

FINANCIAL TIMES

October 16, 2011 4:12 am

Excessive fees linked to US subadvised funds

By Maura McDermott

US mutual funds that hire subadvisers tend to be slightly more expensive than those that do not, according to a recent report by Lipper. Such funds have recently begun to draw the attention of plaintiffs' attorneys, who have filed lawsuits accusing them of fleecing investors.

The starkest difference in total expenses is for equity funds; among those funds, subadvised funds' total expenses were about 10 basis points higher than their non-subadvised peers, according to the report, which tracks fund fees and performance.

For bond funds, the gap was about 5 basis points. Not all subadvised funds were pricier; among fixed income variable insurance products and institutional money funds, subadvised funds were less expensive by at least 2.5 basis points.

All mutual funds hire advisers, whether to decide what securities to invest in or to oversee a passively managed index fund. The fees paid to the adviser typically make up the largest portion of investors' total expenses. However, in some cases the adviser will farm out some or all of its work to subadvisers. In those cases, the adviser will share its fees with the subadviser.

Hiring a subadviser can benefit a fund in several ways, says Sasha Franger, the Lipper fiduciary research analyst who wrote the report. It allows the adviser to avoid the start-up costs associated with a new fund, and it can offer expertise in a niche where the adviser is not as experienced as the subadviser. However, she says, "the biggest potential drawback is that increased expense ratio".

Subadvised funds make up a large slice of the market. Slightly more than a third of open-end funds are subadvised, along with nearly two-thirds of variable insurance products, according to Lipper. Only about half of subadvised funds disclose the exact amount paid by advisers to their subadvisers. Among those, median fees charged by subadvisers range from 6 basis points for money market funds within variable insurance products, to 40 basis points for open-end equity funds.

The median share of advisory fees retained by the principal adviser varies by asset class and fund size, according to Lipper. For equity funds, the typical adviser retains up

to 55.6 per cent of the fee, depending on the size of the fund, for bond funds, up to 58.3 per cent, and for money market funds up to 80 per cent.

Investors do not suffer a huge price hit when they buy subadvised funds, says Lipper. In fact, subadvised equity funds charge investors 135 basis points in median total expenses; the 10-basis-point price difference between those funds and non-subadvised funds makes up only 7 per cent of their total price tag.

However, two recent excessive-fee suits have heightened concerns about subadvisory fees. In July, Axa Equitable was hit with a lawsuit charging that the firm collected “exorbitant profits” from its subadvised funds.

The adviser retained portions ranging from 50-94 per cent of overall fund advisory fees, despite “performing little, if any additional work”, according to the complaint.

Last year, plaintiffs levelled similar charges against The Hartford funds’ adviser, which kept between 62 per cent and 74 per cent of advisory fees, according to the complaint. Both firms have declined to comment on the litigation.

The focus on the portion of fees retained by principal advisers is “a tool plaintiffs’ attorneys have used to get media attention”, says Domenick Pugliese, a partner with Paul Hastings Janofsky & Walker.

Whether an adviser hires a subadviser to run an entire fund or a portion of it, the adviser’s costs increase because it must oversee the subadviser’s performance, he says. By contrast, he maintains, subadvisers often simply add the new account to an existing portfolio. “Adding a new client to the mix does not increase their cost very much,” he says.

Despite the controversy, subadvised funds appear to be on the rise, says the Financial Research Corporation. A recent report by the firm found subadvised mutual funds’ assets rose nearly 48 per cent between 2005 and June 2011, from \$860bn to \$1,270bn. The funds’ asset levels will grow to \$2,200bn by 2016, the firm predicts.

Meanwhile, subadvised funds within variable annuity products saw their assets rise by 58.4 per cent in the same period, from \$370bn to \$586bn. Those funds’ assets are expected to rise to \$1,000bn by 2016, says the FRC.

Not everyone is a fan of subadvised funds. Niels Holch, executive director of the Coalition of Mutual Fund Investors, says investors should be wary, given the finding that they tend to be more expensive and the allegations made in the recent lawsuits.

“If the management fee is several multiples higher than the subadvisory fee and the subadvisers are doing all the advisory services, you have to ask yourself, ‘What is the management company doing for its fee?’” Mr Holch says.

Maura McDermott is associate editor on BoardIQ, a Financial Times publication

Printed from: <http://www.ft.com/cms/s/0/77562c0a-f3da-11e0-b221-00144feab49a.html>

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2011 FT and 'Financial Times' are trademarks of The Financial Times Ltd.