Canadian Mutual Fund Ownership Costs: Competitive Relative to the U.S.

- Research Summary -

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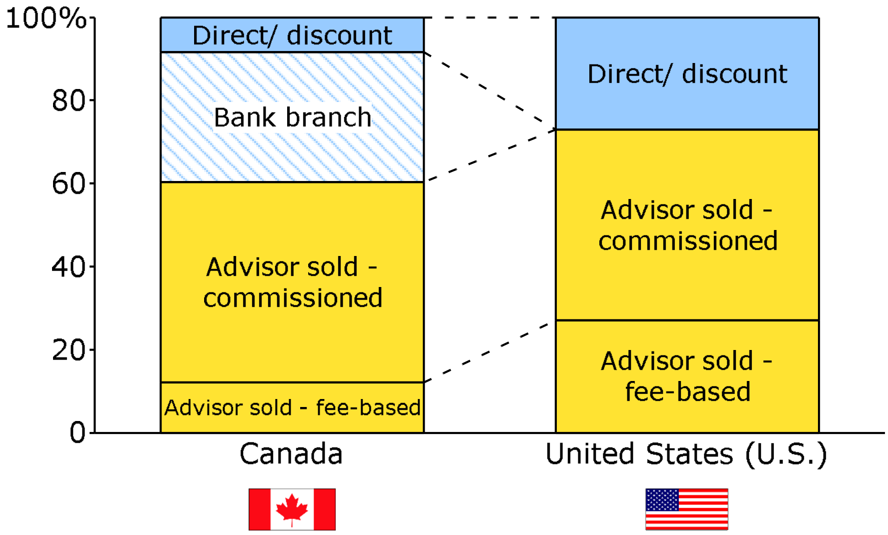
The majority of investors purchase mutual funds with the assistance of an advisor in both Canada and the United States (U.S.). However, the calculation of mutual fund expenses is different between the two countries. Research done by Bain & Company, a leading global consulting firm, indicates that when an accurate comparison of advisor sold funds is made, mutual fund Cost of Ownership (COO) in Canada is very comparable to the U.S.

Most Investors in Canada and the U.S. Purchase Mutual Funds with the Assistance of an Advisor

In both countries, advisors are a significant means of providing investors with assistance in purchasing and managing their mutual funds. For comparability, this analysis focuses on funds sold by financial advisors (see table 1).

Table 1 – Retail mutual fund assets[1] by distribution method



Furthermore, in both markets, advisors are most commonly compensated through commissions charged both in and outside the expense ratio. This review is focused on commission based pricing arrangements, though the conclusions do not substantially change when comparing fee based arrangements.

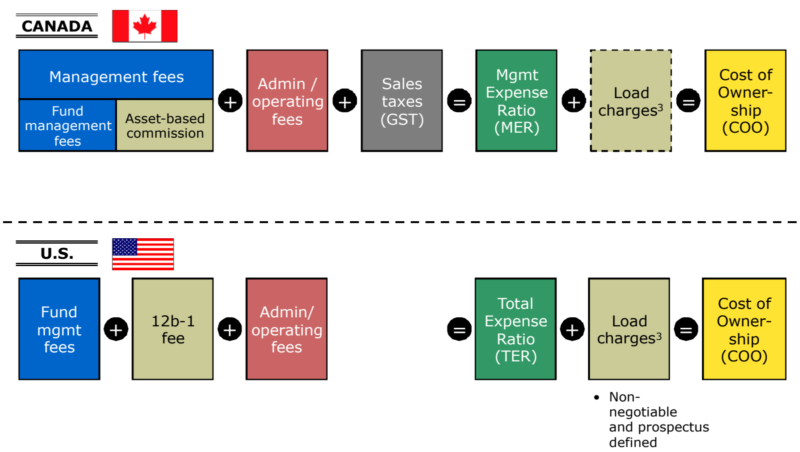
"Apples to Apples" Comparison of Mutual Fund Cost of Ownership (COO) between Canada and the U.S.

Aside from Money Market Funds, virtually all Canadian mutual funds fall into one of four categories: Domestic Equity, International Equity, Balanced, and Fixed Income. To build a valid Cost of Ownership comparison, a database of funds that account for 80% of these four types of mutual fund assets in Canada

[1] Chart excludes 401k and group plan assets; Canadian asset split based on 2009 data, U.S. asset split is based on 2008 data and excludes Money Market funds.
Source (table 1): Investor Economics; Cerulli ; ICI

and the U.S. was examined.[2] Table 2 provides a visual comparison of the various components in each country which need to be considered:

Table 2 – Canada versus U.S. Cost of Ownership (COO), commission-sold example



Commission based advisor compensation and sales tax are generally included in the expense ratio in Canada, but not included in the equivalent U.S. measure.

1. <u>Front –End Load Charges (U.S.)</u>

   Front-end load charges do exist in Canada, but they are rarely charged, as dealers typically receive an annual compensation equal to 1% of assets that they use to pay advisors.[4] In the U.S., commission based advisors and their dealers are compensated with both a ~0.25% annual fee of assets (12b-1 fee) and a front-end load charge. These U.S. front-end load charges are prospectus defined and can be as high as ~5% for an investor with less than $100K invested at a fund manager. Clearly, the addition of these front-end load charges (amortized over the investment holding period) substantially increases the mutual fund COO for U.S. investors.[5]

2. <u>Deferred Sales Commission Charges (Canada)</u>

   Deferred sales commission (DSC) funds have been included in the Canadian analysis as they are used much more in Canada than in the United States. Canadian back-end funds have similar Cost of Ownership to front-end funds in the majority of complexes. The only additional cost for DSC funds is the cost of redemption fees, which are charged to investors who exit a back-end fund family before the stated redemption period is complete.

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[2] Through Simfund, FINRA, Morningstar, Globefund, and fund prospectuses, fee data collected for the largest funds (as of December 2009) from each of the largest ~30 managers in the U.S. and the largest ~16 managers in Canada for each of 10 major asset classes. Resulted in a database of over 1,000 U.S. mutual funds and over 350 Canadian mutual funds.
[3] Load charges refer to commission paid by the investor to an advisor to purchase a front-end fund; refer to redemption fees for back-end funds.
[4] Fee based accounts typically pay a similar 1% ongoing commission, though it is paid directly by the investor.
[5] Estimated holding periods vary between sources for U.S. front-end load mutual funds, with DALBAR estimating 4 years for equity funds and industry experience generally reflecting a holding period for front-load funds of approximately 5 years. 5 years used in calculations.
Source (table 2): IFIC; Morningstar; Globefund; Fund Documents

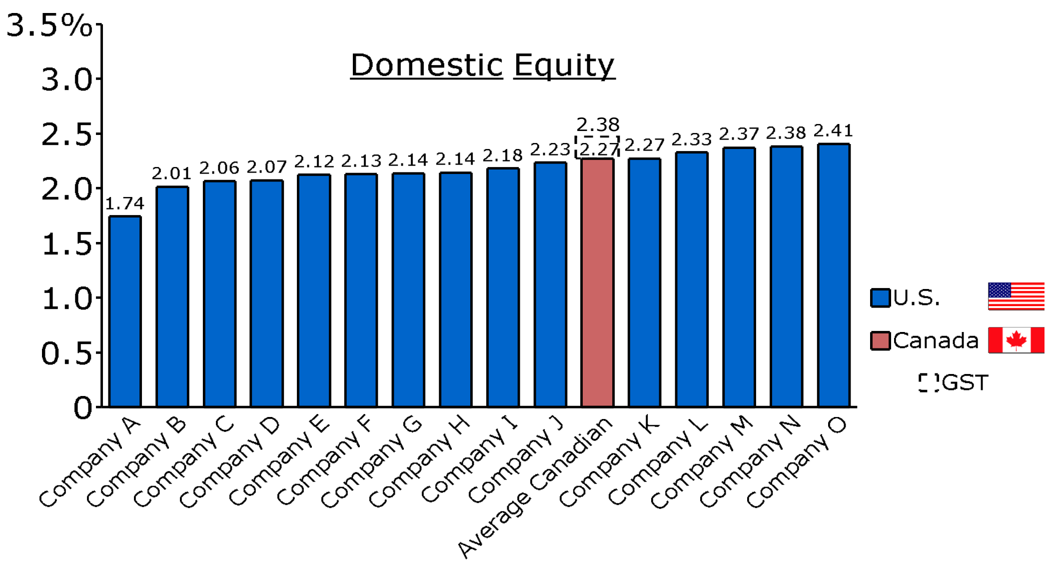
3. Sales tax (Canada)

Canadian expense ratios contain embedded GST, unlike in the U.S. where mutual funds are not subject to value-added sales tax. This difference accounts for approximately 0.10% of incremental Cost of Ownership in Canada versus the U.S. and is directly related to government taxation policy differences between the two countries. The introduction of HST in certain provinces will further increase Canadian Cost of Ownership.

Canadian Mutual Fund Cost of Ownership is Comparable to U.S. Mutual Funds Sold with Advice

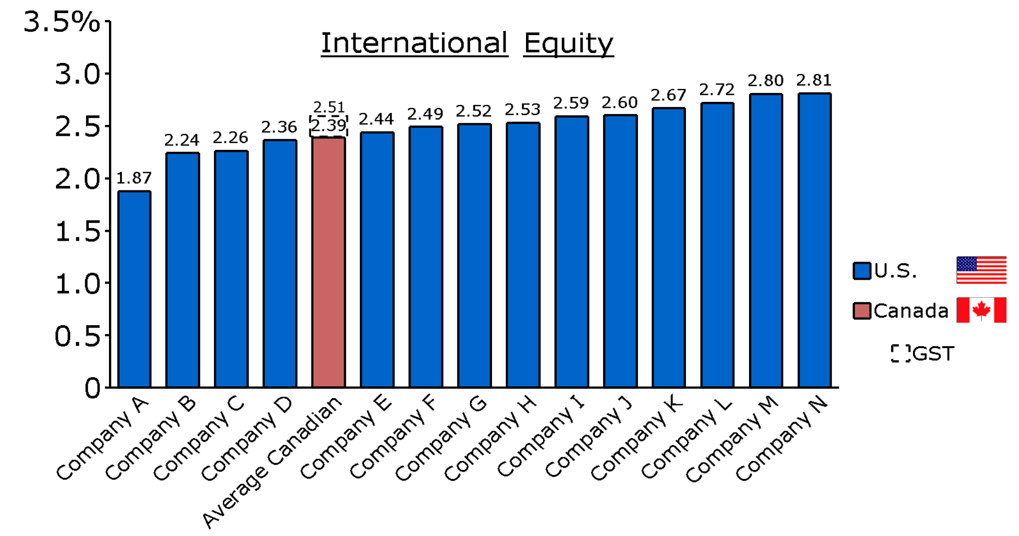
On an "apples to apples" basis, the vast majority of investors in Canada and the U.S. incur a comparable Cost of Ownership (COO) when purchasing mutual funds with the assistance of an advisor. This is illustrated in Table 3, which shows mutual fund COO for 15 of the largest U.S. fund managers, excluding those whose funds are sold primarily direct. For each of the major mutual fund categories (Domestic Equity, International Equity, Balanced, and Fixed Income), the average Canadian pre-GST COO falls within the range of U.S. managers.

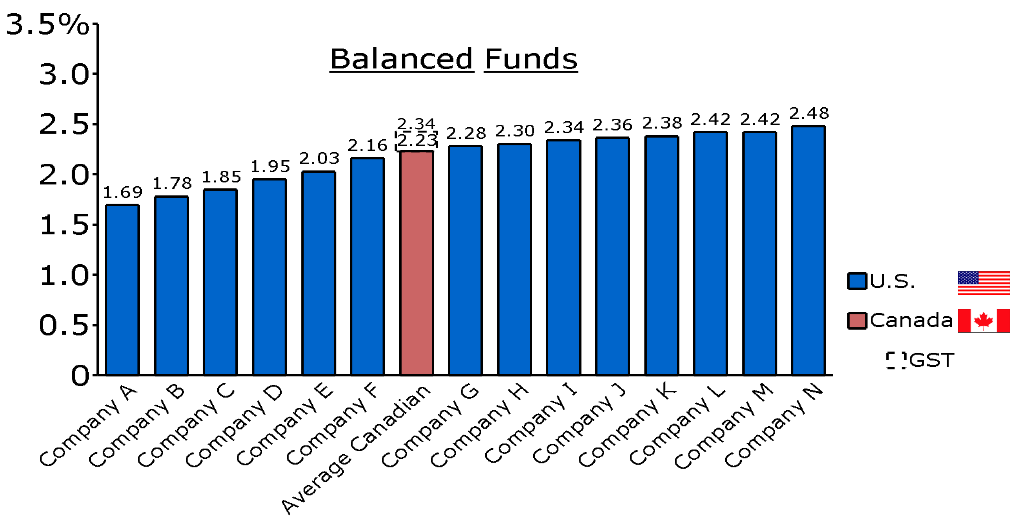
Table 3 – Cost of Ownership for front load advisor sold mutual funds by manager[6] ($0-100K account size)[7]

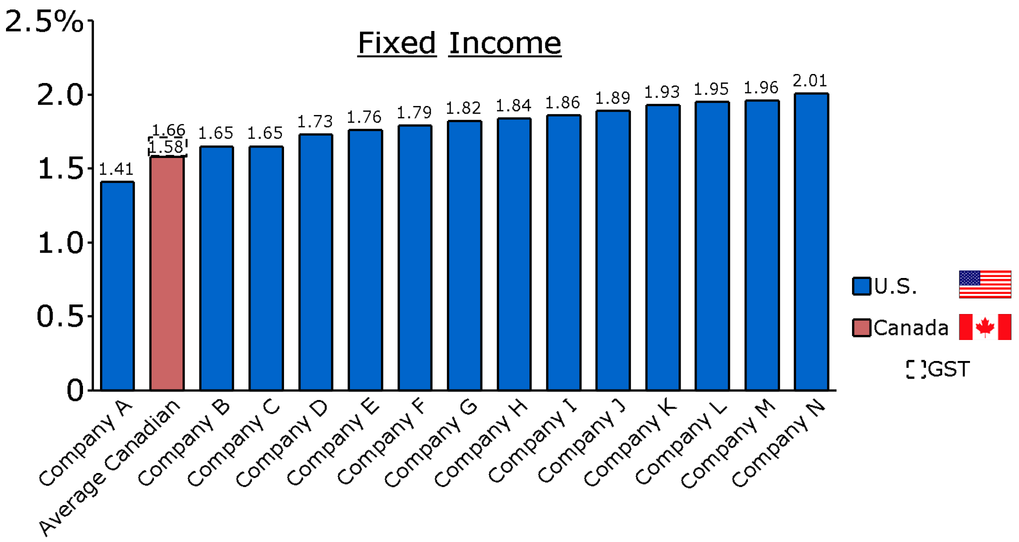


[6] U.S. managers labelled company A through O; letters given to a specific manager may not be consistent between graphs

[7] Over 95% of mutual fund investors in Canada have less than $100K invested with a given fund manager


International Equity
3.5%
3.0
2.5
2.0
1.5
1.0
0.5
0
1.87
2.24
2.26
2.36
2.51
2.39
2.44
2.49
2.52
2.53
2.59
2.60
2.67
2.72
2.80
2.81
Company A
Company B
Company C
Company D
Average Canadian
Company E
Company F
Company G
Company H
Company I
Company J
Company K
Company L
Company M
Company N
U.S.
Canada
GST


Balanced Funds
3.5%
3.0
2.5
2.0
1.5
1.0
0.5
0
1.69
1.78
1.85
1.95
2.03
2.16
2.34
2.23
2.28
2.30
2.34
2.36
2.38
2.42
2.42
2.48
Company A
Company B
Company C
Company D
Company E
Company F
Average Canadian
Company G
Company H
Company I
Company J
Company K
Company L
Company M
Company N
U.S.
Canada
GST


Fixed Income
2.5%
2.0
1.5
1.0
0.5
0
1.41
1.66
1.58
1.65
1.65
1.73
1.76
1.79
1.82
1.84
1.86
1.89
1.93
1.95
1.96
2.01
Company A
Average Canadian
Company B
Company C
Company D
Company E
Company F
Company G
Company H
Company I
Company J
Company K
Company L
Company M
Company N
U.S.
Canada
GST

Other Methods of Fund Distribution

The 30% of U.S. mutual funds not sold by advisors are primarily funds sold directly from the fund manager to the investor or through discount complexes. In Canada, direct and discount sold funds accounts for only 8% of the total mutual fund assets. Funds distributed in this manner generally have a higher Cost of Ownership in Canada than the United States. Mutual funds sold through bank branches represent approximately 31% of Canadian mutual fund assets offering a hybrid of the direct and advice approaches.

Summary of Findings

Commonly referenced mutual fund expense ratios do not accurately reflect the relative Cost of Ownership between Canada and the United States. When proper comparisons are made, it becomes clear that mutual fund Cost of Ownership in Canada is very comparable to the U.S. for the majority of Canadian investors.