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Subadvised Funds Are Pricier Than Non-Subadvised: Lipper

By Maura McDermott September 27, 2011

Mutual funds with subadvisers tend to be slightly more expensive than those without, according to a recent report by **Lipper**. The finding has implications for directors of subadvised funds, especially in light of the recent excessive-fee cases against **The Hartford** and **Axa Equitable**, experts say.

The starkest difference in total expenses was for equity funds; among those funds, subadvised funds' expenses were about 10 basis points higher than non-subadvised funds, according to the Lipper report. For front-end and no-load bond funds, the gap was about five basis points. Not all subadvised funds were pricier, though; among fixed-income variable insurance products and institutional money funds, subadvised funds were less expensive by at least 2.5 basis points.

About half of subadvised funds disclose the underlying subadvisory fees along with overall management fees, according to Lipper. Of those, the median fees ranged from six basis points for money market funds within variable insurance products, to 40 basis points for open-end equity funds.

"The most important thing is that the board needs to ask, 'Why are we 10 basis points more expensive than the peer group median?'" says Sasha Franger, a fiduciary research analyst at Lipper and author of the report.

Fund boards need to evaluate the portion of the management fee being retained in light of the duties performed by the principal adviser, Franger says. They also need to compare the fees and performance of their subadvised funds to comparable funds with and without subadvisers, she says.

Hiring a subadviser can be beneficial for many reasons, she says. 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."

The median share of 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% of the management fee, depending on the size of the fund. For bond funds, the typical adviser retains up to 58.3% of the management fee. And for money market funds, typical advisers retain up to 80% of the management fee.

Slightly more than a third of open-end funds are subadvised, while nearly two thirds of variable insurance products are subadvised, according to Lipper. The top three subadvisers by assets under management are **Wellington Management**, **Geode Capital Management** and **Pimco**.

The difference in fees is not dramatic; in fact, the 10 basis point difference for equity funds makes up only 7% of those funds' average 135 basis point expense ratio, according to the Lipper report.

However, two recent excessive-fee suits have heightened directors' concerns about subadvisory fees. In July, Axa Equitable was hit with a lawsuit charging the firm collected "exorbitant profits" from its subadvised funds. The adviser retained portions ranging from 50% to 94% of overall fund advisory fees, despite "performing little,

if any additional work," according to the complaint. In a similar 36(b) case last year, plaintiffs accused The Hartford funds' adviser of charging fees that are "disproportionate to the services it renders." The adviser kept between 62% and 74% of the management fee, according to the complaint. Both firms have declined to comment on the litigation.

The lawsuits "will cause everybody in the industry to focus on the cases. Directors are always looking to see if there are lessons to be learned," says Amy Lancellotta, managing director of the Independent Directors Council. "That goes hand in hand with understanding what the different responsibilities will be and how the fees are allocated between the principal adviser and the subadviser. The board may want to ask, 'What will the principal adviser be doing, and what will the subadviser be doing?' They should understand the two different roles and allocation of responsibilities, and then understand the fee."

DeWitt Bowman, who sits on the boards of the **Forward Funds** and the **Brandes Institutional Fund**, says the lawsuits call attention to certain factors that directors "should be concerned about or at least actively involved in looking at."

He adds, "Basically, if you are acting appropriately as a fiduciary, you're going to be looking at these elements anyway, regardless of whether the cases are there or not."

There are good reasons for hiring a subadviser, Bowman continues.

"You can tap into expertise that you might not have in-house," he says. Plus, he adds, "If you find that the managers of those investment areas being subadvised are not doing a particularly good job, it is far easier to make a change and bring in a subadviser who will do a better job than it would be if you were employing people internally to manage the product. It provides an element of flexibility that they would not have otherwise."

Bowman says he believes it is unnecessary to disclose the subadvisory fee, as long as the overall management fee is appropriate and fully disclosed. The fees for the Forward Funds' subadvised accounts compare favorably to their peer groups, he says.

However, he acknowledges, "For the subadvisory fund, there probably is an element of cost that would be absent in a non-subadvised account. Just the actions involved in choosing the subadviser and monitoring what the subadviser is doing, there's an element of redundancy in there that gets factored into the costs."

The main reason funds hire subadvisers is they believe they can achieve better performance by doing so, says Lynette DeWitt, research director for subadvisory and lifecycle funds at the **Financial Research Corporation**. "If you feel like the results are better for going outside of the firm, you're going to do that," she says.

Even if that's the case, though, boards are under pressure to demonstrate that they are looking out for investors. The increased focus since the financial crisis on the potential perils of affiliated relationships has prompted many fund boards to push their advisers to make a strong case if they want to hire an affiliated subadviser, DeWitt says.

"There is a trend toward the increasing use of external subadvisers," she says.

Any board that oversees subadvised funds should ask for written analyses of the factors the adviser considered in its supervision of the subadviser, says Domenick Pugliese, a partner with **Paul Hastings Janofsky & Walker**. "You have to make sure you have a documented process that demonstrates that the adviser is performing the oversight" that justifies its retention of its share of the management fee, he says.

However, Pugliese argues that the focus on the percentage of fees retained by principal advisers is simply "a tool plaintiffs attorneys have used to get media attention, frankly."

Whether an adviser hires a subadviser to run an entire fund or a portion of it, the adviser's costs increase and its profits fall, he says. "The adviser has to make sure the subadviser is doing its job and also make sure the portfolio as a whole makes sense from a risk and performance perspective," 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 arguments in favor of subadvised funds, Niels Holch, executive director of the Coalition of Mutual Fund Investors, says the finding that subadvised funds tend to be more expensive should cause directors to ask tough questions about potentially improper layering of fees.

"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?'" Holch says. "The fund director's role is to be an independent watchdog on behalf of the shareholders, and I think they ought to be putting the shareholders first as opposed to just taking actions to avoid the risk of a lawsuit."

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