenous products is generally an indirect measure of market inefficiency with a direct impact on consumer welfare. In the case of dispersed prices, there are sellers who charge non-marginal prices, which reduces “consumer surplus.”

However, actively managed mutual funds are not homogenous. The primary source of fund fee dispersion is heterogeneity of products, clienteles, and production functions. Approximately 40% of fee dispersion is explained by observable sources of heterogeneity, which include past performance and fund and fund adviser characteristics.

Theory also predicts that investor search costs generate mutual fund fee dispersion. Controlling for observable sources of fund heterogeneity, fee dispersion decreases with fund size and age and fund adviser assets under management. Fee dispersion is also lower for funds that charge marketing and distribution fees. The effect of these proxy variables on search costs is economically significant and symmetrical. Findings are consistent with the prediction from theory that search costs positively impact fund fee dispersion.

## STRATEGIC PRICE SETTING AND PERFORMANCE SENSITIVITY

Gil-Bazo and Ruiz-Verdu [2009] explain why investors buy actively managed mutual funds that generally provide smaller returns than index funds. But why do funds with worse before-fees performance charge higher fees? The negative relationship between fees and performance can be explained as the outcome of strategic fee setting for investors with varying degrees of performance sensitivity. There is also some evidence that funds with better governance may bring fees more in line with performance.

Previous studies have attempted to determine if equity mutual funds are able to generate positive risk-adjusted returns. While significant differences in returns have been found, they are largely due to differences in

fund fees. Most research has focused on determining whether cross-sectional variations in fund performance unexplained by fees can be explained instead by superior portfolio manager stock-picking skills. However, there has been little attention paid to the relation between before-fee fund performance and fees. This study focuses on this relation and assesses whether fee disparities reflect differences in value created for fund investors.

Mutual fund fees pay for services provided to investors. Because portfolio management is the major service provided, fees should reflect risk-adjusted performance. Therefore, there ought to be a positive relation between before-fee risk-adjusted expected returns and fees. In contrast to this prediction, a puzzling negative relation is found between before-fee risk-adjusted performance and fees in equity funds. That is, funds with worse before-fee risk-adjusted returns charge higher fees. The negative relation between before-fee risk-adjusted returns and fees survives robustness tests.

In summary, Gil-Bazo and Ruiz-Verdu's [2009] analysis finds a negative relation between mutual fund before-fee performance and fees charged. This evidence is inconsistent with economic intuition; nonetheless, all robustness tests performed verify the findings. Two explanations are examined for this anomalous result. The first explanation states that the negative relation between before-fee performance and fees charged results from factors that are both positively related with returns and negatively related to operating costs. The second explanation states that this negative relation results from funds that strategically set fees as functions of past and expected performance.

Strategic fee-setting behavior has three rationales: First, funds with worse past performance have investor pools that are less sensitive to performance. These underperforming funds have inelastic demand for shares and optimally increase fees. Second, funds with lower expected performance optimally increase fees and target performance-insensitive investors. These underperforming funds anticipate they will not be able to compete with higher-performing funds with sophisticated investors. Higher-performing funds charge lower fees because of competition for performance-sensitive investors. Third, funds with different expected performance use different marketing strategies. Funds with low expected performance are marketed to performance-insensitive investors and have higher distribution costs, which translate to higher fees.

Empirical analysis finds support for all of these mutual fund strategic pricing explanations. While operating costs are important fee determinants, they do not explain away the negative relation between before-fee performance and fees. Controlling for cost determinants, funds with lower-than-expected before-fee performance and those with less elastic demands charge higher marketing and non-marketing fees. It thus appears that fund competition and regulation have been inadequate to ensure that fees reflect the actual value provided to investors. But there is some evidence that improved fund governance may be related to fees that are more in line with performance. For the best governed funds, worse performance need not indicate higher fees.

## HETEROGENEOUS RELATIONS AND FEE MARKUPS

Hu et al. [2009] develop a principal/agent model of representative investors and mutual fund managers in an asymmetric information framework. The model indicates that investor perceptions of the fund market play the key role in fee-setting mechanisms. However, the true ability of fund managers to deliver performance is not relevant. Along with a simple relation between fund fees and performance, empirical evidence suggests that most domestic equity funds have added high fee markups in recent years. To justify these fees, investors would have to expect funds to deliver an annual excess return of around 3% relative to the S&P 500, net of fees, regardless of fund investment style and risk. Thus, high fee markups exploit investor optimism bias, which is based on a lack of financial literacy, and are in large part driven by marketing costs.

Investor indifference to mutual fund underperformance is widely reported. Why do investors continue to invest in underperforming funds, and what explains the ongoing puzzle of high fee markups? The principal/agent model suggests that self-serving fund managers exploit investors' lack of information and unrealistic risk preferences in order to set exorbitant fees. Because investors have limited information concerning true fund manager abilities, they may have biased views of true fund performance. Fund managers take advantage of investor "optimism bias" by attracting inflows and charging exorbitant fee levels.

The model also suggests two alternative fee-setting mechanisms. First, when funds provide diversification

benefits to investor global portfolios, demand-insensitive investors pay higher fees. Second, when leveraged funds do not provide diversification benefits but instead add risks, they lower fund fees to obtain inflow from less performance-sensitive investors.

Mutual fund fee markups can be explained by observable heterogeneous decisions in fund and investor attributes and relations that include, among others, 1) fund redemption fees; 2) performance in bad times; 3) irrational fund behavior; 4) investor information asymmetry; 5) market competition; 6) active versus passive funds; 7) investor financial sophistication; 8) SEC disclosure policy and investor financial knowledge; 9) investor financial literacy; 10) investor fee sensitivity; 11) investor rationality; 12) investor optimism bias; 13) investor knowledge of fund market; 14) marketing practices; 15) distribution practices and flows; 16) fee dispersion across funds; 17) fund selection bias; 18) investor demand variations; 19) incentive contracts and risk; 20) investor over-optimism; 21) principal/agent information; 22) investor demand function; 23) portfolio manager skill; 24) fund private information; and 25) investor informational disadvantage.

In summary, Hu et al. [2009] analysis provides three major results. First, mutual fund fee levels are determined only by investor preferences and information, and true fund manager ability is irrelevant. Second, the analytical formula derived provides an empirical framework that helps investors assess funds and their portfolios. Third, the model identifies two alternative fee-setting scenarios that depend on possible fund diversification benefits. Leveraged funds tend to exploit demand-insensitive investors by charging higher fees, while funds providing diversification benefits reduce fees to attract more-risk-averse investors and charge higher fees to less-risk-averse investors.

Analysis of domestic equity funds for the years 2003–2007 identifies positive fee markups for some 80% of sample funds. These funds underperform low-cost index funds or ETFs, after considering fund returns, diversification benefits, and fees. However, investors keep investing in underperforming funds. This puzzling behavior reflects an optimism bias toward future performances. Investors *ex ante* expect funds to outperform the S&P 500, net of fees, regardless of investment style and risk level. Optimistic investor expectations lead to high fee markups. The correlation between investor overconfidence and exorbitant management and dis-

tribution (12b-1) fees suggest the latter play a role in promoting the former. Another element of investor optimism bias is lack of financial knowledge, which can be rationalized by assuming investors choose risk-free assets as benchmarks. Empirical analysis suggests both factors may explain investor overconfidence.

## INVESTOR SEGMENTATION AND FEE DISPERSION

Houge and Wellman [2006] state that mutual fund investors are more aware of up-front loads than annual operating expenses, both of which lower performance. As funds become more adept at segmenting investors by levels of investment sophistication, load funds charge higher expenses to less-knowledgeable investors. No-load funds offer lower expenses to more sophisticated investors. There is a growing cost disparity among new and existing equity, bond, and index funds. Abuse of fees is growing, especially among load funds that charge 12b-1 fees even when funds are closed to new investors. Thus, load-fund investors are more likely to pay higher fees and receive lower returns.

Mutual fund use and abuse of fees can be explained by observable heterogeneity in decisions concerning fund and investor attributes and relations that include 1) portfolio diversification; 2) economies of scale; 3) asset growth; 4) performance marketing; 5) investment policy; 6) service quality; 7) cost competition; 8) segmentation by investor sophistication; 9) direct versus indirect distribution; 10) load versus no-load funds; 11) knowledge of expense ratios versus loads; 12) loads, expenses, and fund flows; 13) investor focus on volatility versus fees; 14) search costs and advice use; 15) size of fund complex; 16) media attention; 17) actively managed versus index funds; 18) fund quality; and 19) segmentation by share class, among others.

In summary, Houge and Wellman [2006] find that whereas mutual funds aggressively advertise past performance, they rarely compete on the basis of cost. While fees provide deadweights on fund returns, few investors actually estimate them. Funds have become very adept at segmenting customers by level of investment sophistication. Funds use this ability to sell high-cost funds to less-knowledgeable investors. Dissatisfied investors, who may face high costs in the search for lower-cost alternatives, may instead opt to maintain the status quo.

Load mutual funds consistently charge higher 12b-1 fees, management fees, and total expenses than do no-load funds, signaling that load and no-load fund investors have different levels of sophistication. Over time, fund 12b-1 fees have increasingly replaced sales loads, thus shifting a portion of these fees to expense ratios, where they are less likely to be noticed by investors. There is growing distribution abuse from use of 12b-1 fees when funds are closed to new investors.

Mutual fund market segmentation provides different levels of beneficial investor services. However, its use to extract higher fees from less-knowledgeable investors raises ethical issues. One possible SEC solution would be to require funds to disclose the dollar amount of operating expenses paid annually by each shareholder. This requirement would enable investors to make more informed decisions.

Increased expense ratios of load mutual funds contradict the key broker sales pitch that such funds are cheaper than no-load funds because of their lower expense ratios. While sales loads initially lower investor returns, lower expense ratios could more than make up for this over time. Load mutual funds had lower expense ratios from 1970 to 1990, but investors were unlikely to have recouped the high loads. It could be argued that high loads motivated investors to hold funds for the longer term, which encouraged value-maximizing behavior.

Mutual funds have apparently embraced a path that generates the most profit from investors with the least resistance. The trend of increasingly poor fund performance relies on unsophisticated investors for its continued success. Load fund shareholders often pay higher fees, which are generally used to pay for marketing costs that benefit fund advisers. Overall, investors are not well served over time by load funds.

## BOARD DECISIONS AND FEE DISPERSION

Tufano and Sevick [1997] analyze composition and compensation of mutual fund boards to determine the relation between board structure and fund fees. Shareholder fees are found to be lower when boards have fewer directors, have larger proportions of independent directors, and when those directors serve on a large proportion of other sponsor fund boards. There is also evidence that funds paying higher compensation to independent directors approve higher fund fees.

Mutual fund board structure and decision making is narrowly assessed. First, law gives fund boards or, more precisely, independent directors, a defined set of responsibilities. The most important duties are to negotiate and approve annual contracts with fund sponsors, distributors, and other service providers. These contracts set the fees shareholders pay for these services and, importantly, determine their returns.

Second, mutual fund directors typically serve on many boards of a single fund sponsor. Fund sponsors typically select the initial independent directors of each new fund. Independent directors that sit on many boards in a single complex of funds are usually highly compensated. It has been alleged that many independent directors routinely approve higher fees and fail to exercise their fiduciary duty. The issue is whether fund sponsors are likely to select independent directors who are unwilling to approve their fee proposals.

Cross-sectional analysis explains much of the differences in mutual fund fees. Lower fees are charged by boards with the following differences in attributes: 1) smaller number of directors; 2) larger percentage of independent directors; and 3) directors sit on larger percentage of sponsor fund boards. Board structure better explains fee differences between fund sponsors than for single sponsor funds.

Certain configurations of board size and composition are found to be effective in dealing with conflicts of interest between mutual fund managers and shareholders. However, board structure has little differential effect on fees paid to fund sponsors and third-party service providers. Therefore, it should not be assumed that board structure impacts fund fees directly through the reduction of agency conflicts.

Tufano and Sevick [1997] discuss the reasonableness of mutual fund fees explained by observable heterogeneity in fund board and sponsor decisions and related attributes that include the following: 1) outsourced management services; 2) board structure (size, composition, compensation); 3) legal roles of boards; 4) "interested" versus independent directors; 5) legally empowered board duties; 6) independent director choice of fund sponsors and service providers; 7) fund sponsor management decisions; 8) independent director fee approval standards; 9) fund sponsor and independent director fee and service provider negotiations; 10) legal standards for board fee and service provider decisions; 11) shareholder skill, information, and monitoring; 12) market

imperfections and rents; 13) fund sponsor motivation for higher fees; 14) board traits for higher versus lower fund fees; 15) board monitoring effectiveness; 16) frequency and results of director-related fee scandals and litigation cases; and 17) economies of scale and scope in board oversight, among others.

In summary: Tufano and Sevick [1997] offer cautions to previous major research findings. First, it is implied that more effective independent directors would charge shareholders lower fees, controlling for factors influencing them. Legally, directors are required to charge fees that are "not excessive," but a higher standard is applied. By basing board effectiveness solely on size of fees approved, several differences in effectiveness are ignored. These exclusions include ensuring that fund advisers follow charter restrictions and regulations, administrators comply with regulations, and misleading advertising is not used. It is recognized that directors have many duties, of which fee setting is one of the most economically significant. Empirical research is required to understand these decisions and their impact of governance.

Second, mutual fund board structure is partly exogenous, but largely reflects endogenous decisions of fund advisers under the Act. Rather than board structure influencing fees, fund advisers with different target fee levels may select different types of boards. If so, changes in board structure will not necessarily lead to changes in fee levels.

Finally, concern exists about the relative effectiveness of different types of boards. Attention must be paid to the absolute effectiveness of boards in protecting shareholder interests relative to other approaches. Restraints on fund advisers desire for higher fees, and boards willingness to approve them, include requiring fund advisers to justify their continuation of fee and service levels annually to independent directors. Also, directors could be sued for failure to perform their duties as "shareholder watchdogs."

## FACTORS IMPACTING EXPENSE RATIOS

The SEC [2000] analyzed major factors with significant negative or positive relationships to various types of expense ratios: 1) asset size is negative relative to operating expense ratios, 2) investment category (specialty funds have higher operating expense ratios than equity funds), 3) index and institutional funds both have

lower operating expense ratios than other fund types, 4) fund family asset size (large families have lower management fee ratios than small families), 5) level of portfolio turnover is positive relative to operating expense ratios, 6) funds in large families have lower management fee ratios than funds in smaller families, 7) management fee schedules of most large funds have breakpoints, and 8) expense ratios (asset weighted) of 401(k) plan funds are lower than for all other funds.

Further, the following major factors with significant negative or positive relationships to operating expense ratios (expense ratios minus 12b-1 fees) and one expense ratio are identified: 1) fund assets (negative relative to operating expense ratios), 2) fund family assets (negative relative to operating expense ratios), 3) number of family funds (negative relative to operating expense ratios), 4) fund category (equity funds have higher operating expense ratios than bond funds), 5) index funds have lower operating expense ratios than other funds, 6) institutional funds have lower operating expense ratios than non-institutional funds, 7) front-end load funds have lower operating expense ratios than no-load funds, 8) funds with 12b-1 fees have higher expense ratios than other funds, 9) portfolio turnover (positive relative to operating expense ratios), 10) portfolio holdings (positive relative to operating expense ratios), 11) multi-class funds have higher operating expense ratios than single-class funds, and 12) fund age (older funds have higher operating expense ratios than younger funds).

To conclude, the study's 20-year findings are summarized: 1) expense ratios have primarily increased; 2) overall cost of owning funds may not have increased if sales loads are considered; 3) higher expense ratios can be attributed primarily to changes in how distribution and marketing fees are paid by funds and shareholders; 4) funds with largest proportions of 401(k) pension plan assets generally have lower expense ratios; 5) expense ratios generally decline as fund assets increase; 6) specialty funds have higher expense ratios than equity funds, and equity funds have higher expense ratios than bond funds, and international funds have higher expense ratios than comparable equity funds; 7) index funds and institutional funds have lower expense ratios than other types of funds; 8) funds in large fund families tend to have lower management fees than funds in small fund families; and 9) larger funds generally have fee breakpoints (reductions) that reduce fund management ratios as total value of assets increases.

## CONCLUSION

The purpose of this article is to discuss research that identifies heterogeneous mutual fund and investor attributes and relations that explain dispersion in fund fees. One might think there is a short list of attributes and relations, such as high versus low expense ratios, that tell the full story of fund fee dispersion, but the story is much more complicated and nuanced. The research topics discussed are not inclusive of heterogeneous fund and investor attributes and relations that generate dispersions in fund fees, but they do provide depth within particular research domains.

Select findings for discussions of factors influencing dispersion of mutual fund fees include 1) fund competition and agency conflicts are important determinants of fund pricing; 2) fee dispersion primarily arises from heterogeneity of products, clientele, and production functions; 3) negative relations between fees and performance is due to strategic fee-setting and investor sensitivity to performance; 4) investor perceptions of fund markets are key to fund fee-setting mechanisms; 5) funds segment investors by level of investment sophistication and sell high-cost funds to less-knowledgeable investors; and 6) fees are lower with small boards, boards with relatively more independent directors, and boards where a higher proportion of directors sit on boards of other sponsor funds.

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# The Journal of Wealth Management

## **EVALUATING CLIENT DISCOVERY INTERVIEWS AT A FINANCIAL ADVISORY FIRM** 9

JEFF BELKORA

Discovering the client agenda involves interviewing clients to assess their interests, issues, concerns, questions, goals, and priorities. This is similar to discovering the patient agenda in medicine. The SLCT (pronounced "select") process is an evidence-based interview protocol that has been found effective in stimulating patient disclosure in health-care settings. After evaluating discovery practices among six advisors at a registered investment advisor firm before and after training them in the SLCT process, the author based the analysis on observations, notes, transcripts, and survey responses from the interactions of six advisors with 18 simulated and 12 real clients. Observations and survey responses indicated that advisors lacked a common protocol for discovery interviews prior to training. The analysis shows that, even with minimal training, advisors using SLCT achieved an improved rate of insight into client needs. Training in SLCT was associated with increased advisory inquiry, client disclosure, and documentation of the client agenda.

## **MAKING THE CASE FOR CUSTOMER PROTOTYPING FOR FINANCIAL PLANNERS TO INCREASE SAVINGS BEHAVIOR** 25

MICHAEL BENTLEY

Evidence has shown that personal savings behaviors are at low levels for individuals within the United States, with the problem only being enhanced by low levels of financial literacy among the general population. Failure to properly plan for retirement, unemployment, poor borrowing strategies, and debt are all attributed to ignorance of basic financial concepts. While steps have been taken to analyze effectiveness and promote financial education and literacy, it solves only one facet of improving savings behavior. Thus, private-sector financial planning firms need to implement customer prototyping on the microeconomic level to improve savings behavior of individuals of varying market segments.

## **IN DEFENSE OF EVIDENCE-BASED WEALTH MANAGEMENT: *Where's the Beef?*** 30

WM. MARTY MARTIN

Wealth management is a profession that bridges the art and the science of the discipline and practice. It is argued that wealth management must be built on a solid theoretical and empirical foundation, similar to that used in the medical profession, that guides practitioners to implement evidence-based wealth management recommendations. A client presenting the same financial/wealth management data to two wealth managers should generally be given a similar set of recommendations. Public trust and the credibility of the wealth management profession depend on a core body of knowledge, assessment of competency, upholding the ethics of the profession, and increasingly utilizing theory and empirical evidence from the academic literature of wealth management, financial planning, finance, economics, behavioral finance, communication, and other related disciplines, given the interdisciplinary nature of wealth management. After reading and reflecting upon this article, the reader should be able to articulate the case that wealth management is a profession and not simply a trade or craft; to define evidence-based wealth management and offer an example; to list the characteristics of evidence-based wealth management; to differentiate between data and opinion; to identify the levels of analysis; and to differentiate between two wealth management practice models. In conclusion, the decision to practice evidence-based wealth management is not a matter of personal preference but is an ethical choice that can also serve as the basis for an effective business model.

## **MUTUAL FUND HETEROGENEITY AND FEE DISPERSION** 41

JOHN A. HASLEM

This study discusses research that identifies heterogeneous mutual fund and investor attributes and relationships that explain dispersion in fund fees. One might think there is a short list of attributes and relations, such as high versus low expense ratios, that tell the full story of fund fee dispersion,

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but the story is much more extensive and nuanced. The research topics discussed are not inclusive of heterogeneous fund and investor attributes and relations that generate dispersions in fund fees, but they do provide depth within particular research domains. Select findings for discussions of factors influencing dispersion of mutual fund fees include 1) fund competition and agency conflicts are important determinants of fund pricing; 2) fee dispersion primarily arises from heterogeneity of products, clienteles, and production functions; 3) negative relations between fees and performance are due to strategic fee-setting and investor sensitivity to performance; 4) investor perceptions of fund markets are key to fund fee-setting mechanisms; 5) funds segment investors by level of investment sophistication and sell high-cost funds to less-knowledgeable investors; and 6) fees are lower with small boards, boards with relatively more independent directors, and boards where a higher proportion of directors sit on boards of other sponsor funds.

## CURRENCY HEDGING IN THE EMERGING MARKETS: *All Pain, No Gain* 49

TIM ATWILL

Investors in foreign equities are exposed to potential risks from both the movement of security prices and currency exchange rates. Over the past two years, the U.S. dollar has strengthened significantly against most developed and emerging-market currencies, resulting in material performance headwinds for U.S. dollar-based investors. This, in turn, has led to a growing interest in hedging the effects of currency movements on developed international equity holdings. As a consequence, many investors also wonder whether they should apply a similar program to their emerging-market assets. While this is a natural question, it ignores some of the major differences between implementing a hedging program for developed market currencies versus doing so for emerging-market currencies. We discuss these implementation issues and point out the historical relationship between stock price movements and currency returns in emerging markets. The authors find that for many emerging-market countries, these implementation issues make it operationally impossible to hedge many of these

currency exposures; for those that are possible to hedge, the current market environment makes it very expensive. Furthermore, if one looks at the theoretical impact from hedging currency in emerging markets, it appears to be a minor one over the long term and is equivalent to making episodic market calls in the short term.

## SECTOR ROTATION WITH MACROECONOMIC FACTORS 54

JAMES CHONG AND G. MICHAEL PHILLIPS

Implementing sector rotation strategies with a set of low-frequency economic measures, the authors construct long-only sector exchange traded fund (ETF) portfolios that respond differently to the economy via alternative optimization methods, such as mean-variance and low-volatility allocations. These economic-based portfolios, when assessed against the S&P 500 Index and the equal-weighted ETF portfolio, performed relatively well in absolute and relative terms, for the whole period as well as subperiods. This study sheds further light on the effectiveness of economic factors when applied to investment strategies.

## STATIC AND DYNAMIC APPROACHES TO STUDYING FACTORS AFFECTING THE PRICE OF GOLD 69

MANU SHARMA, ESHA PRASHAR,  
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The study examines the relationship of the price of gold to five factors: the U.S. GDP, Consumer Price Index, U.S. dollar index, S&P 500, and LIBOR, for a period of 10 years, from December 2001 to December 2011. When the values of each precedent were perturbed from the base value, it was found that U.S. GDP has the highest impact on the price of gold. It was also found that the price of gold has a positive relationship with U.S. GDP, CPI, U.S. dollar index and the S&P 500 and a negative relationship with LIBOR. The U.S. GDP shows the highest nonlinear rank correlation, whereas the LIBOR shows the lowest nonlinear rank correlation. It is also proven that it is important to perform