



# MPI Annual Survey of Gartenberg Profitability Benchmarks

July 20, 2017

A Mutual Fund Directors Forum Webinar



**MUTUAL FUND DIRECTORS FORUM**

*The FORUM for FUND INDEPENDENT DIRECTORS*

# Today's Speakers



**Carolyn McPhillips**

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*(Moderator)*



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# Agenda

- Gartenberg overview
- 2017 Survey results based on 2016 reported financials
- Analyses clients have found useful
- Further profitability discussions with management
- Survey methodology summary

*This annual MPI Gartenberg Survey is incomplete without accompanying remarks and should not be used without the advice of Counsel*

# Gartenberg Overview

- Independent directors/trustees are required to assess reasonableness of profits earned by the management company on the advisory contract.
- A difficult process because, unlike 15(c) analysis, there is no comparable *fund-level* public data available.
- Available benchmarks are *firm-wide*, and can be obtained from SEC filings of public investment companies where advisory revenues can reasonably be identified as a separate line of business.
- Some of the best known financial companies are so diverse that the profitability on investment management or advisory activities cannot be segmented.

# Profitability and Board Oversight

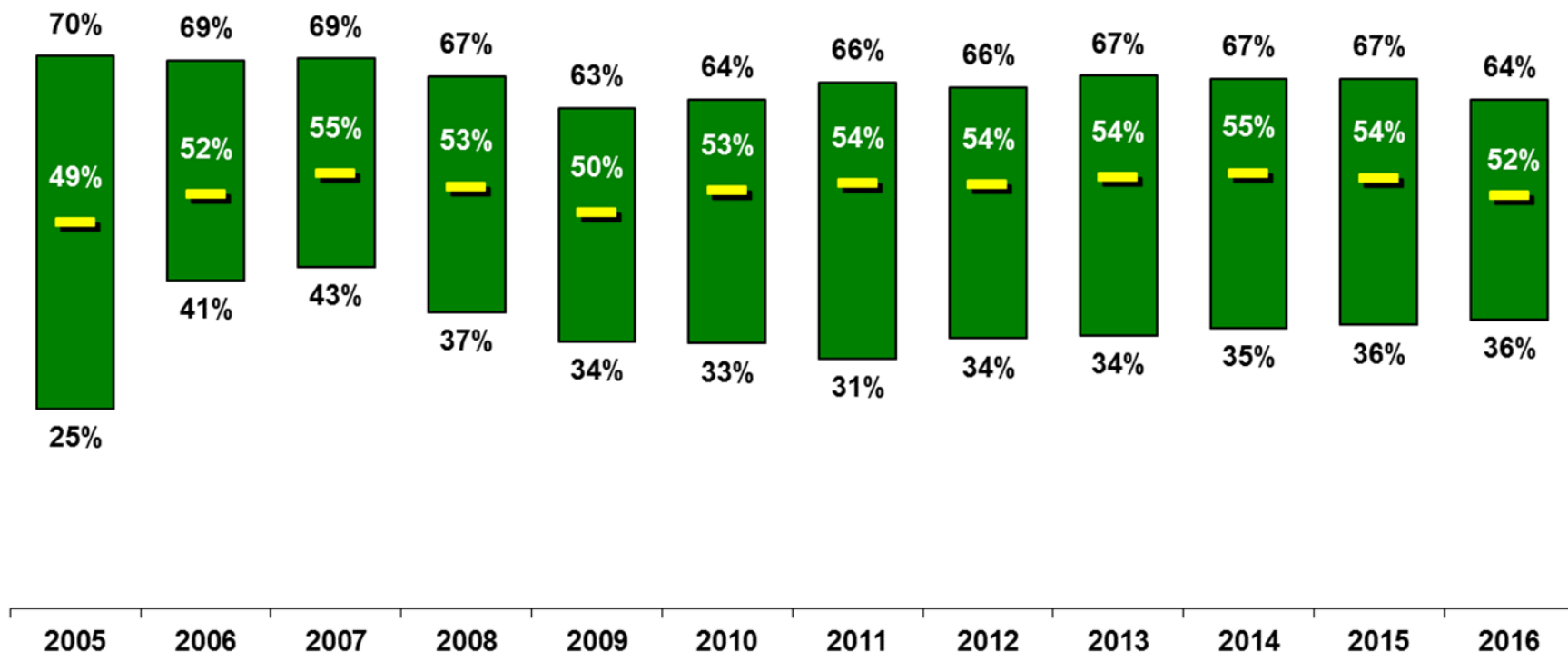
- 36(b) cases, including Jones vs. Harris in 2010, reinforced Gartenberg, which established the fund board's responsibility to review fund profitability.
- Board's responsibility is oversight – does not include methodology creation or audit of calculations.
- No “right” or standard way to calculate profitability, but does highlight process, procedure and documentation.
- Schuyt case found profits as high as 77% of revenues before marketing and taxes and including shareholder and administrative services to be not excessive. However, profits below 77% might be excessive, or exceeding 77% might not. |
- Important to carefully consider all Gartenberg factors.

# 2017 Survey Results and Highlights; Based on 2016 Publicly Reported Financial Statements

- Advisory profitability trends
- Trends in overall investment management profitability
- Flows by category and fund type
- Average AUM trends and correlation to profitability
- Lower fee environment impact on profitability

Summary of Pre-tax Profit from **Advisory Activities** of Selected Publicly-held Companies  
Significantly Engaged in Mutual Fund Management in 2016

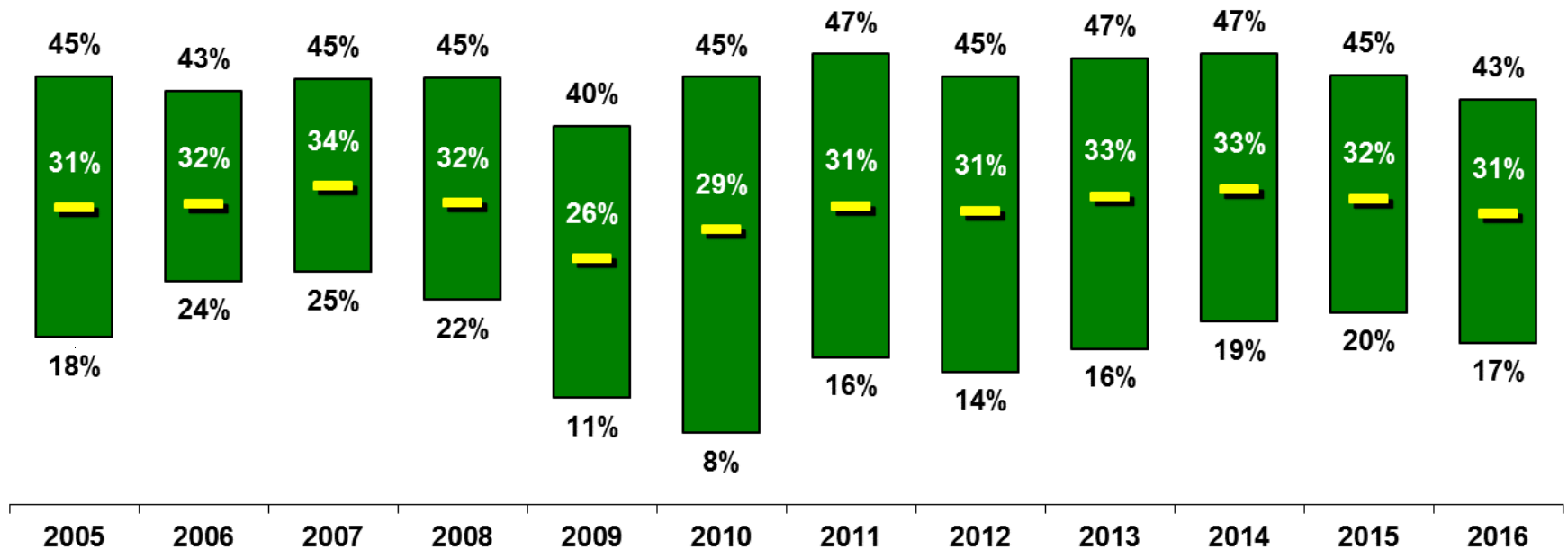
**Range of Pre-Tax Profit as a % of Advisory Revenue,  
2005 - 2016**



16 selected companies in 2016 meet current and historical requirements for comparability

Summary of Pre-tax Profit on all **Investment Activities** (including distribution) of Publicly-held Companies Significantly Engaged in Mutual Fund Management in 2016

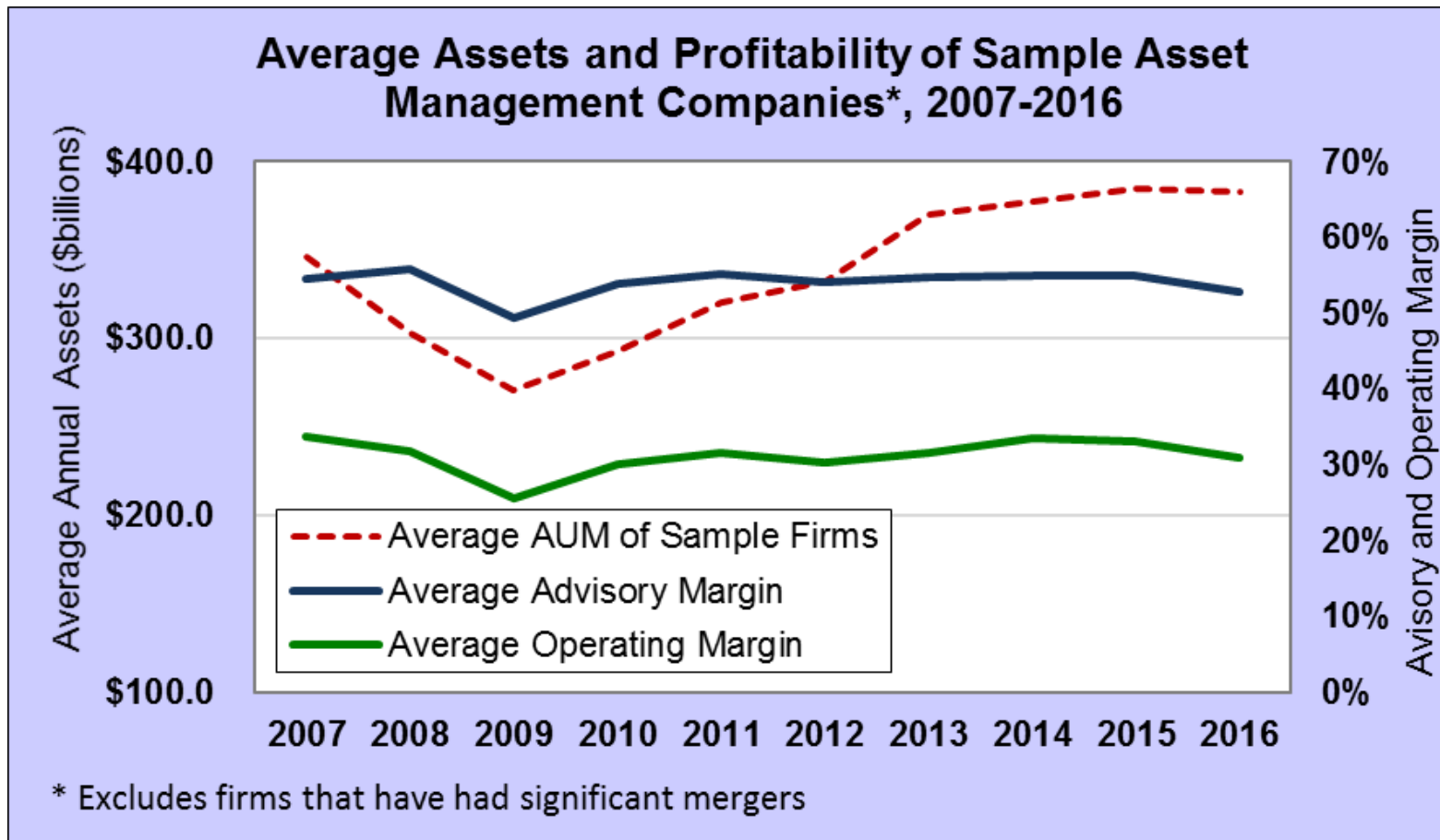
**Range of Pre-tax Profit as a % of Investment Revenue,  
2005 - 2016**



18 selected companies in 2016 meet current and historical requirements for comparability

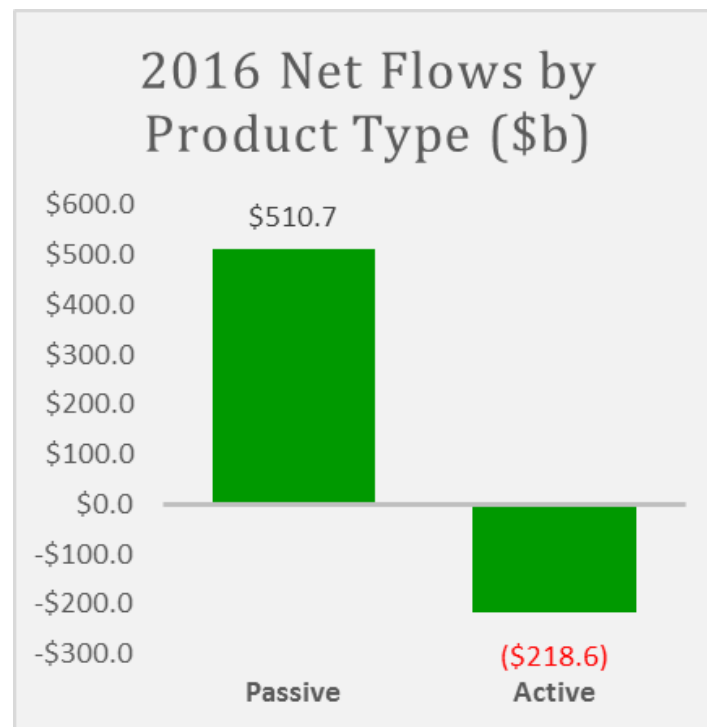


# Profitability Ranges Remained Relatively Stable During Times of Change



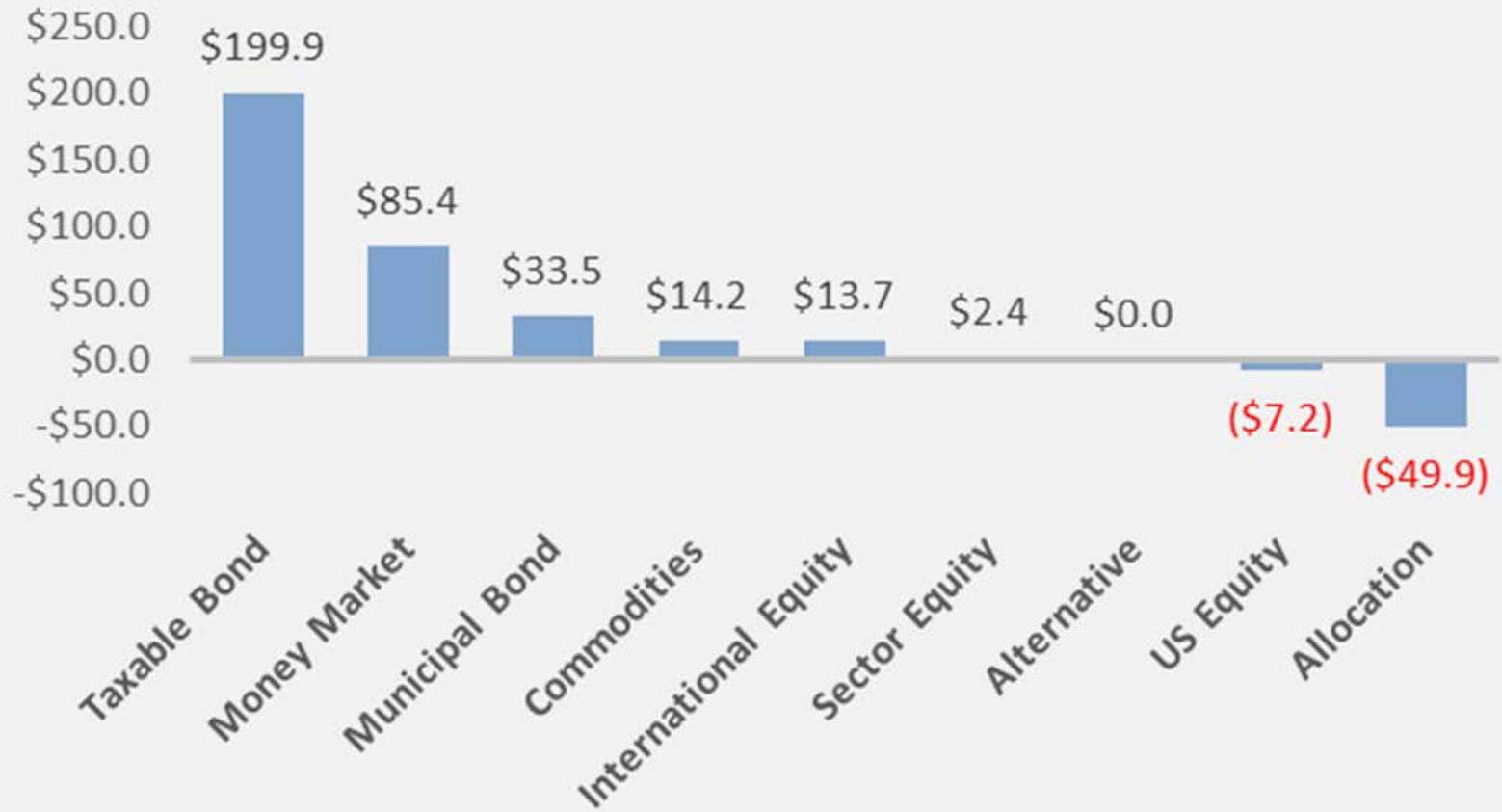
# Industry Net Flows in 2016

- The 2016 trends in product and strategy flows impacted the average basis points collected on average assets under management.



*Flow data reported by Morningstar, Inc.*

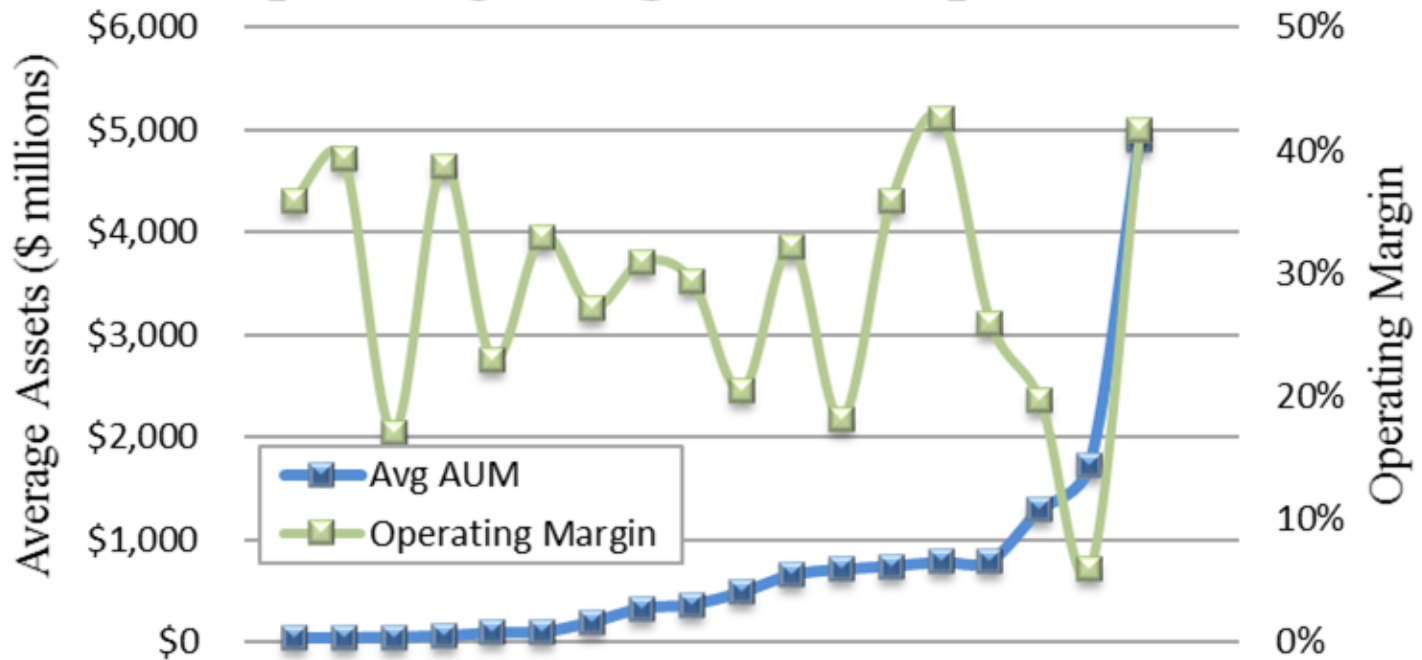
## 2016 Net Flows by Sector (\$b)



Flow data reported by Morningstar, Inc.

# Average Assets are Not Directly Correlated to Profitability

## 2016 Average Assets and Pre-Tax Operating Margins of Sample Firms



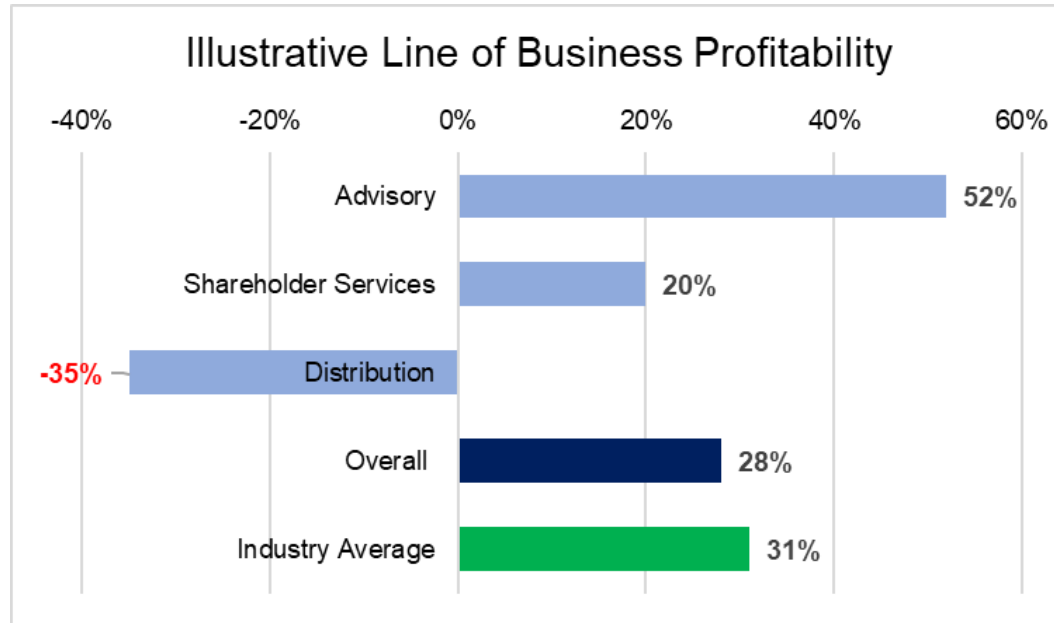
# Remaining Profitable in a Lower Fee Environment

- Between 2005 and 2016, the sample firms' average bps collected on assets declined 15% on advisory revenue and 22% on total investment revenue.
- In addition to changes in product and sector assets under management, different share classes offered and general pricing pressure have lowered average advisory revenue basis points collected.
- Also, products such as “No-fee” ETFs which have no commissions charged on trading, have lowered the total bps collected.
- Some active managers, realizing outflows, were able to remain profitable by offering indexed products, new share classes or offsetting revenue loss through reduced expenses such as distribution and compensation.

# Useful Board Profitability Procedures Include:

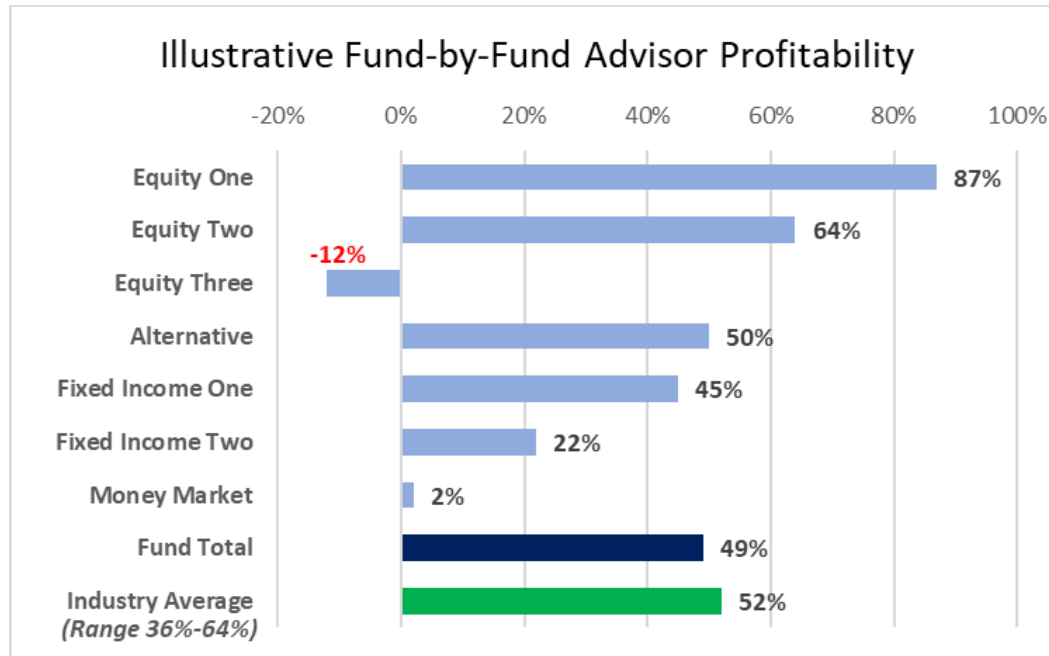
- Requiring clear documentation of methodology, including the expense allocation process.
- Ensuring consistent methodologies year-over-year.
- Consistency with other board materials.
- Documenting and discussing any changes in the allocation procedures.
- Requesting further information until any questions are answered.
- Explanation of difference between advisory and overall investment activity profitability.
- Have independent benchmarks to aid and frame discussions.

# Firm Advisory Activities are One Piece of the Investment Puzzle



- The profitability of all investment activities is generally lower than profitability of advisory activities alone.

# Illustrative: Underlying Individual Fund-by-Fund Profitability May Range Dependent on Variables





## Further Discussions With Management Regarding Profitability

- To ensure understanding of changes in profitability, fund board may discuss with management larger economic and market influences.
- Examples of impacts in 2016 might have included:
  - Slower than expected economic growth
  - Market volatility related to elections (domestically and internationally)
  - Changes in money market fee waivers
  - Anticipation of Fed tapering

## Profitability Beyond Gartenberg

- Gartenberg does not preclude analyzing overall profitability to understand the full economics of the funds and business. This includes requesting after marketing fund profitability and the allocation between funds and other products.
- Consideration of profitability enables a board to evaluate the financial stability of the adviser.
- Boards can also use this information to identify any differences – and potential conflicts – inherent in side-by-side management and other management activities.
- Assessing economies of scale, including waivers and expense caps.
- Ancillary benefits and reinvestments recognized by fund investors (e.g. technology, key staffing and infrastructure for example).

## Selection Set/Methodology in the Report

- 18 publicly-reported asset managers for the year ending 12/31/2016:
  - They must be primarily engaged in the business of investment management.
  - They must have at least \$10 billion in assets under management.
  - Advisory segment figures are only included in the analysis when “logical” (16 of the 18 firms)
  - Financial information must be publicly available with sufficient historical data.
- Due to variances in reporting of revenue and expense line items, best efforts are made to normalize comparable advisory profits.
- Data is restated to create comparable information for 12 years.
- Selection of companies has varied year-to-year due to mergers, acquisitions, and delisting, but in order to have comparable figures, the analysis only includes the historical statistics of the companies participating in the most current year.

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