Assessing Mutual Fund Advisor Profitability

Should Boards Have Goals and Margin Expectations?

*This topical white paper is intended primarily for **Keil Fiduciary Strategies LLC** (KFS) and **Pharos Mutual Fund Analysis** (Pharos) clients and their legal counsel's informational use. Yet, other investment company business participants are also free to download and print this document – from www.keilfiduciarystrategies.com – on a fully gratis basis. KFS and Pharos jointly retain all ownership, rights and privileges of this document's intellectual content. Jeff Keil would like to recognize Doug Bridwell, founder of Pharos Mutual Fund Analysis, for his expertise and insightful contributions to several sections of this white paper.*

preface

Requests, review, and consideration of fund advisory profitability data by trustees is undeniably one of the most critical and complex exercises undertaken during the advisory contract consideration ("15(c)") process. Profit margins – and effective endorsement of certain levels by boards – may be significantly impacted by many factors such as general business model, the extensiveness of outsourcing, types of asset managed and their age, investment philosophies, compliance approaches, and soft dollar use, amongst others. All these issues intertwine to form a complex web to which a trustee's business judgment must be applied. Add to this plethora of issues an unavoidable lack of comparable margin data and the scenario complicates further. Therefore, from a trustee standpoint, a board's challenges may be broadly characterized as actively seeking out knowledge of an advisor's business, the bases on which fund-by-fund profitability data are computed, applying what few benchmarks are available, accounting for reinvestment by the advisor in their business, the extent to which services provided are of the highest quality attainable (performance, servicing, compliance etc.), and the operating expenses incurred by an advisor.

Should a board set goals prior to reviewing profitability data? Goals may help to facilitate the review process. Should a board expect/direct an advisor to provide a highly rigorous profitability analysis? Expectations should arguably be set in order to obtain an analysis that provides the desired level of knowledge and insight. Should those goals include profitability expectations and even a margin above which a board would generally seek to reduce fees and/or expect higher quality service or reinvestment? Perhaps. We will examine these questions in more detail in subsequent sections.

Executive Summary

Over the course of reviewing profitability analyses, we advise that trustees should generally consider the following, in addition to other information:

- ü The preparation rigor, level of inherent bias (if any), and purity of data in profitability analyses
- ü The makeup of revenue streams, associated costs, and thus strategic direction
- ü Cost allocation consistency and identification, benefits, objectivity, overhead burden, timeliness, and management cost allocations
- ü Request and obtain margin data on public investment advisors; design a peer group
- ü Set goals of the profitability exercise at the outset
- ü Ensure that the advisor understands the trustees' expectations with regard to data scope, timeliness, compilation background and the like
- ü Memorialize some, if not all, of the data requested and reviewed, in addition to the related inquiries directed at the advisor

And, trustees should keep in mind vital information such as:

- ü Profit margins in the context of quality of service and value provided to shareholders
- ü The financial viability of the advisor and its ability to provide quality services
- ü The advisor's ability to realize economies-of-scale (or not)
- ü Business judgment and the weighting of qualitative factors that may ultimately trump purely raw data when determining "reasonableness" and, if applicable, the possibility of "excessive profitability"
- ü Courts have reinforced the concept that an apparently "high margin" may not be considered "excessive" merely due to its level

Regulatory, legal background

The SEC stipulated in 2002 that investment company boards must disclose in N-1B filings the "factors considered" when they renewed or ratified new advisory contracts (presumably) with current fund advisors. Effective in 2005, the disclosure requirement was further refined to target shareholder reports as the location for the "contract renewal rationale." Furthermore, added guidance was provided as to factors that must be cited as considered. Two of those obligatory factors were the costs of the advisory and related services provided to the fund(s) and the profits realized by the advisor and its affiliates. The disclosure requirement effectively codified two of the factors considered in case law (most publicly indicated by the *Gartenberg (1982)* decision) and now implicitly sanctioned by the SEC.

While the consideration of a fund advisor's profit margins – and thus necessarily consideration of quality of services provided – were cited as vital to the contract renewal decision, precise margins realized by the advisor in the *Gartenberg (1982)* case arguably did not play a major role in the determination of "fair" and "reasonable." 'Possible' after-tax margins varied from about 39% to a loss, depending on the cost allocation methodologies, and – in the court's words – "…could hardly be labeled so excessive as to constitute a breach of fiduciary duty." The court also opined that an advisor's compensation should be considered <u>only</u> in the context of cost burden and profits realized for services provided.

In the *Schuyt (1987)* case*,* the court cited profitability as a relevant factor for consideration, but did not feel it was rightfully "controlling." Presumably due to the plaintiff's pleadings, precise profit margins over several years became integral to the record of the proceedings. Most pertinent, a now-famous, pre-tax margin of 77.3% in 1981 brought into question what was an "excessive margin." The court decided that such a profit margin did not, in and of itself, constitute excessive compensation. When taking into account the quality of services provided (which were viewed as high quality including high-ranking performance) and the relative expenses charged (Lipper rankings were favorable), the court felt that compensation was not excessive as overall value was being realized by shareholders. However, the court also stated that such a margin may not always be deemed as reasonable, i.e., under different circumstances, a 77.3% margin could be considered excessive.

In the *Krinsk (1988)* decision, the court reinforced the notion that a profitability level (percentage) alone does not constitute unreasonableness simply due its absolute level.

The 1991 *Kalish* case provided reinforcement of the industry contention that profitability computation methodologies can be very problematic. While the court did not provide guidance on specific ways of computing margins that were considered valid and reasonable, it had to consider two divergent reports from independent auditors of the fund. Interestingly, while the margins differed, they were very similar regardless of the way in which (in this case, labor) costs were allocated. The court determined that the likelihood that margins exceeded 35% was very low, advisory fees were not excessive, and "… superior performance operates to justify a relatively high fee, which is turn increases profitability."

In the *Meyer* case, pre-tax margins in the 80 – 90% range did not result in an automatic conclusion that fiduciary duty had been breached. The court also stated that profitability should be computed as a percentage of revenues rather than other measures such as ROI.

The case law documentation has typically stated that full knowledge of applicable business-related facts and prevailing circumstances by a board is vital to a solid contract review process and application of business judgment. This concept undoubtedly applies directly to advisor profitability reviews. Furthermore, the cases have generally been interpreted by legal counsel in the fund business as implying that fund-by-fund profitability analysis is a more prudent and defensible course of action than simply relying on complex-wide margin analysis. Lastly, the ultimate care and conscientiousness of trustees applied to the process was a vital determinant of whether trustees had adequately fulfilled their fiduciary responsibility.

Management reporting

As one might imagine, independent trustees are wholly reliant on the advisor (or "management company") for fund-centric profitability information. By their very nature, profitability analyses are traditionally complicated, especially if a management company's funds are sold using various product wrappers and distribution channels. Furthermore, many services required by virtually all retail mutual funds may also be provided by businesses owned by the advisor. How can trustees be sure the analyses provided by a fund manager are reasonable, provide an accurate assessment of each fund's profitability, and fairly reflect how the manager's business is run? If the independent board members cannot be confident of their understanding of the manager's profitability analysis and its bases, they may be exposed to excessive fee or breach of fiduciary duty (36(b)) litigation. Most fund business professionals would argue that it is vital that Trustees seek to understand enough about the potential methods and processes to ask probing, applicable questions thereby satiating their need for a business judgment basis.

In order to gain comfort with the reasonableness, and thus usefulness, of an advisor's profitability analyses, independent trustees should apply the following tests in their review:

1. Rigor – do the analyses address all the material aspects necessary to provide a reasonably accurate assessment of the management company's profitability with respect to its contract(s) with the fund(s)?
2. Bias – do the analyses skew, intentionally or unintentionally, the presentation of profitability information in favor of any products, channels, etc.?
3. Purity of Data – does the process by which the analyses are prepared introduce risks that the accuracy of the analysis may be compromised?

RIGOR

Two elements are critical in effectively reviewing the rigor employed in the preparation of a profitability analysis: 1) the sophistication of the analysis; and 2) its presentation.

When examining the **sophistication** of a profitability analysis, there are many tests a board can employ to assess how thoroughly the manager has analyzed its business. One of the primary purposes of a profitability analysis is to help a firm's management team understand the critical drivers of the business. For example, which fee structures are the most profitable? How do different compensation schemes impact margins? Why are certain asset classes more profitable to manage than others? Are shareholder servicing operations largely outsourced (and therefore generally a cost that simply flows through to shareholders) or in-house (where profit may or may not be derived)? How do different subsidiaries impact profits? Are expense allocation methodologies based on conditions unique to the advisor's business or are widely accepted methods simply used?

Independent board members also can assess the sophistication of a profitability analysis by inquiring about how the critical drivers of the business are reflected in the analysis. Some **questions trustees may want to ask** are:

1. How many different metrics are used to allocate costs and revenues? [If the manager can only identify a handful, the analysis may need to be examined for meaningful inclusions or exclusions of business drivers.]

2. What expenses are truly driven by assets? [Many profitability analyses rely heavily on average assets to allocate many of the manager's costs. Independent trustees may need to inquire further about expenses that are truly driven by assets and those that are not.]

3. Were operations staff surveys and input incorporated into the analyses? [An effective audit of staff time and/or effort expended may provide a check on business model realities and buffer purely accounting-based system limitations.]

Examples of critical fund advisory business drivers – that must be understood by trustees and considered by advisors when assembling profitability analyses – are displayed in the grid below.

Distribution Channel	Sample Drivers	Importance
Retail Direct	Transaction phone volume	Some fund companies with a large Retail Direct business have a wholly owned/captive transfer agent whose expenses are driven by shareholder activity.
Broker/Dealer	Gross flows	Gross asset flows are often a driver for sales staff compensation, one of an advisor's largest expense line items.
Broker/Dealer	Average reimbursement rate/change	Trustees should understand the asset-based charges of the largest distributors. Understanding each distributor's share of sales will provide insight into channel cost structure.
Retirement	Proportion defined benefit/defined contribution	The type of retirement plans will give an indication of the demand for product type (fixed income or equity) and give insight into the channel's revenue profile.
All Channels	Product mix (investment discipline)	The make-up of the product mix in a given channel will indicate the 'revenue profile' of the channel.
All Channels	Average account size (assets under management)	Oftentimes, average account balance is difficult to assess given that most third-party distributors have omnibus accounts with the advisor. However, to the extent this number can be derived, trustees will have a better understanding of the reasonableness of asset-based servicing costs.

The **presentation** of the analyses is equally critical to assessing whether the manager employed sufficient rigor in its preparation. Does the analysis provide sufficient line-item detail to afford trustees a meaningful look at the operations of the firm? Does the management company provide year-over-year comparisons to give trustees an understanding of changes in profitability over time? Perhaps most pertinent, the analysis should optimally be presented within a strategic context, i.e., does the manager use the profitability analysis as a basis to determine overall strategic direction? Is the analysis, or a variant, used as a part of the fund manager's strategic decision-making? [If the manager does <u>not</u> employ, as a critical part of its own operations, the <u>same</u> profitability analysis as is provided to the board, the trustees should be wary of how much attention the manager pays to preparing it for contract renewal purposes.] If the fund advisor is a publicly traded entity, do the analyses vary from the SEC filing data? What would rightfully account for variations?

BIAS

Trustees should ask themselves if the expense allocation methods employed in the analysis are rational and intuitive, and know if they are applied consistently to funds as well as other investment management products. In larger complexes with more convoluted distribution networks and servicing requirements, there are correspondingly a greater number of ways to present fund profitability information. If a manager is 'favoring' a particular product (disproportional resource dedication), or has a large captive distribution segment that favors a particular fund, the profitability analysis may not transparently show subsidies to those favored products.

For example, a profitability analysis that relies heavily on asset-based allocations will tend to smooth margins across funds, with larger funds receiving a greater share of expense, therefore benefiting smaller funds that may be loss-makers. Correspondingly, a profitability analysis that relies heavily on pro-rata allocations of costs will allocate a greater share of costs to smaller funds, possibly leading to an advisor request for a fee increase. [*Figure 1* below depicts the effects of pro-rata allocation. *Figure 2* examines AUM (assets under management) allocations' effects on operating margin.]

Figure 1 – Pro-Rata Allocations

Sample Profitability Analysis - Pro-Rata Allocation

	Fund 1	Fund 2	Fund 3	Fund 4	Fund 5	Total
AUM	$ 150	$ 275	$ 400	$ 123	$ 600	$ 1,548
Revenue	1.1	1.4	2.6	0.8	4.8	10.6
Variable Expense	0.6	0.7	1.6	0.5	2.7	6.1
Fixed Expense	0.2	0.2	0.2	0.2	0.2	1.2
Total Expense	0.8	1.0	1.8	0.8	2.9	7.3
Operating Income	0.2	0.4	0.8	0.0	1.9	3.3
Operating Margin	20%	29%	31%	5%	39%	31%

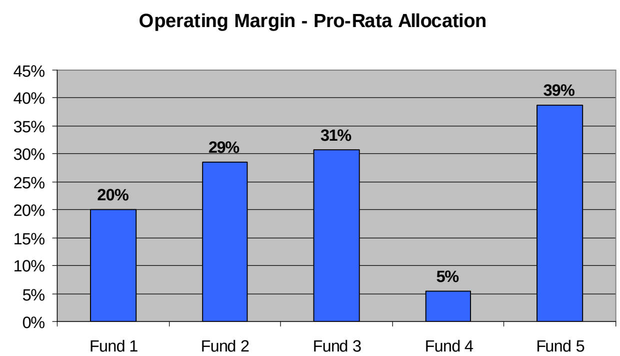
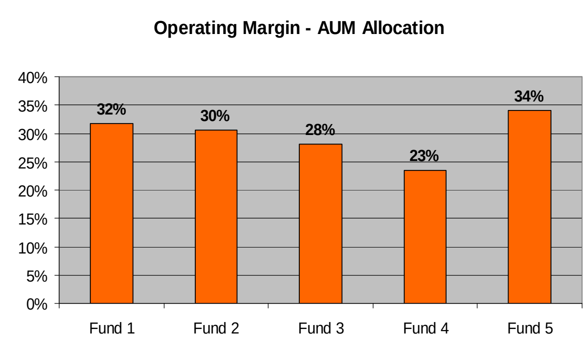


Figure 2 – AUM Allocations

Sample Profitability Analysis - AUM Allocation

	Fund 1	Fund 2	Fund 3	Fund 4	Fund 5	Total
AUM	$ 150	$ 275	$ 400	$ 123	$ 600	$ 1,548
Revenue	1.1	1.4	2.6	0.8	4.8	10.6
Variable Expense	0.6	0.7	1.6	0.5	2.7	6.1
Fixed Expense	0.1	0.2	0.3	0.1	0.5	1.2
Total Expense	0.7	1.0	1.9	0.6	3.2	7.3
Operating Income	0.3	0.4	0.7	0.2	1.6	3.3
Operating Margin	32%	30%	28%	23%	34%	31%



Profitability analyses can also be presented in different ways depending on the inclusion or exclusion of certain costs. Are corporate overhead charges allocated appropriately? More broadly, are unrelated parent company expenses included in the analysis? Is the analysis presented before- and after-tax? Does the analysis present margins that include and exclude distribution-related charges?

In order to identify possible intentional or unintentional biases in the analysis, independent board members must understand the direction in which the manager seeks to take the firm. Without an understanding of management's strategic direction, it is difficult to assess whether a particular fund is being favored over another. The profitability analysis should be a tool independent board members can use to better understand what the manager is intending to do with fund shareholders' assets, not a means by which that understanding may be clouded or confused.

PURITY OF DATA

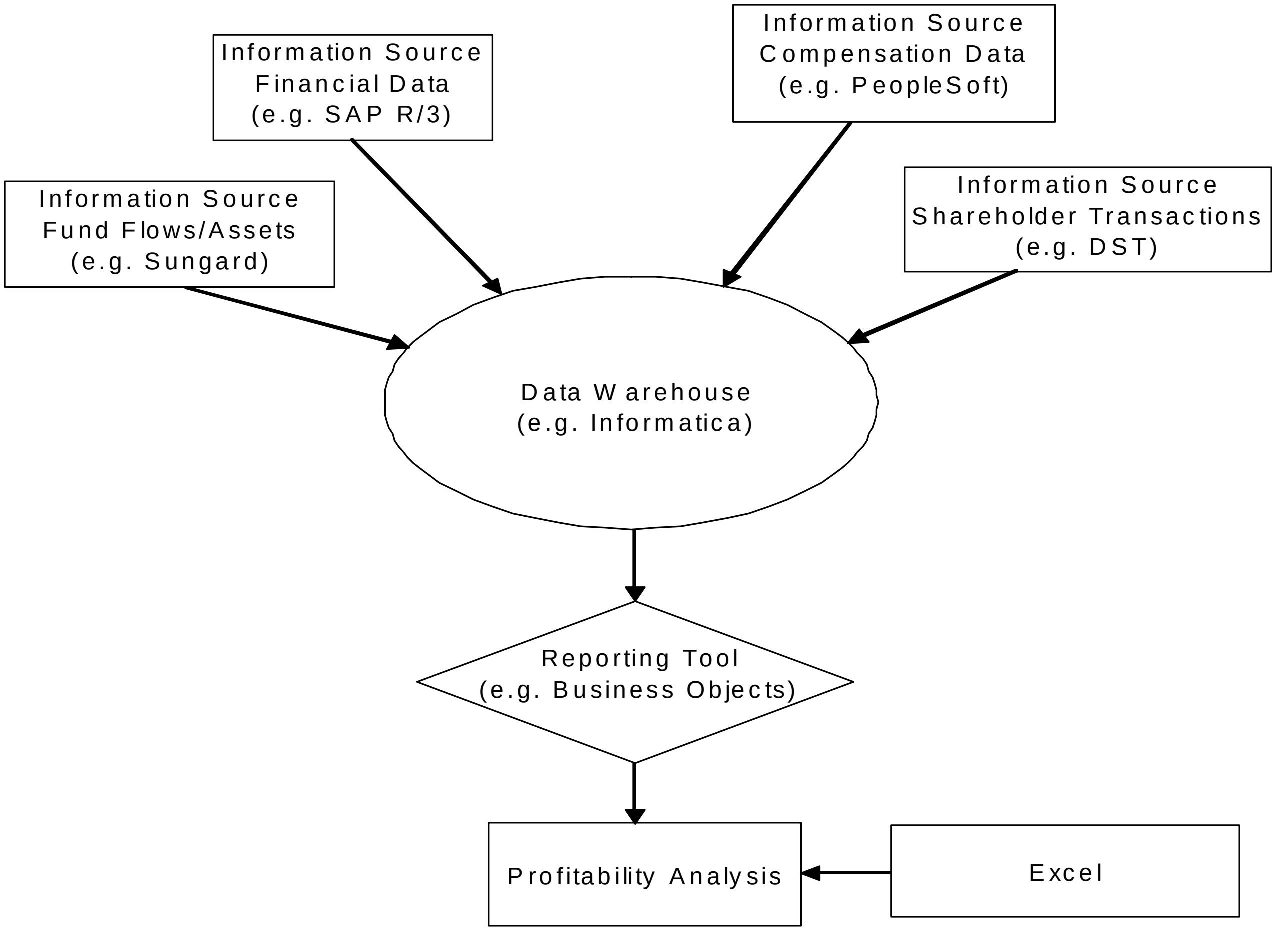
There are a number of factors to consider when assessing the purity of data used to prepare a profitability analysis. Does the analysis utilize one source of record or many? Are there multiple layers of consolidation, multiple systems utilized, or significant corporate overhead allocations from other legal entities (such as a parent company)? What is the review process for the analysis? How are the data sources reconciled and/or audited for accuracy? Are these same systems used to report financial statement data to the SEC?

With larger complexes, data is often derived from a number of sources of record (which sometimes do not agree), utilizing different systems with multiple layers of consolidation. This complexity can often introduce accuracy risk. Assessing data purity can be very difficult for independent board members, especially if they are unfamiliar with the technology utilized to prepare an analysis.

There are actions independent board members can take, however, to scrutinize the integrity of the raw data underlying the analysis. For example, the independent trustees can request that the manager prepare a map of the analysis' data sources.

[Sample map shown as *Figure 3* below.]

Figure 3



Any number of charts similar to the above example will provide a quick visual representation of the depth and breadth of the data used to prepare an analysis. Also, independent trustees may wish to ask the manager to identify where risk to the integrity of the data is introduced into the analysis, and what quality checks the manager employs to mitigate that risk.

Business factors and margins

What should a profitability analysis provide boards of trustees? Generally, its purpose is to communicate how much money/profit the advisor (manager) is earning on the management of shareholder assets. More specifically, it should ultimately give trustees insight into <u>how</u> the manager makes money. What are the key factors impacting the firm's operations, i.e., what are the "drivers" of the firm's investment management business? How has the firm positioned itself to anticipate and respond to material changes in these drivers? Will the firm have sufficient resources to consistently, and in a quality manner, fulfill the requirements of the contracts with its proprietary funds?

Profitability analyses are typically presented in the form of an income or profit and loss statement (P&L). The Investment Company Act of 1940 ("'40 Act") implicitly requires (and case law reinforces) that trustees thoroughly examine the P&L statement of the advisor and assess whether fees, and the profits on those fees, are "reasonable" (or, in other words, "not excessive") relative to the services provided by the advisor. Understanding the advisor's business model is essential to determining the reasonableness of fees and profits. Without this understanding, trustees have no way of assessing, for example, which costs are necessary to run the business, how operationally efficiently the business is, or how funds are typically priced in the marketplace.

Moreover, the SEC has consistently emphasized the role of independent trustees as "watchdogs," i.e., shareholder advocates, who monitor and guard against unnecessary conflicts of interest between the asset management firm and a fund's shareholders. Trustees should regularly inquire about the strategic direction of the firm in order to anticipate how business decisions by the asset manager will impact a fund's shareholders. An analysis of the advisor's profitability will provide meaningful insight to help trustees anticipate and identify potential conflicts of interest.

Sample **questions trustees may want to ask** related to a fund advisor's operations:

- What business conditions truly have large impact on strategy and profitability?
- Given the embraced business model, does the advisor have sufficient resources to continually provide quality asset management and administrative services to fund shareholders?
- Is the advisor heavily reliant on a particular distribution channel or specific sales firm?
- Are there opportunities for economies-of-scale in the advisor's business?
- What reinvestment has been undertaken by the advisor to maximize probabilities of financial viability and competitiveness?

Each section of the income statement gives clues and valuable information about the key elements, or "drivers," that impact the advisor's business. To further deepen knowledge of an advisor's financial wherewithal, independent trustees or committees may want to consider also requesting a current balance sheet and cash flow statement to enable assessment of issues such as assets owned, return-on-investment, and necessary cash deployment.

REVENUE

The composition of revenues can obviously give valuable insight into, and clues about, the strategic direction of a firm. A fund's "packaging" will be primarily determined by the channel through which it is sold. The revenue structure will take on the characteristics of the "product" that sells most efficiently in a particular channel. As a result, the derivation of a fund's revenue streams can indicate where management's efforts are focused.

Related to the derivation of revenues, **trustees may want to ask** questions such as:

- What are the primary revenue streams to the advisor from the fund(s)?

- How does the fund's distribution fee structure compare to similarly managed and distributed funds of other firms?
- If a fund's management fee has a breakpoint structure, does it share a reasonable amount of operating scale with shareholders?

EXPENSE

An advisor's cost structure will also afford trustees a wealth of valuable clues about the strategic direction of the firm, how well the firm is managed, and the existence of economies-of-scale. The channels through which funds are sold will also have a significant impact on what kinds of costs are incurred. If an asset management firm grows its assets under management, a broader distribution platform is typically necessary and a greater variety of cost considerations is required.

A thorough examination of an advisor's costs may include **trustee questions** such as:

- What proportion of the advisor's costs vary, proportionally or otherwise, with revenue?
- What are the major components of compensation for portfolio management, executive management and sales staff? What metrics drive their incentive compensation?
- Aside from compensation, what are the top five cost line items for the firm and what proportion of the firm's expenses do they represent? What are the primary drivers of these expenses?
- What methodology is used to allocate expenses amongst private (separately managed) accounts and retail funds?
- How much does portfolio management rely on external research (third-party or proprietary)? What proportion of those reports are obtained using soft dollars?

In general, trustees should assess and be concerned with allocation consistency, benefits derived from each cost center, whether costs are directly identified (and allocated as such), objectivity of allocations, the handling of overhead, timeliness of data, and management salary allocations.

BENCHMARKING

While trustees can use stand-alone profitability analyses to help identify conflicts of interest and understand the advisor's business model, it is difficult to assess the reasonableness of an advisor's profit without comparing it to other fund firms in the investment management business. Publicly available information, however, is scarce. Regrettably, *only a limited amount of publicly traded fund management firms exist whereby the required financial disclosures facilitate a reasonable level of investment management margin analysis*. Even when considering/including larger investment banks with asset management segments (that generally provide very little segment detail) the sample size consists of approximately 18 firms (early 2006). Some of these 18 firms are large, some are not. Happily, the list of public traded investment management firms seems to be growing through recent IPOs, but the derivation of applicable benchmarks is dependent on detail and transparency.

Sample size is not the only problem. Because firms have broad discretion in how financial statements and segment information are presented, and because business models will vary, finding a reasonably comparable peer group can be difficult. While it is tempting to dismiss profitability benchmarking because it is problematic, there is still value in looking at the limited information that is available. As stated previously, trustees should carefully examine the profitability analyses prepared by management to understand the basic structure of the business. Trustees may then decide to engage consultants or other experts to help find an appropriate peer group for the advisor.

Once a ‘profitability peer group’ is established, **some questions trustees should consider asking** are:

- What firms does the advisor utilize to benchmark its financial performance?
- How does the advisor account for differences in profitability with its peers?
- Are margin differences primarily the result of pricing or market share (revenue-related) or are they due to differences in operations (expense-related)?
- Does the advisor’s relative profitability make intuitive sense, e.g., proportionally lower to account for higher expenses etc., when compared to the competitive positioning of its fees?

Some larger consulting firms such as McKinsey conduct securities industry profitability surveys that delve deeper than merely an examination of publicly available information. Trustees should ask management if they participate in any such surveys and, if so, secure any and all applicable data that are available.

Interestingly, a very recent study conducted by Casey, Quirk & Associates concluded that, after studying 20 large (anonymous) investment managers, the correlation between assets under management and profit margin was very weak. In other words, when an advisor grows its asset base, this apparent success may not translate to higher (%) margins. *Cash flows were a quite significant determinant of profitability*.

One may easily view such counterintuitive (?) study results as putting a damper on the notion that a larger advisor should automatically create higher margins and scale, all other factors being stable. Most likely, behind a significantly expanding asset base are increased distribution expenditures, modified infrastructure, and more staff. This business reality speaks to our contention that boards should clearly understand direction, investment, and advisor stability in relation to profitability.

Publicly traded advisor margins

As implied previously, publicly traded mutual fund advisor financial statements can provide some insights into general levels of profit margins, thus serving as broad benchmarks for comparison. While these publicly traded companies may not fit the strict definition of “market peers,” margin data may nonetheless be one more bit of context that helps to paint a profitability picture, albeit probably impressionistic.

In virtually all cases, the margins that may be computed from publicly traded fund advisors’ financial statements are *investment management margins* and <u>not</u> profits attributable only to investment company management. Financial statement presentation does not allow for segmentation of fund management alone. While not directly applicable, such data are available from firms such as Lipper Inc., Strategic Insight, PriceWaterhouseCoopers, and Putnam Lovell and display a very wide range of margins dependent on factors such as flows, firm size, asset classes managed and proportions, investment style and the like. It is not uncommon for pre-tax, pre-distribution profit margins to range from single digits to approximately 80%. However, on average, margins accounting for distribution outlays are frequently less than one-half that level and taxes obviously <u>also</u> take a sizeable bite.

For fund advisors that are publicly traded, their fund boards are arguably in a position to enjoy more financial context and form the basis for more **trustee inquiries**. For example:

- In the event that overall investment management margins are commensurate with other publicly traded firms yet are much lower than fund margins, what might account for the difference? Are expenses being allocated in a reasonable manner?
- If other publicly traded firms with similar asset class distribution are realizing much lower margins, what 'extra' expenses is that advisor potentially assuming that your advisor is not?
- How do Executive compensation schemes compare for firms of similar size? What is the impact on margins?
- How does one balance the inherent interests of "two masters," i.e., a fund board's duty to shareholders, obvious pressure from publicly traded advisor shareowners and the impact on an advisor's financing avenues?

Due to the scarce nature of margin data, boards are well-advised to at least consider requesting and reviewing the financial information on publicly traded advisors even if applicability is a stretch. Some profitability data are undeniably better than no data. And, some context is more desirable than clinging to a vague sense of profitability that may be supported by little empirical evidence.

Board process, considerations

As with many board actions and in line with fiduciary responsibility, review of profitability data must be framed by a solid process. The process <u>must</u> result in the board requesting, obtaining, and reviewing any and all information that it views as pertinent to attaining full knowledge of the factors that impact profitability and, thus may apply its professional business judgment. Based on case law, the process utilized to review factors such as quality of service is at least, if not more, important than the actual profit margin realized. The bottom-line value realized by shareholders should be of primary concern.

The profitability review process employed by a board may be enhanced by up-front planning in the form of goals. Such **goals** may include, but are not limited to, full **understanding** of:

- All significant profit drivers of the advisor
- Expense elasticity
- The effect of flows on margins
- Why margins floated from one year to the next
- Limitations of the analyses

And, the **board should entertain obtaining** items such as:

- Fund-by-fund pre-tax, post-tax, pre-distribution, and post-distribution margins for at least three (3), current, sequential fiscal years
- Satisfaction that full transparency has been achieved
- Some level of proof that computational methods are widely accepted
- Clear explanations of the bases for expenses allocations and any changes applied
- Timely responses and full cooperation from the advisor when questions surface

- A rational and coherent explanation from the advisor why margins may have significantly deviated from mutually chosen benchmarks and why the board should be accepting of those margins
- Training provided by the advisor to ensure all trustees are adequately informed

Some of these goals may be memorialized in the form of an advisor memorandum that outlines expectations for transparent and detailed information.

Generally, some of the **crucial board considerations** that necessarily emerge from the profitability review exercise may include the:

- On-going financial viability or desired 'vitality' of the advisor
- Advisor's commitment to business reinvestment
- Creation of scale economies and impact on margins
- Impact of wholly owned service providers (if any) on margins, i.e., transfer agency, administration, custody, and distribution
- Levels of profitability in relation to overall quality of services provided

Given the complexity of the review process and the time expenditure required to fully realize adequate due diligence, boards may decide that enlisting a consultant is a wise course of action. In some cases, the alternative may be a less than iron-clad process. The decision to enlist a consultant clearly should be driven – to a large extent – by the expertise levels of boardmembers and their ability to dedicate sufficient time. Consultants typically enhance the review process by offering verifiable facts as well as perspectives on the validity of allocation methodologies, overall accuracy, care applied during report preparation, sophistication, and context with regard to other competitive entities. While engaging a profitability expert is obviously not a regulatory requirement, it may give a board comfort that they have (presumably) confirmed the applicability, accuracy, and validity of profitability analyses and may confidently apply the reported margins to their decision-making process.

Profitability Disclosures of note

Close examination of profitability-related disclosures in shareholder reports reveals many unique and interesting passages that are worthy of note. The excerpts offer small insights into board perspectives, albeit <u>not</u> typically precisely <u>how</u> trustees dovetail profitability information with other oversight factors. A few disclosures reflect arguably controversial positions while most merely echo general industry sentiment (and are noted above). The most notable examples are excerpted below and were intentionally selected to cover most of the pertinent profitability-related topics.

"[The board] considered that the [profitability] information provided to them was necessarily estimated."

"The Board and the committee reviewed information regarding [the advisor's] costs of provide services to the [moniker] Funds, as well as the resulting levels of profits to [the advisor], noting that the results were comparable to the reported results of several large, publicly held investment management companies."

"…while other allocation methods may also be reasonable, [the advisor's] profitability methodologies are reasonable in all materials respects."

"The Board paid specific attention to the cost allocation methodology used in the profitability analysis and determined that the methodology used was reasonable."

"The Board considered the estimated costs and pre-tax profits realized by the Advisor from advising the [moniker] funds, as well as estimates of the pre-tax profits attributable to managing the Fund in particular. The Board also received information regarding the estimated enterprise-wide profitability of the [advisor's] organization with respect to all fund services in totality and by fund."

"When reviewing profitability, the Trustees also considered court cases in which adviser profitability was an issue in whole or in part …"

"…the Directors seek to evaluate economies-of-scale by reviewing other information, such as year-over-year profitability of the advisor generally, the profitability of its management of the fund specifically, and the breakpoint fees of competitive funds not managed by the advisor over a range of asset sizes."

"The Board considered that the Manager must be able to pay and retain experienced professional personnel at competitive rates to provide services to the Fund and that maintaining the financial viability of the Manager is important in order for the Manager to continue to provide significant services to the Fund and its shareholders."

"The Board noted that [the advisor's] operations remained profitable, although increased expenses in recent years have reduced [the advisor's] profitability."

"…the amount of profit is a fair, entrepreneurial profit for management of the fund."

"A considerable amount of time was spent discussing the profitability to the Advisor of the [moniker] Fund and the increase in profitability since the previous year. In reviewing the Advisor's profitability of the [moniker] Fund, the Board considered that the Advisor had agreed to include an additional breakpoint level in the management fee of the Fund, which could decrease the profitability of this Fund to the Advisor in the future."

"They further considered the profits realized by the Investment Adviser and its affiliates from non-fund businesses that may benefit from or be related to the Fund's business."

"The Board and the committee considered [the advisor's] willingness to invest in technology, infrastructure and staff to reinforce and offer new services and to accommodate changing regulatory requirements."

"…they considered [the advisor's] overall profitability within its context as a private, employee-owned, S-Corporation and relative to the favorable services provided."

"Although the board considers the profitability of the [advisor's] organization as a whole, it does not evaluate, on a fund-by-fund basis, [the advisor's] "profitability" and/or "costs" …"

"In the Board's view, the cost of performing advisory services on a fund-specific basis is both difficult to estimate satisfactorily and a relatively minor consideration in its overall evaluation."

"The Board considered recent increases to [the advisor's] gross revenues, and noted the importance of [the advisor's] profitability – which is derived solely from management fees and does not include other business ventures – to maintain its independence, company culture and ethics, and management continuity. They noted [the advisor's] profitability is enhanced due to its efficient internal business model, and that the compensation/profit structure at [the advisor] is vital for remaining independent and facilitating retention of its management and investment professionals."

"…the Adviser should generally be entitled to earn a reasonable level of profits …"

"The Board reviewed [the advisor's] methodology in allocating its costs to the management of the Fund. Although the Board noted the inherently subjective nature of any allocation methodology, the Board received an attestation report from an accounting firm affirming that the allocation methods were consistently applied and were based upon practices commonly used in the investment management industry."

"The Trustees considered the Investment Adviser's profit margins in comparison with limited available industry data."

"They considered the profitability of the funds in light of such factors as, for example, the information they had received regarding the relation of the fees paid by the funds to those paid by other mutual funds, the investment performance of the funds, and the amount of revenues involved. In light of these factors, the Trustees did not consider that the profitability of any of the funds, individually or in the aggregate, was such as to prevent their approving the continuation of the agreement."

"…the Adviser's profitability would have been somewhat lower if it did not receive research for soft dollars…"

"They also noted that [the advisor] has voluntarily limited growth of assets by closing the [name] Funds to new investors, and by not taking on new [asset class name] separate account clients. The Board noted that these actions were financially disadvantageous to [the advisor], but illustrated a commitment to act in the best interest of existing Fund shareholders and separate account clients."

"The Independent Directors then considered the costs of the services provided by the Advisor, recognizing that it is difficult to make comparisons of profitability from investment management contracts."

"…the sub-advisory fees paid to [sub-advisor] had been negotiated by Funds Management on an arms-length basis and the [sub-advisor's] separate profitability from their relationship with the Funds was not a material factor in determining whether to renew the agreements."

"The Board did not consider a separate profitability analysis of [an affiliated sub-advisor], as its separate profitability from its relationships with the Funds was not a material factor in determining whether to renew the agreements."

"The Board did not consider in this review the profitability of the Adviser as the management fees and other expenses of the Funds were low compared to the category average and the peer group, therefore benefiting the shareholders."

"Upon closely examining the information provided concerning the Advisor's profitability, the Board concluded that the level of profits realized by the Advisor and its affiliates with respect to each Fund, if any, was reasonable in relation to the nature and quality of the services that were provided."

The excerpted passages demonstrate that fund boards do not always concur with one another on the applicability and importance of profitability. Of all the contract consideration-related disclosures, one of the least homogenous and most contentious topics is profitability. Given the intertwined nature of margins and economies-of-scale, both are typically mentioned aside one another and noted as interdependent. It is fair to say that the disclosures do not, and probably should not, provide a definitive roadmap. They are simply perspectives to be considered given the unique structure of an advisor and focus on their core strategies to remain vibrant.

Target margin sought?

The nagging question that has not been truly addressed by court cases and arguably does not have one right answer is: how much margin is "too much?" What profit margin level should be considered "excessive" to a prudent, reasonable person overseeing the investment management industry? While some boards possess trepidation when 'testing' margins cited in litigation, there may not be any reason for concern … or, should there? We would argue that the specific factors surrounding how the margins were derived and the relative quality of services realized by shareholder should drive any decisions that may potentially be viewed as "tolerant of healthy margins." In our view, a board should not financially punish and disincentivize their funds' advisor – by aggressively buffering margins – for creating operational efficiencies that (presumably) result in providing quality collective investment fund products.

Directors' perspectives and comfort levels with certain margins diverge and, therefore, so will profitability firm-by-firm. However, available investment management benchmarks provide some context on what levels are being achieved financially. These analyses may drive some "regression to the mean" phenomena, but only to an extent due to divergences in operational structure, service quality, and boards' application of business judgment. Do benchmarks not move over time? Does the industry not evolve? Does the advisor's level of services necessarily fluctuate over time? Yes, in all cases.

Therefore, should a board determine a "target margin" or ceiling above which profitability is, by definition, "unacceptably rich" and should be necessarily reduced by some means at a board's disposal? Such a course is probably not prudent. As with widely accepted tests for "reasonableness" and "fairness" of advisory fees, we would argue a profit margin must bear no reasonable resemblance to other companies providing similar levels of value and services to be considered "excessive." This very fuzzy test floats over time and is highly subjective. Bottom line – there are no canned formulae or concrete levels that may be set in order to simplify the profitability review exercise.

Concluding remarks

Due primarily to the "funds scandal" which broke in 2003, the mutual fund business has faced many added challenges over the last several years. In addition to compliance cost pressures, the SEC and other regulatory bodies are demanding far more from independent trustees to justify the renewal of advisory and servicing contracts. Independent trustees are expected to demonstrate their reasoning and review procedures with much greater detail that can, correspondingly, expose them to greater criticism and possible legal liability. An iron-clad process and carefully crafted documentation has increasingly become vital, while agreed-upon goals and communicated advisor expectations at the outset can lubricate the process. Elevated board scrutiny effectively affords trustees an 'opportunity' to gain a greater understanding of the profitability puzzle. Much of the education process burden naturally falls to a fund's advisor.

As alluded to previously, the board's end objective of the profitability review exercise is not to – as some observers like to point out – intentionally keep margins down or "in check." An "appropriate margin" can only be determined in context with other service providers and with extensive due diligence. After all, are not profit motive and the ability to earn healthy returns the bedrocks of the capitalist system and the basis for spurring competition? Appropriate margins are those that incentivize incumbent players, support competition, and bait new entrants. The fund business may be characterized as 'offering' attractive margins (mature business) while possessing these three characteristics.

In our view, the goal of the profitability review process is better characterized as ensuring that trustees understand a manager's business and can then adequately apply professional judgment. Trustees must be aware of the deployment of all shareholder assets and must be able to identify a lack of financial wherewithal that may impede a manager's ability to deliver shareholder value. By acquiring a robust knowledge of an advisor's approach to profitability, independent trustees can not only better insulate themselves from unwarranted criticism, but they can also foster a healthier relationship with the firm's management, acting more as an informed business partner than a regulatory obstacle. Most importantly, a board, the funds overseen, and the advisor will undoubtedly become stronger in the process.

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Keil Fiduciary Strategies LLC (KFS) is a fund business consulting firm owned and operated by Jeff Keil. To obtain more information on consulting services offered by KFS please contact Mr. Keil at (303) 662-8180, keil.fiduciary@comcast.net, or visit the firm's website (www.keilfiduciarystrategies.com).

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