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U.S. Fund Fee Study

Average Fund Fees Paid by Investors Decreased 8% in 2017, the Largest One-Year Decline Ever

Morningstar Manager Research
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Contents

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Executive Summary

Investors paid lower fund expenses in 2017 than ever before. Our study of U.S. open-end mutual funds and exchange-traded funds found the asset-weighted average expense ratio across funds was 0.52% in 2017, from 0.56% in 2016, reflecting an 8% decline. This is the largest year-over-year decline we have recorded since we began tracking the trend in asset-weighted average fees in 2000. Consequently, we estimate that investors saved roughly $4 billion in fund expenses last year. This fee decline is a big positive for investors because fees compound over time and diminish returns.

This 8% decline in asset-weighted average fees was driven by $949 billion in flows into funds with fees that rank within the bottom 20% of their category group. This flow into low-cost funds was a 60% increase from 2016's $593 billion. About 70% of 2017's flows into low-cost funds were into passively managed funds, with active funds accounting for the remaining 30%.

In addition, there was an uptick in active funds reducing fees in 2017, thanks to scale economies achieved through asset growth. Among actively managed U.S. equity funds, strong equity-market performance lifted asset levels, more than offsetting outflows. The launch of lower-cost share classes, a multiyear trend, also helped drive lower fund expenses for investors.

Key Takeaways

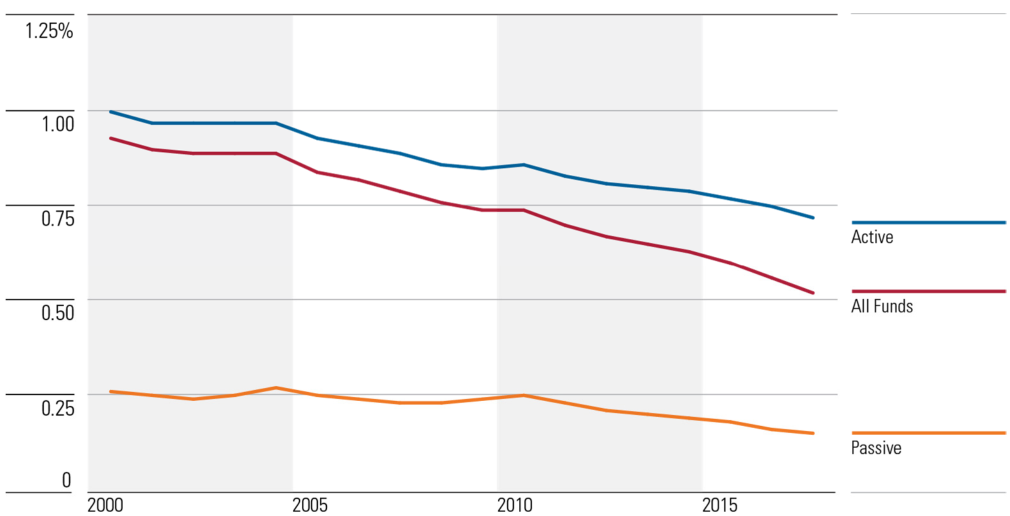
- In 2017, investors paid an average 0.52% expense for funds, as measured by the asset-weighted average expense ratio of roughly 25,000 U.S. open-end mutual funds and ETFs. This reflects an 8% decline from 2016, the largest year-over-year decline we have recorded since we began tracking this data in 2000.
- As a result of this decline in asset-weighted average fees, we estimate that investors saved roughly $4 billion in fund expenses last year.
- The asset-weighted average expense ratio for passive funds fell to 0.15% in 2017 from 0.16% in 2016, a 7% decline. This reflected strong flows into the lowest-cost equity and bond funds, as well as fee cuts by some asset managers for widely held broad index funds.
- Changes in fees charged by asset managers are represented in the equal-weighted average expense ratio, which for passively managed funds was 0.30% in 2017, from 0.31% in 2016. This decline of 3% was smaller than the 7% decline in the asset-weighted average. This, combined with the large difference between the 2017 asset-weighted and equal-weighted averages, indicates that among passively managed offerings, investors are gravitating to the lowest-cost funds.

- The asset-weighted average expense ratio for active funds fell to 0.72% in 2017 from 0.75% in 2016. This 4% decline was the largest annual percentage decrease in over a decade and was driven mainly by large net flows from expensive funds to cheaper funds, and secondarily by fee reductions. On average, active funds exhibited a 2% decline in equal-weighted average fees, to 0.85% in 2017 from 0.87% in 2016. The difference between the asset-weighted and equal-weighted average among active funds is not as great as it is among passive funds.
- On the passive side, fee cuts were larger among U.S. equity and taxable-bond funds, which reflects the aggressive pricing environment for broad index funds used as core holdings. On the active side, fees for U.S. equity and international equity funds exhibited the largest declines. This was primarily the result of strong equity-market performance driving up asset levels (and offsetting outflows), triggering breakpoints that lower management fees.
- In 2017, the cheapest 20% of funds (funds with fees that fall within the bottom 20% of their category group) saw net inflows of $949 billion, with passive funds soaking up 70% of those inflows and with active funds accounting for the remaining 30%. The (more expensive) other 80% of funds saw net outflows of $251 billion, which was less than $414 billion in net outflows in 2016.
- Most investors now own lower-priced funds, as a result of the trends. Eighty-three percent of all assets reside in mutual funds and ETFs whose fees are in the bottom 40% when compared with other funds in their category group.
- As an alternative to higher-cost actively managed funds, some asset managers have launched strategic-beta funds, which are strategies that seek to provide exposure to factors (such as value or growth) or achieve an outcome (such as income). In 2017, the asset-weighted average fee for U.S. equity strategic-beta funds was 0.18%, which was slightly higher than traditional index funds' fees of 0.09%, but significantly lower than active funds' fees of 0.73%.
- Vanguard continues to have the lowest asset-weighted average expense ratio, which was 0.10%, followed by State Street at 0.16% and iShares at 0.25%. During the past three years, Vanguard's asset-weighted average fee declined a cumulative 25%, the biggest drop among the 10 largest fund families as measured by total assets under management, followed by iShares (19%), and Fidelity (14%).

Part 1: Trends in Fund Fees Paid by Investors

Investors paid lower fund expenses in 2017 than ever before. Our study of U.S. open-end mutual funds and exchange-traded funds found the asset-weighted average expense ratio across funds was 0.52% in 2017, an 8% decline from 2016. This is the largest year-over-year decline we have recorded since we began tracking the trend in asset-weighted average fees in 2000. Consequently, we estimate that investors saved roughly $4 billion in fund expenses last year (see Appendix for details). This fee decline is a big positive for investors because fees compound over time and diminish returns.

Exhibit 1 Asset-Weighted Average Fees for Funds Decline 8% in 2017



Source: Morningstar. Data as of 12/31/17.

In this study, we examine the trend in mutual fund expenses paid by investors using the asset-weighted average expense ratio as our measure. The asset-weighted average is a better measure of the average cost borne by fund investors, rather than an equal-weighted average. For example, for U.S. equity funds, the asset-weighted average expense ratio was 0.45% versus the equal-weighted average expense ratio of 1.10%. Funds with expense ratios above 1.10% accounted for less than 10% of assets invested in U.S. equity funds in 2017, so the simple average does not reflect most investors' experiences.

The main asset classes, U.S. equity, taxable-bond, and international equity, exhibited the largest annual decline in asset-weighted average expense ratios. (Allocation funds are underrepresented in this study, as most employ a fund-of-funds structure. We omitted funds of funds as their underlying funds' fees are already represented in the study.) U.S. equity funds (which account for 42% of invested assets in mutual funds and ETFs) saw asset-weighted average fees decline 9% to 0.45% in 2017. Taxable-bond funds (21%) saw asset-weighted average fees decline 7% to 0.44%, and international equity funds declined 8% to 0.64%. These averages include active and passive funds in aggregate.

Declines in the asset-weighted average fees were more pronounced among passively managed funds thanks to strong flows into the lowest-cost funds, as well as fee cuts by some asset managers for widely held broad index funds. In aggregate, passively managed funds exhibited asset-weighted expense ratio declines of 7% from 2016. International equity funds exhibited the largest declines among passive funds, whose asset-weighted average fees fell 9% to reach 0.23%.

Declines in asset-weighted average fees on the active side were driven primarily by large net flows out of expensive funds, and large net flows into cheaper funds. Also in 2017, there was an increase in the percentage of active funds exhibiting lower fees. As a result, in aggregate, asset-weighted fees for actively managed funds declined 4% in 2017 from the year prior, the largest annual decrease in over a decade.

Exhibit 2 Investors' Average Fund Costs as Represented by Asset-Weighted Average Fees

	Asset-Weighted Average Fees (%)					
	Active			**Passive**		
	2015	2016	2017	2015	2016	2017
U.S. Equities	0.79	0.77	0.73	0.12	0.12	0.11
Sector Equity	0.91	0.90	0.88	0.29	0.27	0.27
Allocation	0.76	0.74	0.71	0.18	0.16	0.15
Intl Equity	0.93	0.92	0.88	0.29	0.26	0.23
Taxable Bond	0.61	0.59	0.56	0.15	0.14	0.13
Muni Bond	0.55	0.54	0.51	0.25	0.25	0.24
Alternative	1.38	1.40	1.36	0.86	0.84	0.86
All Funds	0.77	0.75	0.72	0.18	0.16	0.15

Source: Morningstar. Data as of 12/31/17.

Exhibit 3 Fees Paid for Passive Funds Exhibit Larger Declines Than Fees Paid for Active Funds

	Asset-Weighted Average Fees: Change from Prior Year (%)					
	Active			**Passive**		
	2015	2016	2017	2015	2016	2017
U.S. Equities	–2	–2	–5	–7	–5	–8
Sector Equity	–4	–1	–2	–5	–5	–2
Allocation	–3	–3	–4	–10	–10	–9
Intl Equity	–2	–1	–4	–4	–12	–9
Taxable Bond	–5	–4	–5	–10	–9	–5
Muni Bond	–2	–2	–5	0	–1	–3
Alternative	–1	2	–3	0	–3	2
All Funds	–3	–3	–4	–6	–9	–7

Source: Morningstar. Data as of 12/31/17.

Part 2: Trends in Fund Fees Charged by the Industry

Investors' move to lower-cost active and passive funds has been a key driver of falling costs. In 2017, fee reductions by the asset-management industry for active funds had a larger impact on investors' falling fund expenses, relative to recent years.

Changes in fees charged by asset managers can be represented by trends in the equal-weighted average expense ratio. Below, we calculated the equal-weighted average expense ratio for active and passive funds, by asset class. We used an equal-weighted average here, as opposed to an asset-weighted average, to reflect what the asset-management industry is charging for its products, regardless of the fund's size. The calculations below represent 90% of all assets (the 5,000 largest share classes). We culled the universe to avoid skewing the overall figures toward funds with low asset levels and high fees.

Exhibit 4 Fund Fees Charged by Asset Managers as Represented by Equal-Weighted Average Fees

	Equal-Weighted Average Fees (%)					
	Active			Passive		
	2015	2016	2017	2015	2016	2017
U.S. Equities	0.91	0.90	0.88	0.25	0.24	0.23
Sector Equity	1.03	1.03	1.01	0.38	0.38	0.38
Allocation	0.91	0.92	0.89	0.31	0.29	0.31
Intl Equity	1.05	1.04	1.01	0.40	0.38	0.37
Taxable Bond	0.68	0.67	0.66	0.20	0.19	0.18
Muni Bond	0.62	0.62	0.61	0.26	0.26	0.26
Alternative	1.37	1.40	1.40	0.98	0.98	0.98
All Funds	0.87	0.87	0.85	0.32	0.31	0.30

Source: Morningstar Direct. Data as of 12/31/17.

Exhibit 5 Among Active Funds, Larger Fee Declines in 2017 Relative To Prior Years

	Equal-Weighted Average Fees: Change from Prior Year (%)					
	Active			Passive		
	2015	2016	2017	2015	2016	2017
U.S. Equities	–1	–1	–3	–2	–4	–4
Sector Equity	–2	–1	–1	–2	0	0
Allocation	–1	0	–2	–4	–4	5
Intl Equity	–2	–1	–3	–1	–4	–3
Taxable Bond	–2	–1	–2	–6	–5	–4
Muni Bond	–1	–1	–2	–6	–1	0
Alternative	–2	2	–1	–2	0	0
All Funds	–1	–1	–2	–3	–3	-3

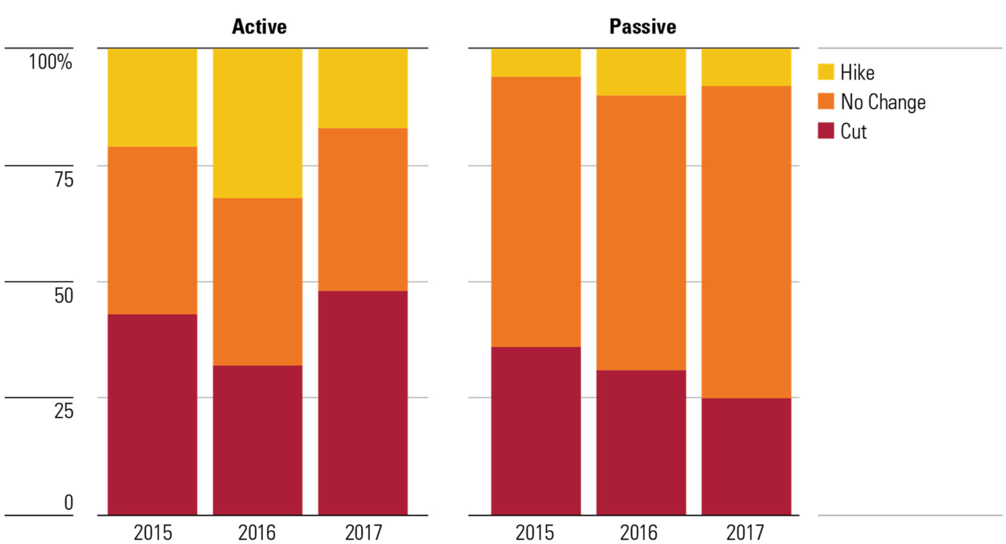
Source: Morningstar Direct. Data as of 12/31/17.

Over the past three years, passive funds (across the three main asset classes) have exhibited steeper declines in equal-weighted fees, relative to actively managed funds. Vanguard, which levies its fees at cost, has set a low bar for fees for broad index funds, and in recent years, BlackRock/iShares, Schwab, and Fidelity have aggressively cut fees for core broad index funds. Some asset managers now charge only a few basis points for core index funds. This has resulted in larger declines in average fees for passively managed U.S. equity and taxable-bond funds, which account for 64% of assets in mutual funds and ETFs. In 2016 and 2017, funds from these two asset classes exhibited the largest annual fee declines, of 4% to 5%.

On the active side, the percentage of funds exhibiting lower fees rose in 2017 relative to 2016. At the same time, fewer funds exhibited higher fees. However, the percentages of active funds exhibiting higher or lower fees from year to year is not consistent, as opposed to passive funds, which tend to not raise fees. One reason for this that passive funds have enjoyed consistent inflows, across asset classes, over the past 18 years. Active funds as a group have experienced more erratic flows, but most notably, actively managed U.S. equity funds have experienced continuous outflows since 2006. Changes to funds' asset levels can trigger breakpoints that raise and lower fund fees.

In 2017, the increase in active funds exhibiting lower fees was observed primarily in U.S. equity and international equity funds. International equity funds exhibited the largest percentage drop in equal-weighted fees of just over 3%. U.S. equity funds followed, with declines of just under 3%. Most of these declines reflected strong equity-market performance that raised asset levels and triggered fee breakpoints. Particularly for active U.S. equity funds, market appreciation more than offset the 5% in outflows in 2017.

Exhibit 6 Passive Funds Are Less Likely to Raise Fees Relative to Active Funds



Source: Morningstar. Data as of 12/31/17.

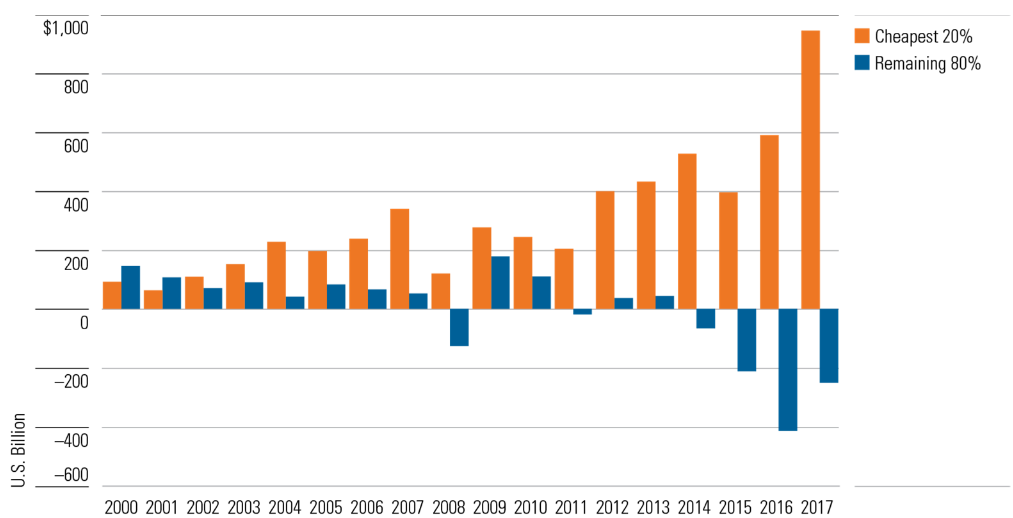
Part 3: Asset Flows Favor Lower-Cost Passive and Active Funds

Morningstar research has demonstrated that mutual fund costs are a reliable predictor of future returns, as low-cost mutual funds generally outperform their more-expensive peers.

Since 2000, net flows into funds with a Morningstar Fee Level — Broad rank of Low (fees ranked in the bottom quintile, or 20%, among funds within their category group; see Appendix for additional details) continue to trend higher. In 2017, these Low-fee-ranked funds saw net inflows of $949 billion, the highest ever, and a 60% increase over 2016 levels. In 2017, passively managed funds accounted for 70% of the net flows into Low-fee-ranked funds, while actively managed funds accounted for the remaining 30%.

Flows out of funds with Below Average, Average, Above Average, and High ranked fees (the remaining 80%) have been ongoing since 2014 and reached $251 billion in 2017, a decline from 2016's $414 billion, but higher than 2014 and 2015 levels of $66 billion and $212 billion, respectively.

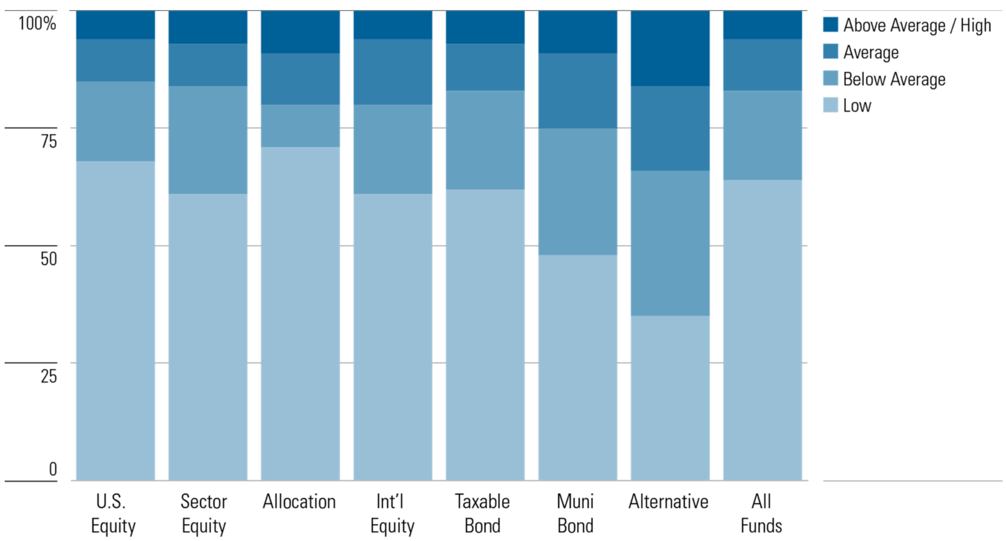
Exhibit 7 The Shift into Low Fee-Ranked Funds Accelerates



Source: Morningstar. Data as of 12/31/17.

Because of these trends, most investors are in lower-priced funds. Currently, 83% of all assets are in open-end mutual funds and ETFs that have a Low or Below Average Morningstar Fee Level — Broad rank (fees within the bottom two quintiles), 11% are in funds with an Average rank, and 6% are in funds with an Above Average or High rank.

Exhibit 8 Most Investors Are in Funds with Low or Below-Average Fees



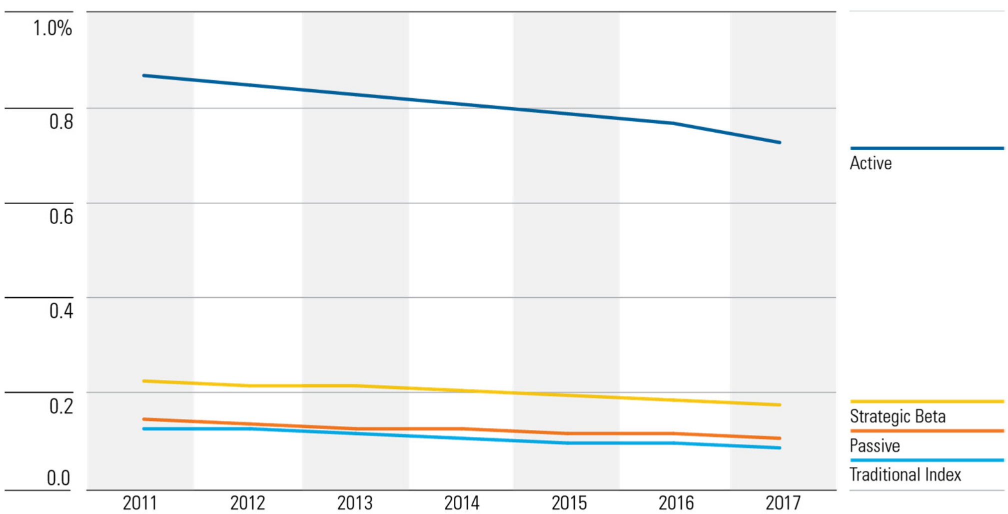
Source: Morningstar. Data as of 12/31/17.

Part 4: Strategic Beta, a Low-Cost Alternative to Active

Another industry trend adding cost pressure on active funds is the introduction of strategic-beta funds. Strategic beta refers to index-tracking strategies that tilt toward certain factors or follow a set of rules, aiming to enhance returns or minimize risk relative to a traditional market-capitalization-weighted benchmark. Given that active managers often emphasize these same factors in implementing their strategies, strategic-beta funds represent a potential, lower-cost alternative to traditional active funds. Out of 845 strategic-beta funds in Morningstar's database, 80% carry fees that rank within the bottom quintile relative to category peers.

In 2017, strategic-beta funds accounted for 13% of passively managed fund assets and were growing faster than the average for passively managed funds. Most strategic-beta funds are in U.S. equity categories. Last year, the asset-weighted average fee for U.S. equity strategic-beta funds was 0.18%, which is higher than that of traditional cap-weighted passive funds (0.09%), but well below that of active funds (0.73%).

Exhibit 9 Among U.S. Equity Funds, Strategic-Beta Funds Are Significantly Cheaper Than Active Funds



Source: Morningstar. Data as of 12/31/17.

Part 5: Vanguard Continues to Lead on Low Fees

Vanguard continues to have the lowest asset-weighted average expense ratio, which was 0.10%, followed by State Street at 0.16% and iShares at 0.25%. During the past three years, Vanguard's asset-weighted average fee declined a cumulative 25%, the biggest drop among the 10 largest fund families as measured by total AUM, followed by iShares (19%) and Fidelity (14%).

In 2017, however, Fidelity funds saw the largest fee decline of the 10 largest fund families, with its average asset-weighted fee falling to 0.53% from 0.59% in 2016. This was primarily the result of performance-related fees, which Fidelity levies on many of its funds and which fluctuate from year to year, depending on a fund's performance relative to its benchmark. Fidelity also launched over 80 lower-cost share classes in the past two years, whose net expense ratios were included in this study for the first time and contributed slightly to falling fees. Fidelity's asset-weighted average fee declined by a much smaller 2% in 2016 and 2015. (Fidelity cut fees on 14 index funds in 2017, which occurred after the funds filed their 2017 annual reports. As such, those cuts are not reflected in this study, which used net expense ratio from 2017 annual reports.)

Exhibit 10 Fidelity Takes the Lead in Fee Reductions in 2017

	Asset-Weighted Average Fees (%)		Year End AUM ($ Bil)	Market Share (%)	Asset Growth ($ Bil)	Est. Net Flow ($ Bil)
	2017	% change vs. 2016	2017	2017	2017	2017
Vanguard	0.10	–9	4322	26	768	346
American Funds	0.64	–5	1524	9	196	17
Fidelity Investments	0.53	–10	1470	9	205	11
iShares	0.25	–6	1338	8	296	201
State Street	0.16	–3	622	4	110	33
T. Rowe Price	0.69	–2	592	4	74	–11
Dimensional Fund Advisors	0.35	–1	403	2	76	31
Franklin Templeton	0.85	–2	384	2	1	–28
PIMCO	0.64	–3	352	2	26	33
JPMorgan	0.68	–6	305	2	29	–0.6

Source: Morningstar. Data as of 12/31/17.

Appendix

I. Morningstar Fee Level — Broad

The Morningstar Fee Level — Broad includes all open-end registered investment funds. This includes '40 Act open-end funds, with or without exchange listings; UITs with legacy ETF exemptions; Grantor Trusts registered under the '33 Act; and any other collective investment that Morningstar deems to be an open-end fund for comparison purposes. Fund share classes are first placed into category groupings. The methodology applies to all U.S.-open end funds and ETFs in Morningstar's database.

Within each comparison group, a fund share class' most recent prospectus net expense ratio will be ranked against its peers. The prospectus net expense ratio should be annualized. If it is not annualized, it should be discarded in favor of an older ratio that is annualized. Each share class is assigned a quintile score (1 to 5) and a corresponding Fee Grade/Label (Low, -Avg [Below Average], Avg [Average], +Avg [Above Average], High).

Additional details at:
https://corporate1.morningstar.com/ResearchLibrary/article/823651/morningstar-fee-level-for-funds-methodology---us/.

II. Investors' Cost Savings Calculation

To estimate the roughly $4 billion in cost savings, we multiplied the 2016 and 2017 active and passive asset-weighted average fees with 2017 average asset levels in active and passive funds, respectively. The difference from these calculations using 2016 and 2017 asset-weighted average fees is the estimated cost savings.

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