Recommendation of the Investor as Purchaser Subcommittee Regarding Mutual Fund Cost Disclosure

Preliminary Observations

- It is generally accepted that costs have a significant impact on investment success, particularly over the long term. As the Commission itself noted in an *Investor Bulletin* that urges investors to understand and compare costs, “Over time, even ongoing fees that are small can have a big impact on your investment portfolio.”[1]

- All types of investment costs, including costs for advice and services as well as costs for investment products, affect the total monies accumulated by an investor in a long term investment. Because of the important role mutual funds play as long-term investments for individual investors, however, and because costs can vary greatly from fund to fund, providing clear disclosure of mutual fund costs has long been a priority.

- Since 1988, the Commission has required the mutual fund prospectus to include a fee table that shows all fees and charges associated with a mutual fund investment as a percentage of net assets. In 2004, the Commission added a requirement for funds to disclose costs per $1,000 investment as a dollar amount in the annual shareholder report.[2]

- Despite this disclosure, evidence suggests that many mutual fund investors do not have a good grasp of the amount they pay annually in mutual fund fees or the long-term impact of those fees on their portfolio’s performance. The Commission reported in its 2012 financial literacy report, that “many investors … are not fully aware of investment costs and their impact on investment returns.”[3] Academic researchers have similarly concluded that investors do not pay sufficient attention to mutual fund expenses.[4]

- While research specific to investors’ understanding of fund costs is limited, one unpublished study that asked about investor’s knowledge of fund costs found that only about half of investors who own mutual funds say they know roughly how much they pay in mutual fund fees. When asked to provide an estimate, the majority of respondents greatly under-estimated the costs.[5]

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[1] SEC Office of Investor Education and Advocacy, *Investor Bulletin*, “How Fees and Expenses Affect Your Investment Portfolio,” available here: https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf

[2] Funds are required to disclose two amounts: (1) the cost in dollars associated with an investment of $1,000, based on the fund's actual expenses and return for the period; and (2) the cost in dollars associated with an investment of $1,000, based on the fund's actual expenses for the period and an assumed return of 5 percent per year.

[3] Staff of the Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors* as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, August 2012 (available here: https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf)

[4] Palmiter, A. R., and A. E. Taha, “Mutual Fund Investors: Sharp Enough?” *Journal of Financial Transformation*, Vol. 24, January 2008, pp. 113–121. As of August 13, 2015: http://www.researchgate.net/publication/46557869_Mutual_Fund_Investors_Sharp_Enough

[5] SM – Diversification/Portfolio Survey 2015. When asked about if they know how much they pay in mutual fund fees, 31.35% answered yes, 32.65% answered no, and 36% indicated that they did not own mutual funds. Asked to

- While the Commission has taken a number of steps over the years to improve mutual fund cost disclosure, the Committee believes more can and should be done to enhance the quality and effectiveness of these disclosures.

Recommendation

The Investor Advisory Committee recommends that the Commission explore ways to improve mutual fund cost disclosures. The goal should be to enhance investors' understanding of the actual costs they bear when investing in mutual funds and the impact of those costs on total accumulations over the life of their investment. In the short term, the Committee believes the best way to make investors more conscious of costs is through standardized disclosure of actual dollar amount costs on customer account statements. In addition, as part of a longer term effort to improve disclosures, we encourage the Commission to explore ways to provide context for cost information in order to improve investor understanding of the impact of those costs.

Supporting Rationale:

Disclosures play an important role in helping investors both make sound investment decisions and evaluate the investments they own. Even investors who do not themselves read disclosures can benefit indirectly if improved transparency leads to beneficial market competition. Reflecting the view that investors and the market benefit from price transparency, the Commission has since 1988 required mutual funds to provide detailed information about their costs in the fund prospectus. Since 2004, funds have been required to provide additional cost information in the annual shareholder report. This information, presented in a standardized format, allows cost conscious investors who know where to look to compare costs across funds. The Committee remains concerned, however, that these disclosures suffer from several serious shortcomings that undermine their utility, particularly for investors who are not already focused on costs as an important factor to consider when making a fund selection.

- The disclosures are located in documents that many investors do not read.

Many investors simply do not read the disclosure documents containing information on mutual fund costs. Among respondents to the survey conducted for the Commission's 2012 financial literacy study, for example, more than four in ten mutual fund investors (44.3 percent) indicated that they never (8.7 percent), very rarely (12.0 percent), or rarely (23.6 percent) read a prospectus when they receive one. Even fewer (24.6 percent) identified the prospectus as one of their main sources of information when making a fund purchase, and just 6.2 percent identified the prospectus as their most important information source.[6] Another study of investors' mutual fund purchase practices similarly found most mutual fund investors do not consider the

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estimate how much they would pay on a $100,000 investment in a fund with expenses equal to the average for actively managed equity index funds, roughly half of respondents (50.92%) estimated that the annual cost would be $500 or less (equating to an expense ratio of 0.5%). Only 6.12% correctly estimated that annual costs would be between $750 and $1500, with another 4.64% estimating costs greater than $1500.

[6] Siegel & Gale, *Investor Research Report*, submitted to the U.S. Securities and Exchange Commission, July 26, 2012 (available here: https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part3.pdf)

prospectus as having been even somewhat influential in the purchase decision.[7] Investors appear to be even less likely to rely on disclosures in shareholder reports.[8]

Investors appear to be much more likely to review their account statements. A 1997 Investment Company Institute (ICI) survey of how investors obtain information about their funds indicated that investors typically view the account statement as the most important communication that they receive from a mutual fund company, and nearly all shareholders use such statements to monitor their mutual funds.[9] Nearly two-thirds of respondents to the survey for the Commission's financial literacy study indicated that they either always (42.0 percent) or usually (26.8 percent) check their account statements for possible mistakes, and only about 15 percent indicated that they either rarely (11.3 percent) or never (3.6 percent) do so. This suggests that investors are not only more likely to read the account statement, but to read it closely.

- The complex, technical nature of the fee table disclosures likely inhibits investors' willingness and ability to make good use of the information provided.

The typical mutual fund fee table for a fund with multiple share classes can quickly overwhelm the user through the sheer volume and complexity of the information presented. It is unclear what benefit the typical investor gets from the break-down of annual fund operating expenses, for example, and the provision of that detailed information in the fee table adds greatly to the complexity of the disclosures. Similarly, some of the labels are likely to be confusing to financially unsophisticated investors. Labeling sales charges "Shareholder Fees," for example, seems to unnecessarily obscure the purpose of these fees. And describing 12b-1 fees as "distribution or service fees" does little to clarify their significance. Simplifying the disclosures could lead to better investor understanding. Definitions or brief descriptions should be provided when the label or heading itself does not clearly indicate or imply the purpose of the fees.

- Presentation of the costs as a percentage of assets can give the appearance that costs are negligible when this is not the case.

The primary way in which fund costs are disclosed is as a percentage of assets, which may cause investors to under-estimate the impact of those costs. Researchers have documented a phenomenon they refer to as the "absolute magnitude effect," which is the tendency for people to perceive numbers as the absolute value of the quantities inherent in them, and not as the actual

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[7] Roper, Barbara and Brobeck, Stephen, "Investors' Mutual Fund Purchase Practices: An Analysis of Survey Results," Consumer Federation of America, June 2006 (available here: http://consumerfed.org/_archives/elements/www.consumerfed.org/file/finance/mutual_fund_survey_report.pdf) Among those who purchased their funds primarily from a financial professional, 44% rated the prospectus as either very (22%) or somewhat (22%) influential. Among those who purchased funds primarily through a workplace retirement account, 43% rated the prospectus as either very (19%) or somewhat (24%) influential. Only among those who purchased their funds directly from a fund company did a majority (55%) rate the prospectus as either very (37%) or somewhat (18%) influential.

[8] On the survey for the Commission's financial literacy study, 21.8 percent and 4.4 percent respectively identified the annual shareholder report as either one of their main sources or the main source of information.

[9] Government Accountability Office, Statement of Richard J. Hillman, Director, Financial Markets and Community Investment before the U.S. Senate Committee on Governmental Affairs Subcommittee on Financial Management, the Budget and International Security, "Mutual Funds: Additional Disclosures Could Increase Transparency of Fees and Other Practices," January 27, 2004 (available here: http://www.gao.gov/assets/120/110547.pdf)

statistical figures they represent. As researchers who examined this phenomenon explained, this causes a person "to perceive a larger change in their portfolio if the return was expressed as 24 percent versus an identical return of 0.24" and to "perceive an even larger change if it was expressed in a dollar amount as long as the change was more than $24."[10] It is logical that the same would be true of fund costs – that investors would be more likely to better appreciate the magnitude of fund costs if they are presented as a dollar amount (e.g., $100), rather than as a percentage (1.0%).

Fund companies are required to provide certain dollar amount disclosures based on various hypothetical scenarios. The prospectus must include an illustration showing dollar amount costs of investing in various different fund classes over 1-, 3-, 5-, and 10-year periods. This illustration assumes an investment of $10,000, a return of 5 percent, and that all shares are redeemed at the end of the period. An additional illustration is provided for share classes that charge deferred loads assuming that shares are not redeemed at the end of the period. Shareholder reports are required to include two additional illustrations – one showing the dollar cost expenses per $1,000 invested using the fund's actual performance over the reporting period and another using an assumed rate of return of 5 percent. Unlike the prospectus disclosures, which come at the start of the document, the shareholder report disclosures may be found at the back of the report at the end of many pages of dense data.

In addition to being presented in documents many investors do not read, the dollar amount disclosures that are provided require the investor to extrapolate their own costs based on the hypothetical costs presented. Nothing in the Commission's extensive study of financial literacy and disclosure effectiveness suggests that a majority of investors are likely to make those calculations. On the contrary, the Commission's research demonstrates that even investors who claim to understand cost disclosures often fail to calculate costs accurately.[11]

- Current disclosures do not provide a ready context to show whether a fund's costs are relatively high, low, or about average or how those costs might impact total accumulations.

Investors who wish to measure how their fund costs compare to costs of other funds must seek out additional information to make that assessment. While the information and cost comparison tools are readily available to those who go in search of them, consumer behavior research suggests that this is not how consumers typically shop. [12] Federal Reserve officials who grappled with this problem in the context of designing improved APR disclosures concluded based on research and testing that consumers can benefit from inclusion of information on disclosure documents that help them to put costs in context. With that in mind, they proposed to include a graphic showing the APR in relation to APRs on similar loans offered to borrowers with excellent credit.[13] While providing context of this kind is not a panacea, mutual fund

[10] "Numerical Information Format and Investment Decisions: Implications for the Disposition Effect and the Status Quo Bias," (Rubaltelli et al., *The Journal of Behavioral Finance*, 2005, Vol. 6, No. 1, 19–26)
[11] See, for example, Siegel & Gale findings regarding investor understanding of investment adviser costs disclosed on ADV forms.
[12] Hogarth, Jeanne M. and Merry, Ellen A., "Designing Disclosures to Inform Consumer Financial Decision-making: Lessons Learned from Consumer Testing," *Federal Reserve Bulletin*, August 2011 (Vol. 97, No. 3)
[13] *Ibid*

investors, many of whom have little understanding of what constitutes a low-, average-, or high-cost fund within a particular fund category, could likely benefit from information that helps them to put those costs in context. Similarly, while the Commission emphasizes the importance of understanding the impact of costs on total accumulations over the lifetime of a long-term investment, it does not require funds to present cost information in a form that promotes this understanding.

Proposals to Address these Short-comings

- As a first step toward improving cost disclosures, the Commission should take immediate steps to require dollar amount cost disclosures on account statements as a supplement to existing prospectus disclosures.

The Committee believes the account statement is the best location for cost disclosures because it is the disclosure document most likely to be read, and read closely, by fund investors. Furthermore, providing dollar amount cost information on the account statement, where it will be juxtaposed with information about fund returns, increases the likelihood that investors will appreciate the significance of those costs, even without the provision of additional contextual information. We are optimistic that this form of disclosure would have the effect of making more investors cost conscious when selecting and evaluating funds. That would not only directly benefit those investors who take steps to lower their investment costs, it would provide indirect benefits to the market as a whole by promoting cost competition.

The GAO recommended this approach in a series of reports issued in 2003 and 2004. GAO noted that "most other financial services disclose the actual costs to the purchaser in dollar terms." GAO speculated that "seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis," and they added that such disclosures "may also increasingly motivate fund companies to respond competitively by lowering fees." When it adopted its requirement for cost disclosures in shareholder reports, however, the Commission rejected this approach on the grounds that it would be too costly. The Commission cited a report commissioned by ICI which estimated that implementation costs would exceed $200 million and that annual compliance costs would be about $66 million. Using those numbers, GAO estimated that the cost per account would be minimal, increasing the average fee by just 0.0038 percent.[14]

We recognize that the Commission must carefully weigh the potential costs and benefits of proposed changes to regulations such as this. In considering this proposal, we urge the Commission to carefully weigh its costs against its potential benefits, focusing in particular on which approach has the greatest potential to increase investors' awareness of costs and, with it, their likelihood to make more cost-conscious decisions. Should the Commission conclude that the costs of this proposal outweigh its benefits, we encourage the Commission to consider less costly alternatives, such as requiring a standardized illustration of the fund's operation costs, expressed as a dollar amount, as an enclosure in account statements.

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[14] GAO, Statement of Richard J. Hillman

The Committee questions whether the additional cost disclosures required to be included in Annual Shareholder Reports add measurably to investors understanding of their fund costs. At the very least, we believe the time has come for a comprehensive review of the effectiveness of the required disclosures and alternatives, such as dollar amount cost disclosures on customer account statements, to determine whether changes to these requirements could promote greater cost consciousness among mutual fund investors, more informed investment decision-making, and increased market competition based on fund costs. If, as we expect, analysis shows that disclosures in account statements are more effective than shareholder report disclosures in conveying the desired information, the Commission could consider replacing the existing shareholder report disclosures with the new account statement disclosures as a way to balance any increase in costs.

- Over the longer term, the Commission should consider additional disclosure changes to improve investors' understanding of fund costs.

In addition to requiring new account statement cost disclosures, the Commission should consider ways to improve the disclosures currently provided in the prospectus. Through testing, the Commission could identify ways to simplify and clarify the fee table. At the same time, the Commission should explore ways to put cost information in context. One possibility, for example, would be to require funds to disclose their costs relative to a benchmark showing the category average cost. This would help investors determine whether their own costs are higher, lower, or in line with the category average. The Commission should explore the feasibility of such an approach, examining such questions as how to define fund categories, what to use as the cost benchmark for those categories, and how best to present that information.

Such disclosures could be even more effective if they also showed how much more or less the investor would pay over various periods relative to the category average. This is information that some funds provide voluntarily today.[15] For long-term investments, such as target date funds, the comparison could be based on a period coinciding with the target date of the fund. Another possible approach would be to require funds to present a graph, similar to that used in the Commission's *Investor Bulletin* on the impact of investor costs, showing the impact on total accumulations of the fund's actual expenses and the category average expense, using an assumed rate of return and over an extended holding period. The Commission might also consider the benefits of requiring a reference to the link for the *Investor Bulletin* about mutual fund fees.[16]

Another possibility would be to require funds to provide an annual performance and fee report for each investor showing the actual performance and associated fees by fund or fund company. This could be distributed either with tax information or in an end-of-year account summary.

The above examples are just suggestions for possible approaches. The Committee encourages the Commission to test various such approaches to determine which are most

[15] See, for example, the graph included in Vanguard's online fund summaries (example available here: https://personal.vanguard.com/us/funds/snapshot?FundId=0040&FundIntExt=INT#tab=3)

[16] https://www.sec.gov/oiea/investor-alerts-bulletins/ib_mutualfundfees.pdf

effective in informing investors of the relative costs of their own funds, or funds they are considering purchasing, and the long-term impact of those costs.