Economies of Scale: Implications of Analyses

Depth of a Fund Board's Assessment?

March 2010

preface

For almost 70 years, open-end mutual funds have enjoyed many periods of vigorous asset growth through diverse distribution channels and under the umbrella of many different investment vehicles. With asset growth – and larger organizational size – inherently emerges the issue of economies of scale (also "scale" and "economies"), the potential for operational cost savings* that may be realized by fund sponsors, and a higher likelihood of increased profit margins. In many fund industry participants' views and in light of the potential for increased profitability, at least some of the savings* should rightfully be passed along to shareholders in the form of lower management fees and/or operating expenses.

The pertinent questions from a Board's perspective include: 1) from what business segments does scale originate (and thus 'operational savings')? 2) what is the level of savings? 3) what is the appropriate sharing of savings via scale that should be passed along to fund shareholders? 4) how impactful is corporate structure and investment philosophies on the ability to realize scale? 5) how should savings be used with regard to reinvestment or parent company dividends (if applicable)? and 6) what should a Board expect from a fund sponsor in the way of data, information, analysis and the like that brings transparency to the economies of scale issue, i.e., more concrete evidence that scale creates savings and sharing with investors is indeed occurring?

** For purposes of this paper, the terms "operational cost savings" or "cost savings" or simply "savings" are defined as lower overall operational costs per dollar of fund assets managed. In other words, scale is created. "Sharing" typically refers to advisory fee revenues that are either not collected or discounted in some way to the benefit of fund shareholders, e.g., advisory fee breakpoints, waivers, expense reimbursements etc.*

Clearly, these are complex questions and ones that do not have clear answers due to differences in a fund company's operational structures, market conditions over time, and a fund sponsor's financial health. Nonetheless, Keil Fiduciary Strategies set out to define and uncover the issues related to scale, create a construct within which Boards may choose to examine this issue, and suggest topics that should be raised and seriously considered by fund Boards. This white paper was neither designed nor should be viewed as a comprehensive economies of scale resource, but rather a starting point from which questions may surface. Thorough due diligence conversations between fund advisors and Boards regarding scale should be encouraged, thus enabling reasonable business judgments to be applied.

Readers should be acutely aware that many of the positions stated in this paper are positioned from a more theoretical economic standpoint and will be subject to prevailing circumstances inside a fund complex. To demonstrate the highly customized nature of this topic, KFS will <u>not</u> attempt to hold out possible fund complex scale scenarios since the scope of possible corporate structures, scale magnitude, viewpoints on reinvestment, and circumstances vary substantially across the business and inside boardrooms.

KFS hopes that this white paper will spur more discussions on economies of scale, raise general awareness, elevate the 'art' of scale creation consideration (to the extent feasible), and prompt more targeted board due diligence in this area. The securities market correction in late 2008 (asset reductions) may have diluted the applicability of this issue currently, but with economic stability and persistent asset growth hopefully around the corner, examination of economies of scale should be undertaken now as the potential for scale creation rises henceforth.

[Several of the viewpoints and insights reflected in this paper benefited from conversations with fund business professionals spanning the litigation, consultation, director advocacy, operational, and Board segments of the fund business. KFS very much appreciates the input received from the commenters.]

Executive Summary

Fund Trustees/Directors and other readers are urged to take away and/or seriously consider the following points contemplated by this white paper:

- Economies of scale is an on-going issue inherent to sufficiently sized operational segments of the funds business and should be carefully examined by advisors and Boards alike
- Boards need to understand the factors that drive fund business expense realization, economies, diseconomies, and the general expense allocation and profitability models
- Boards should expect comprehensive, transparent, and detailed economies analyses be provided by their funds' advisor, as applicable
- Based on materials provided and applying business judgment, Trustees should consider forming a Board philosophy on economies of scale and craft related guidelines
- While functions such as fund advisory services *may* generate not insignificant profits for fund management (economies), those margins may be partially or fully negated by expenditures on the sales, marketing, shareholder servicing, and information technology sides of the business

- Ø Items such as waivers, expense reimbursements, expense caps, and reinvestments in a fund advisor's business may be legitimately considered savings or revenues shared with shareholders and can be quantified
- Ø A case can be made for "complex-wide advisory fee schedules" (fee schedules to which assets of multiple funds or all funds across a complex are applied); Boards should consider their applicability, validity and/or usefulness for their own complexes
- Ø When viewing the topic of scale, cost savings and related shareholder sharing, organizational structure and valid "hands in the pot" should be considered
- Ø During the 15(c) process, Boards should always ask insightful, probing questions to satisfy their duty to uncover all issues related to economies of scale
- Ø Boards should create a solid record of due diligence including documenting pertinent questions, management responses, and follow-up actions
- Ø It is vital that this diligence process be void of any "holes"
- Ø Boards should consider requesting an economies of scale analysis from management every 3-5 years, where applicable and applying a Board's business judgment
- Ø However, Boards should be fully aware and factor in the risks inherent to requesting and reviewing economies of scale analyses that may be highly scrutinized at some juncture
- Ø In KFS's view, the *potential* for raising the economies of scale analysis 'bar' should be examined by many complexes and their Boards of Trustees

"Economies of Scale" Defined

As a courtesy and for those readers not versed in economic terminology, one cannot begin a discussion of **economies of scale** without fully defining the term. BusinessDictionary.com defines the term as such:

> *"Reduction in long-run average and marginal costs due to increase in size of an operating unit (a factory or plant, for example). Economies of scale can be internal to a firm (cost reductions due to technological and management factors) or external (cost reduction due to the effect of technology in an industry)."*

Wikipedia's website (www.wikipedia.org) defines economies of scale via internet links in a number of ways:

> *"Cost advantages that a business obtains due to expansion."*
>
> *"Factors that cause a producer's average cost per unit to fall as scale increases."*
>
> *"Savings achieved in the cost of production by larger enterprises because the cost of initial investment can be defrayed across a greater number of producing units."*
>
> *"Increasing returns to scale."*
>
> *"An economic theory that refers to the reducing cost per unit as more items are produced. A decrease in cost as supply increases."*

"Anything that helps save costs if the scale of operations increases."

The concept of economies of scale was first conceived as it applied to the classic factory or assembly line production model, yet can arguably be applicable to other business types. With regard to the mutual fund advisor model, the 'output' is mutual fund shares (and associated performance, services, disclosures) and the 'input' is all the investment personnel, office space, support staff, compliance professionals etc. that must be hired and/or obtained to create a legal and viable registered open-end investment company "complex." The 'scale' of a mutual fund advisor is measured by the number of funds in its product offering and, more importantly, their total (dollar) assets. Given that virtually every mutual fund sponsor charges advisory fees based on a percentage of fund assets, more assets translate into more actual (absolute) fees garnered by an advisor.

In relation to economies of scale and the fund business, the question then becomes: as a fund's assets rise (or a complex's size increases in general), does per unit cost (expenses per shareholder, on average) for an advisor drop such that economies are created through scale? In other words, does the marginal revenue significantly outpace the marginal costs of additional assets and/or shareholder accounts? While some business participants might argue scale – and resulting cost savings – rarely occur, most would argue "yes." But, how exactly do these savings occur? Perhaps most applicable and useful, does the term "constant costs" (when used by a fund advisor) equate to a stable cost/asset ratio? In all likelihood, economies of scale may still be created under a scenario of so-called "constant costs" as fund assets rise and scale is created.

However, the opposite phenomenon occurs when scale, i.e., business expansion (more investment companies and/or total assets in the case of fund business), creates a need for investment that increases the per unit cost of any output. Economists refer to this 'scale in reverse' situation as **diseconomies of scale**. In the manufacturing world, diseconomies may easily be demonstrated by envisioning a scenario whereby increasing production by even 20% may necessarily require a larger factory, more sophisticated (new) equipment, and more technology. A large investment to ramp up production increases costs per unit, at least in the short-term. In the fund business and in KFS's opinion, the possible economy and diseconomy scenarios are ultimately harder to grasp, clearly more numerous, and can shift very frequently.

Regrettably, mutual fund complexes as integrated entities under the umbrella of a corporate parent and those which are publicly traded complicate the scale and sharing scenarios much further.

SEC Recognition of Fund economies of Scale

One of the first instances of more formal recognition of a fund's size and the sharing of potential cost savings from scale came in the form of an SEC report in 1966. The title of the report, *Public Policy Implications of Investment Company Growth*, implied that the SEC felt that the public interest was not necessarily being adequately served by mutual funds in light of asset growth in the early 1960s. Indeed, the SEC stated that it felt mutual funds were not sharing economies of scale savings (as assets increased) in the form of lower management fees and proposed Investment Company Act of 1940 amendments to ensure fee "reasonableness."

What resulted from the discussions of management fee levels, economies of scale, and growing mutual fund companies amongst all interested parties, e.g., the SEC, Congress, mutual fund sponsors, the NASD etc., was indeed amendments to the Investment Company Act of 1940 in 1970. The amendments related to fund complex scale were very likely spurred by the SEC's input almost four years earlier. The pertinent segment of the 1970 amendments was the creation of Section 36(b) which provided shareholders and the SEC with the right to bring legal action against investment company advisors for breach of fiduciary duty with regard to the receipt of fund management compensation. 36(b) stopped short of providing any detail or guidance on how presumed economies of scale should specifically be viewed, accounted for, treated, computed and/or shared with investors. In fact, economies are not explicitly mentioned at all in 36(b), leaving the door open for interpretation, flexibility, and – over time – numerous lawsuits. The lawsuits since the 1970 amendments have typically focused on fee levels, lack of economy sharing, and/or allegedly faulty advisory contract review processes.

Economies of Scale 'Legitimized' via Court Cases

Most business participants agree that *the* landmark 36(b) case is *Gartenberg v. Merrill Lynch* (1982). The case set down 6 'factors' which should be reviewed and considered when determining an advisory fee's fairness and reasonableness. While the continued longevity of the case is currently being tested and scrutinized by the Supreme Court and may end up being modified and/or diluted, most observers in the fund business believe that the basic '*Gartenberg* standard' will hold up and not 'suffer' substantive changes. Economies of scale was one of the six '*Gartenberg* factors' cited, is widely accepted as an advisory contract renewal (15(c)) consideration criteria, was likely included due to the 1966 SEC report, and is the primary focus of this white paper. KFS doubts that fund (or complex) economies of scale consideration(s) will effectively be discarded during the Supreme Court's current review and look forward to the Court's conclusions.

Subsequent to *Gartenberg*, one critical perspective on the sharing of scale savings with shareholders bears mentioning. The concept is that of an advisory fee schedule "subsuming" scale surfaced during at least one court case. In more plain English, an advisory fee schedule can effectively "subsume" breakpoints (or lower percentage fee(s) charged for higher incremental asset levels) by charging a flat fee for all assets and being comparably quite low percentage-wise for <u>all</u> assets in a fund. The lower non-breakpoint fee percentage is then effectively a "blended rate" of higher and lower fee rates – charged by funds with breakpoints – and accounts for scale less explicitly. The blended rate would compare favorably to other funds of similar size, yet not contain breakpoints as fund assets increased, thus clouding fee schedule comparability and the economies of scale issue.

One additional note with regard to litigation is pertinent and should be of interest to readers. Through all the 36(b) cases that have been filed since *Gartenberg*, ***not one plaintiff has been successful in definitively proving the existence of economies of scale***. The inability of prosecutors to nail down and/or quantify this elusive concept elicits a few cheers from the funds business, but do quantification challenges truly equate to a lack of scale creation? Clearly, no. The lack of plaintiff success simply means that careful consideration of complex size and some level of scale sharing with shareholders (coupled with commensurate documentation) *may* effectively afford trustees and Boards alike *some* level of lawsuit protection.

Business Segments and Economies of Scale

Given the diversity of business activities within a self-contained mutual fund company (few, if any, services outsourced), one needs to examine business segments individually to uncover which areas may have large potential to realize scale and which may not. In the typical, albeit larger, mutual fund company, the business structure would include the following departments and/or corporate disciplines:

- *Investment Management*
- *Administration*
- *Sales/Distribution*
- *Marketing/Competitive Analysis/Product Development*
- *Transfer Agency/Shareholder Servicing*
- *Trading/Brokerage*
- *Legal*
- *Compliance*
- *Finance*
- *Human Resources*
- *Information Technology*

Each of these areas clearly has specific focuses, unique resource requirements, may naturally ebb and flow with market conditions (or not), and whose personnel 'drain' or financial burden *may* correlate to complex or fund asset growth. Thus, we examine scale department by department to identify pockets of potential scale savings when assets grow. Readers need note that investment management, administration, sales/distribution (12b-1 fees only), transfer agency, trading fees/spreads, audit, and legal (outside counsel) are functions paid for through use of fund assets while distribution and marketing costs beyond 12b-1 fees garnered, compliance, finance, human resources, and information technology are costs assumed by an advisor as part of operating a funds management business.

Investment Management

The lifeblood and core of any mutual fund company's successes is arguably its investment management personnel. The skill of portfolio managers in managing a fund directly impacts income, capital appreciation, and total return and therefore, can significantly determine asset flows short- and long-term. In extreme cases, fund complexes can thrive or die depending on the actions of managers. Thus, in most fund companies, a significant proportion of total expenses incurred across any investment management entity are dedicated towards portfolio managers, securities analysts, and related support staff.

As assets in a fund (or potentially a complex) swell, is dedication of investment management resources directly proportional to added revenues attained (through asset growth)? Most participants in the business would argue "no." Yet, one can surely argue that the answer to the question is not that simple. As assets rise precipitously, <u>some</u> of the likely actions on the part of a fund sponsor – that impact investment management costs – could be as follows: 1) addition of security analysts to cover more companies' securities; 2) adding a co-manager to spread decision-making and diversify investment ideas; 3) increasing the size of the trading desk; 4) buying additional data sources to expand market coverage or attain deeper analysis/insights; 5) purchasing more sophisticated technology or market modeling software; 6) forming more brokerage relationships to enable swifter and simultaneous trading; 7) increasing budgets for analysts' travel and 'target company investment' meetings; and 8) expanding office space to handle more securities, trading, and support personnel.

In the opposite scenario, as fund assets rise a fund sponsor may opt to not add more analyst or support staff, keep the current manager, simply add more assets to existing investment positions, and keep analysis and transaction models stable, depending on the amount of assets growth and the current market conditions (or projections). Such actions will clearly prompt economies of scale, generate more profitability (or lower losses), and thus raise the issue of shareholder sharing in some form, e.g., breakpoints, waivers, business reinvestment etc. Maintaining current investing models should not necessarily be considered imprudent, but the advisor's rationale and financial impact should certainly be understood by Boards.

Whether the advisor's actions cited above are much more proactive and involve investment in the business or more status quo, may depend on the types of financial assets in which the advisor invests and/or the investment philosophies they embrace. For instance, a very research-intensive investment management model would clearly require many more (typically well-paid) personnel to cover more equity securities while a quantitative approach may only require one-time modifications to software and possibly more routine examination of current market data. The first model arguably has much less potential for scale with asset growth than the second. A second scenario may involve two types of equity funds, one focusing on micro-cap stocks and the second the most publicly capitalized companies in the US. While both funds may be growing towards assets eclipsing $5 billion, they have unique resource requirements due to the universe of stocks from which they choose their investments. The micro-cap fund may be able to attain fewer shares due to liquidity limitations, allowed total investment in a company may come into play, concentration (diversification) may drive necessary investments, and the sheer nature of the micro-cap market may mean regretful data opacity. All these factors 'force' a larger financial commitment to managing the fund as asset rise. Conversely, the large-cap fund has fewer liquidity concerns, cannot likely invest enough fund assets in a company to hit a fundamental policy ceiling, concentration concerns are not prevalent, and company financial data is plentiful. Asset growth can be more easily managed through portfolio manipulation and not necessarily structural expansion. Thus, it is easy to see how investment style or capitalization can drive the potential for scale or spur advisor reinvestment.

Lastly, the potential for fund economies of scale through fund asset growth may be mitigated through approaches to portfolio manager compensation. An advisor may rightfully make the business judgment that an investment team should be more richly compensated when fund assets rise to many multiples beyond previous levels and research demands are much more rigorous. [Yet, stopping short of cripplingly large salaries is obviously reasonable.] Market data clearly show that portfolio managers responsible for large pooled products are compensated at higher levels and may have higher potential for larger bonus payouts. As this scenario unfolds, the question undoubtedly becomes: how much reinvestment is being dedicated to the product in the form of manager compensation and research teams and how much is being realized in the form of higher profits, i.e., what is the split between advisor and shareholder with regard to the scale savings? Boards need be aware of the basic economics and have a solid sense of the actual flow of dollars to all interested parties.

All in all, the potential for scale on just the investment management side of the business appears to be reasonably high.

Administration

Traditionally integrated into a fund advisor's duties to form the so-called "management" functions are necessary regulatory functions and support personnel which are included under the heading "administration." Classified as administrative duties (and typically cited in an administrative services contract) are items such as securing an advisor's office space, administrative support personnel, filing required SEC documents, Blue Sky (state) filings, fund contract administration, fund PR and data dissemination, and may include fund accounting. One can easily surmise that many administrative tasks have scale by their very nature such as fixed office space (up to a point), administrative support (staff required would not rise proportionately), and regulatory filings (which would have similar aspects, tabular disclosures, disclaimers, risks outlined etc.). Fund contract administration and data dissemination would not positively correlate to assets, but rather number of funds.

Administrative tasks, aside from fund accounting, appear to have not insignificant potential for economies of scale.

Most often integrated into custodial contracts but sometimes an administrative or stand-alone cost, fund accounting inherently possesses a different economies model. The complexity of a fund's strategy, e.g., whether it actively lends securities, buys derivatives, holds illiquid securities, pledges assets etc., the amount of overseas exposure, propensity for holdings' fair-valuation, holding time length, and the sheer number of portfolio securities held may all help to determine the custodial and/or fund accounting fee(s). A custodial or fund accounting fee may also be determined by an amalgamation of all funds across a complex and not necessarily reflect a single fund's custodial demands but rather complex-wide holdings issues and scale. Thus, one fund's total net assets may effectively impact the fee in a much less meaningful way and not be reflected by fee breakpoints. However, since many fees are based on fund-level assets and complexity and don't necessarily rise with assets, scale savings are frequently built into custodial or fund accounting contracts. Diseconomies may occur when assets shrink to comparatively paltry levels and not-uncommon minimum annual charges are invoked.

Custodial duties and fund accounting, while complicated, appear to have the potential for scale at very large asset levels. Yet, readers should keep in mind that fund accounting and custodial contracts rarely command more than a few basis points and large volume is required to achieve a palatable return on investment.

Sales/Distribution

The overall shareholder expense burden of sales and distribution efforts is exceeded only by fees for advisory and administrative services and in some cases transfer agency-related fees and expenses. Shareholders pay varying levels of non-load fees for distribution, sales efforts, and personalized service, yet in many cases those amounts may indeed be <u>less</u> than amounts remitted by fund advisors to distribution partners for shelf space, revenue sharing, non-12b-1 marketing/promotion, and advertising. Since redemption requests routinely occur for any mutual fund, on-going sales efforts are vital to counteract fleeing assets, to stabilize fund size for the benefit of portfolio management, to prevent rising expense ratios, and to generally preserve a fund's viability (existence).

Depending on sales arrangements, target market(s), placement in certain channels, distribution philosophies, available resources and general leverage in the marketplace, expenditures for distribution efforts may vary widely. While some fund sponsors clearly have decided to "pay to play," other widely sought-after complexes may have the luxury of few obligatory payments to distribution partners. Complexes may opt to pursue few, but select (well cared for?) distribution channels while others chase numerous channels, a clearly more expensive proposition. Whichever route is chosen, distribution outlays must be set at competitive levels and are unlikely to be inexpensive for a fund sponsor. Most importantly, size of a fund or fund complex may not necessarily determine what absolute distribution outlays are required to get the attention of influential, and thus successful, distribution channels.

Fund sponsors collect substantial 12b-1 fees from investors for sales charges and on-going personalized shareholder servicing, as well as for outlays such as advertising, qualified plan administration, wholesaler support and prospectus printing, which raises the question of economies as assets rise. One of the original arguments behind the enactment of Rule 12b-1 in 1980 was that charging investors a fee for distribution efforts (non-load) would help to build fund size, promote economies of scale, and lower expense ratios. Fund expense ratio data show very clearly that larger funds charge lower fees (percentage-wise) in almost every case, so it would appear that the case for economies at large asset levels holds up. However, one can easily argue it is very hard, if not impossible, to prove direct correlation between actual 12b-1 expenditures and asset growth when many other factors serve to complicate the investor money flow model, e.g., performance, revenue sharing payments, taxable vs. non-taxable accounts, demographics, advertising etc. Furthermore, a large proportion of 12b-1 fees are simply asset-based sales charges and not truly an investment in distribution mechanisms to facilitate fund share sales. Lastly and in KFS's experience, non-load 12b-1 fees can easily be dwarfed by advisor payments to distribution partners for sales support.

Assuming current distribution realities (sales channels inherently possess significant leverage) and a fund sponsor which understands that distribution is vital to on-going fund business success and, thus is very active in promoting distribution, the potential for scale in the sales/distribution area seems to be sparse at best.

Transfer agency

The cost burden of servicing shareholders is a significant part of virtually all funds' expense ratio and assessed typically through per shareholder account charges, asset-based fees and/or a blending of fixed and variable fees. Some funds also are subject to minimum annual fees should assets or shareholder accounts reach minimal levels. Therefore, while fund payments typically float accordingly based on the number of shareholder accounts (likely transaction volume), investments in technology-based systems to handle sales/redemptions, information requests, account information tracking, securities markets updates, fund performance reporting, expenditures to maintain these services may not correlate directly to fees assessed. Situations may clearly arise whereby systems may need expansion or updating based on a 'volume plateau' to handle the servicing load. [Note: Applicability of this function assumes the complex owns the transfer agency entity. If servicing is handled by an external firm, scale savings obviously cannot be directly realized by the advisor.]

Thus, potential to realize scale is highly dependent on charges levied per shareholder account, an entity's investment in and/or commitment to technology, sheer number of accounts, level and quality of services sought, and volume of inquiries handled by a transfer agent. These variables clearly serve to cloud the issue of whether scale may or may not be feasible inside a wholly owned transfer agent.

Generally, based on KFS's experience and in our opinion, the transfer agency function does not generally realize scale to any great degree.

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The following departments are fund sponsor functions that are not traditionally compensated through contractual fund business arrangements, i.e., direct fund remittances for services rendered. [However, in some cases, costs realized may be reimbursed to a fund advisor.] Cost burden of these support departments can increase when fund assets rise and spur requirement for added financial commitment and/or resource dedication throughout a fund complex. Generally speaking, each department is a required, integral part of a fund advisor's corporate structure and subtracts from the potential for economies of scale primarily realized through advisory and/or administrative fee payments.

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Marketing/Competitive Analysis/Product Development

While very large complexes may dedicate substantial personnel solely to the job of analyzing the market, competitive environment, and designing appropriate financial products, many groups dovetail these functions into the sales & marketing area(s). It is also probably fair to say that for most sizable fund groups these functions are sunk costs, integral to sales, and any scale that may be realized simply provides added opportunity to fund the sales efforts.

In addition to more traditional marketing, e.g., market research, wholesaler support staff, advertisements, direct mail, intermediary materials etc., a public website provides opportunities to provide on-going information, post updates, give access to account information, market new products, explain market conditions, educate shareholders, and the like. Yet, frequently visited and successful websites require regular updating, maintenance, feature improvements, security, transaction capabilities, fund prices etc. The costs of providing such on-line services are quite expensive, especially if a fund sponsor seeks to create and necessarily maintain public internet sites in addition to extranets and intranets.

Effectively, marketing and related functions are strategic costs and designed to build a complex's asset base to benefit of the shareholders as well as the fund sponsor. While the costs may result in the building of scale, they may counteract any scale achieved and further compromise profitability if commensurate new sales results are not achieved.

Trading/Brokerage

While investment management is clearly vital to fund complexes, the trading desk plays an extremely crucial role in analyzing trading costs, securing favorable prices and capital gains, selling out of disadvantageous positions in a timely fashion, buying during volatile market movements, and providing market insights. Explicit trading costs may be the most transparent, e.g., cost/share, spreads etc. (traditionally charged directly to the value of a security/asset), but it is the management of implicit costs such as transaction speed, trades' market impact and the like that also must be skillfully managed and can have large impacts on performance.

One may rightfully argue that the higher probability of increased trading volume and more holdings (with more fund assets) increases the need for more trading desk personnel and less scale potential. Furthermore, some studies have shown that larger fund size and the resulting increase in trades, frequently at smaller relative sizes, create diseconomies of scale and increased costs for fund investors. Also, the need for more trading support may be tied to what trading support services have been enlisted (purchased) by the advisor and the cost/volume relationships.

The answer with regard to scale realization may not be clear and widely divergent due to factors such as: 1) the advisor's direct ties to markets and market makers (or not); 2) general approach to trading and required staff dedicated; 3) the extent to which purchased data and market-making services aid the trading process; 4) use of ECNs vs. traditional agency trades; 5) the frequency with which securities are generally bought and sold; and 6) the average size of trades.

One last brokerage issue worthy of some level of consideration is soft dollars. While it is not KFS's intention to offer comments on the validity of soft dollars or "28(e)," a tie-in to economies of scale arguably exists. When a fund advisor relies on the "safe harbor" under 28(e) and is able to legitimately pay a higher-than-market-average price for brokerage and receive securities market research from a brokerage firm, there is an effective transfer of costs from the advisor to the fund shareholder. What was a direct investment management cost by the fund advisor (market research) now becomes a cost burden of the shareholders. This expense transfer, while clearly legitimate and not uncommon, can be substantial. There is no one answer to the question of the 'correct' amount of soft dollar research and shareholder value created as a result. However, performance and volatility results should generally speak volumes about the effectiveness of research purchased with soft dollars. Regardless of current performance rankings, the level of soft dollar expenditures should be factored into a Board's thinking on economy creation, resulting profitability, and scale sharing.

The potential for scale in the trading arena appears to fall in a fairly large range.

Legal/Compliance

The legal and compliance personnel encompass and handle many required SEC-mandated duties, Investment Company Act of 1940 requirements, Chief Compliance Officer responsibilities, registration filings, daily NAV computations, portfolio valuation judgments and the like. Simply put, these requirements are a "necessary evil" of doing business as a mutual fund advisor, the costs for which are not insignificant, and are not to be taken lightly. For any registered fund advisor, an SEC examination *may* be just around the corner and – if not properly prepared for and handled correctly – may threaten an advisor's very viability.

The volume of legal and compliance work (and thus personnel) is highly dependent on factors such as a complex's number of funds, complexity of funds offered, diversity of product line, types of securities held, e.g., international, illiquid, derivatives etc., the complex's approach towards compliance, the amount of funds' fundamental policy restrictions, the sophistication of technology utilized, forensic testing frequency, and the number of employees working for the funds' advisor. In addition, on-going capital is required to maintain the requisite internal systems as markets mature, product lines shift, and the regulatory regime changes. Given changing markets and regulatory landscapes, investments in new and 'smarter' systems and support personnel appear to be constant. Finally, the advisor may also cover the salary and benefits costs of a fund complex's Chief Compliance Officer or may share that cost with the funds.

In general, one would think that an almost fanatical dedication to compliance and extreme product complexity (not assets) would drive capital outlays. Yet, asset growth can spur the purchase of different types of more-complex securities, a larger number of holdings, the need for more investing flexibility, more legal oversight, more frequent fair valuations, and more advanced technology. And, the need for more reinvestment by an advisor, and thus less chance for economies, also depends on where new assets flow and to what degree.

To truly determine if scale might be created in the legal and compliance areas, one surely needs to have a handle on topics such as: 1) the stability of the regulatory landscape; 2) diversity of a group's product line; 3) rigor and sophistication of fair valuation policies and procedures; 4) the extent to which resources are significantly dedicated to a "culture of compliance;" and 5) product sophistication and complexity.

A variety of forces pull the legal and compliance department(s) in different directions and spur a variety of capital requirements, making a definitive assessment of scale very problematic.

Finance, Human Resources

A mutual fund complex is no different than a typical industrial corporation in that it needs a finance department and human resources professionals to provide a variety of services such as those related to capital requirements, cash flows, and reporting, and hiring, benefits, and performance appraisals, respectively. As with many of a firm's decisions, capital dedication to both areas may vary. Yet, outlays in these departments tend to be modest in relation to many other areas and do not necessarily correlate to asset growth. While scale may be created, quantity of personnel remains reasonably stable regardless of market and asset turmoil.

Information Technology

In KFS's view, information technology is the "wild card" in the cost equation and, thus in scale creation discussions. Aside from portfolio management (including analysts and trading personnel) and sales, the information technology department can typically require the most on-going capital. The investment management, trading/brokerage, fund administration, and shareholder transactions functions and very technology-intensive. As technology shifts, investments in new systems and/or upgrades are traditionally required to maintain critical items such as data and information flow accuracy and quality, provide the requisite timeliness for SEC and shareholder reporting, allow compliance to monitor activities surrounding portfolio management and internal trading, afford investment personnel the latest in communication/analysis tools, and general market competitiveness.

Serious lack of investment in any or all of these areas may render a fund sponsor hamstrung with regard to being able to provide quality services, remain compliant with regulators, meet shareholder expectations, and – arguably most important – may compromise the investment management personnel's ability to create competitive total returns for fund shareholders.

Regardless of fund sponsors likely feeling compelled to invest in up-to-date technologies, many simply do not have the resources and/or choose not to for financial reasons. This course may be prudent for smaller fund advisors, but unwise for larger complexes that must oversee large employee bases, manage 100+ funds, process substantial quantities of transactions daily, and have necessarily large commitments to compliance. Many of the above investments in technology/systems are indeed discretionary, albeit potentially detrimental to most of the parties participating in the investment company model if not undertaken. For those fund groups who prudently feel investment in sophisticated fund management and shareholder servicing and data systems is not optional, diseconomies appear very likely, while those who must operate on a modest budget, scale savings are improbable.

The 'correct' amount of investment in technology for a fund sponsor is clearly a shop-by-shop decision, the drivers of which, and rationale for, should by understood by Trustees. The decision(s) should be based on critical factors such as portfolio management's needs, shareholder transaction accuracy, compliance necessities, and regulatory requirements.

Scale Creation: Fund vs. Complex

One cannot discuss scale creation without delving into the issue of whether economies of scale are created at the fund level or simply at the complex level. In other words, when a single fund or a handful of portfolios grow exponentially, do they create scale (more advisory revenues and proportional savings) for the fund advisor OR are many other areas impacted by the asset growth to the extent that expansion and investment are required (beyond investment management) to 'absorb' the additional investments? Perhaps more to the point, <u>are funds and all investment and support personnel so inseparably intertwined that a single fund cannot create scale solely to its own benefit, but rather to the benefit of the entire complex</u>? It appears that many fund sponsors, their auditors, and their fund Boards would tend to respond "yes." The case for significant fund resource overlap across a fund complex is very compelling and the issue of per-fund expense allocation is unavoidable.

If one establishes that scale is not truly created at the fund level, but rather the complex level, how can fund asset-based fees with seemingly arbitrary breakpoints accurately match advisory fee revenues with total (shared) expenses and reflect operational realities when examining scale economies? In all likelihood, they cannot with any accuracy. And, does the premise of complex-wide asset scale economies not then push one towards the validity of complex-wide advisory fee schedules? In KFS's opinion, it does. Yet, since there are some unique commonalities amongst asset classes and resources are not always shared across fund types, savings will arguably not occur at the same rate for, say, equity assets and junk bond assets as they do for short-term treasury assets. Once this philosophy is embraced, the need for several complex-wide fees schedules (customized by asset class) is spurred to more accurately align costs with revenues and pass along economies (to the extent they can be quantified). Lack of such an approach does not mean that economies cannot be passed along to shareholder through fund-level breakpoints, but the potential for more accurate alignment of revenues with costs and a truer picture of scale economies is buffered.

At the time this paper was written, only a handful of fund complexes – primarily very large ones – have implemented complex-wide advisory fee schedules. KFS assumes this is due to a number of factors: 1) many Boards and fund advisors simply don't believe in the complex-wide inseparable cost model; 2) advisory fees have traditionally been charged at the fund level and bucking the trend appears imprudent; 3) the enormous complexity of the exercise and amount of judgment used to determine costs allocations and appropriate complex-wide fee schedules over time; 4) the time dedication and onerous undertaking such a quantification exercise would be (especially for lower-tier complexes); 5) after making the decision to 'crunch the numbers,' the possibility that current fee schedules create the same result, albeit with less accurate revenue/cost alignment; and possibly 6) a hesitation to charge advisory fees based on complex assets due to inherent '40-Act stipulation issues that clearly point to fund-level considerations and cross-subsidization prohibitions.

Regardless of these supposed stumbling blocks, KFS believes that larger complexes should at least discuss the reasonableness and feasibility of implementing complex-wide fee schedules due to their underlying economic rationale and savings creation alignment with fee revenues.

Outsourcing and Economy Sharing

A significant segment of the business's sponsors outsource many functions to parties with no corporate or business affiliation with the fund complex's advisor or related companies. Outsourcing may blanket functions such as (sub-)advisory work, administrative and/or fund accounting tasks and transfer agency/shareholder servicing. As noted earlier, these functions possess the potential for the creation of scale and shareholder savings realization (at the outsource level?). More to the point, the economies of scale issue that may apply involves a misalignment between fees charged shareholders and fees charged outsource agents.

Negotiations between fund advisors and outsource agents may result in arrangements that are very advantageous to a fund advisor's portfolio management functions and, if passed along to shareholders, mitigate return-buffering fees or expenses. However, if fees charges shareholders widely diverge from those charged outsource agents, the potential for advisor scale and profit (at shareholder expense) may be present. While some segments of the functions mentioned above are clearly 'expense pass-throughs,' others involve a split of duties and determination of equitable splits in fees.

For instance, when a fund decides to outsource the advisory function, this "sub-advisor" work may entail providing selection of a fund's securities and brokering securities transactions. Clearly, the "advisor" (sponsor) should feel compelled to rigorously oversee the activities of the sub-advisor. Oversight includes, but may not be limited to, monitoring investment performance, risk assumed, investment personnel consistency, compliance with advisor's policies, trading costs, and requisite reporting. Fees remitted to a sub-advisor by an advisor may take the form of an asset-based fee that recognizes scale in the investment advisory process, i.e., breakpoints built into the advisory fee schedule. Yet, the fee garnered by the advisor may not recognize scale in the same manner or the fee schedule may not have breakpoints at all. If scale is supposedly created at the sub-advisor level, should these savings not be present in the fee levied on shareholders by a fund's advisor? KFS maintains that scale created by, and charged to, an outsource agent should as a general rule be built into fee schedules charged shareholders.

Organizational Structure, Scale, "Hands in the Pot"

While the basic structure of a mutual fund company (complex) is somewhat similar across firms, those individuals and entities with a vested interest in scale and the potential for enhanced profit can vary substantially. An investment advisory firm that sponsors and manages retail mutual funds may be an entrepreneurial venture (sole proprietor), owned by a larger company in a different business segment, or be part of a publicly traded financial services conglomerate. Each of these models bring with them different pressures, incentives, and sharing tendencies.

A small, private sole proprietorship likely has only a few owners who benefit from fund advisory contract revenues. Scale may be elusive (if the firm is modest in size), but when assets potentially balloon to levels enabling economies, owners must decide how the presumably higher profit margins will be deployed. Revenues may effectively be shared amongst the interested parties through (and/or scale savings can take the form of) reinvestment by the advisor in its business (structural or staff incentives), waivers or expense caps, paid out to owners as dividends or bonuses, addition of breakpoints in advisory fee schedules and/or any combination of the aforementioned. The proportion of revenue or scale sharing that is remitted in each manner or 'channel' rightfully depends on factors such as the advisor's financial health and competitiveness, relative fee levels of funds, and current compensation arrangements.

When a fund advisor is owned by a larger parent company, the dynamic dramatically changes. The 'hands in the pot' now include a company which capitalizes the mutual fund sponsor and has a vested interest in receiving a reasonable return on its investment. While the returns for a corporate parent may not necessarily include the expectation of a healthy quarterly dividend, the fund company will arguably compete for resources with other subsidiaries and may not be afforded every advantage desired by the sponsor. Any scale that is created may be at least partially viewed by a parent company rightfully as a return on investment, such as when manager salaries are increased, budgets are elevated, or when other fund companies are acquired (with parent capital) and merged into existing complex assets. When dealing with this return-on-investment dilemma, a fund Board must be concerned about maintaining or elevating the financial health of their funds' advisor and promoting financial incentives and thus, proper motivation.

Adding public shareholders to the mix complicates the economy sharing model and creates a "Tale of Two Masters." Shareholders of a publicly traded fund advisor wish to lay claim to an advisor's fund fee earnings while fund mutual fund shareholders wish to realize fund performance not encumbered by 'healthy' advisor profitability. Those mutual fund companies which are publicly traded (or owned by a publicly traded parent) will have Wall Street earnings expectations thrust upon them, capital investments will be assessed by the securities analyst community, dividend levels will be watched and anticipated, and general business practices will be heavily scrutinized.

So, what is the optimal mix of capital flow to each of these "hands in the pot?" There is no one correct answer. Depending on the prevailing business and financial conditions, even a specific fund complex's answer could vary from year to year. From a fund Board's standpoint, a careful balancing act must be employed, adeptly applying business judgment and factoring in advisor wherewithal and all shareholders' interests simultaneously. Arguably, every outstretched hand should be considered.

Fund Size, Expense Ratio Correlations

While the argument for and against scale creation in the funds business and deviations based on complex size can rage on amongst economists or business professionals for years, one fact remains. The fund business proves that there is an underlying belief in the existence of complex-size scale (and a fiduciary duty to share scale with investors) and demonstrates its collective conviction through the application of advisory fee breakpoints. Based on a recent Lipper Inc. study, the vast majority of funds that reach at least $3 billion in total net assets employ breakpoints in their advisory fee schedules and continue to add more breakpoints if and when higher asset thresholds are reached.

Furthermore and without exception, total expense ratio data for funds in every asset class show that as asset levels rise, expense ratio medians consistently drop. In other words, the median expense ratio for smaller-sized funds is always higher than their larger brethren. There are exceptions to this rule, but the pattern is clear.

The expense ratio data implicitly pushes one towards affirmation of the scale argument, yet the data are not truly correlated enough to derive even ballpark metrics for scale sharing magnitude for complexes of varying size. One should expect this lack of linearity in the data given different corporate models, business philosophies, spreads in capital outlays, and business success(es).

Advisor vs. Board Perspectives on Profitability, Scale

Inherent in the fund advisor/board oversight model is somewhat conflicting interests relating to profitability. Applicable to this paper, scale economies are inextricably intertwined with the issue of profitability. Advisors (and their parent company, as applicable) likely wish to maximize their own profits while Boards are inclined to monitor and assess how incrementally higher fee revenues may be at least partially deployed (or effectively rebated) in the interest of fund shareholders. Business judgments and monetary interests may clearly diverge when views on investment in the business and "time to reap the benefits of ownership" misalign. The realization of scale by a complex undoubtedly can promote larger profit margins, spur discussions over dividend payments, reinvestment in the business, shareholder servicing quality, and total return ranks. In some cases, scale may simply create more cash flow for owners, if warranted, or is left unchecked by less-than-diligent watchdogs. One can surely argue that discussions over what expenses are "fixed costs" vs. "variable costs" will ensue due to divergent views on what constitutes a business necessity, cost vs. benefit, and shareholder value derived (or not!). Added discussions over fund mergers, liquidations, and acquisitions and their impact on scale may significantly complicate the profitability model and Board determinations of what constitutes necessity and value.

Portfolio manager compensation is an issue of keen interest to all parties in the investment company model, yet Board and advisor perspectives may diverge when talks of "necessary" or "reasonable" compensation emerge. A fund's advisor may take the position that quite large amounts of compensation are required to incentivize a portfolio manager and continue to retain his/her services, presumably to the benefit of the manager as well as the shareholders. A Board may not disagree that compensation must be commensurately large, but may believe that the line from "necessary" to "excessive" has been crossed at some salary level. What might be viewed as a "pre-salary excessive profitability levels fueling exorbitant compensation" scenario could result in what appears to be reasonable profitability levels – and, the rationale could rely on above-average advisory fee schedules. Shareholders *could* be paying for excessive compensation through an effective transfer of costs if high margins are funding manager salaries. But, what is "too much compensation?"

To deal with and/or avoid such a scenario, Boards could ask a number of questions such as: What benchmarks were used to determine compensation? What resignation risk does the advisor feel they are assuming if compensation is not at current levels? Are any manager or analyst compensation plans based on sales or assets (<u>not</u> generally desirable)? Is a fund too tied or too dependent on a single manager and risks crippling redemptions if he/she leaves, i.e., does he/she possess too much leverage? What is the impact of (presumably) more modest manager salaries on profitability? If advisory fee income was buffered by the Board in some way, would a decrease in manager salaries be entertained or would some other operational changes be implemented?

Discussions over fixed and variable costs, and thus profit margins by business segment, should raise the issue of internal management reports and how those profit figures dovetail into what fund Boards are provided during the advisory contract renewal process. Are the profitability report figures included in Board materials in line with fund management's decision-making tools? Most important, do the reports show indications of economies of scale? Are the cost allocation methodologies appropriately activity- or time-based (or both)? How are separately managed, institutional, or other non-fund accounts' costs allocated and what are their margins? Any fund vs. other account allocations methods and margins that are not crystal clear and reported to Boards may result in troublesome obfuscation of economies of scale drivers.

An advisor may frequently have a "We have advisory fee breakpoints, thus we pass along scale and should rightfully direct use of profits as we see fit" perspective. This tact may pass Board muster under certain circumstances, but may sidestep the issue of absolute profit levels. Breakpoints in fee schedules may be indicative of an advisor's pricing philosophy (desirable) or simply the result of Board pressure. A fund advisor may also make the case that they invested in the business and thus, created healthier margins which they feel should be retained. Perhaps most compelling, an advisor may reconfigure their business in an effort to create more operational efficiencies (and potentially added scale), resulting in elevated margin. Should an advisor not be financially rewarded (and receive proper on-going motivation) for seeking out operational improvements and a better business model? Is the goal of an advisory fee to not only realize competitive total returns and provide quality services for shareholders, but to motivate a fund's advisor to continue to provide the best quality services that it is able? KFS would generally argue "yes" to these questions. However, such a response assumes critical conditions such as expense levels are commensurate with services rendered, investment returns and volatility are indeed within expected levels, services are of high quality, compliance efforts are iron-clad, and a fund complex is in no danger of significantly altering its business model.

Akin to many other Board duties, analysis of scale and shifting margin levels clearly entails balance of profits vs. motivation, investment vs. services realized, and the interests of shareholders vs. a fund advisor. Perhaps most important, it may be very useful **for a Board to create a philosophy on economies of scale** that will help to guide discussions on targeted issues, balance interests, spur negotiations, and direct resulting actions.

Board Assessment of Scale: Content? Depth?

The culmination of the aforementioned issues and considerations is a Board's assessment of fund complex scale (if applicable) and how any savings realized are used to the benefit of, or shared with, shareholders. What questions should Boards ask? What analyses can reasonably be expected? Can an advisor realistically create a scale analysis that could be applied to make reliable, quantitative business judgments? Are several hypothetical economic scenarios required to provide a sense of outcome differences? Do any figures provided match those financial metrics used by the advisor to manage their business? How frequent should an economies of scale analysis be expected?

KFS believes that, amongst others, the following **Board questions** should start being raised (if not already) when rightfully requesting materials of a fund advisor and discussing economies of scale typically during the advisory contract renewal ("15(c)") process:

1. Does your firm believe economies of scale are (or will be) created within your fund management business? In what ways?
2. In your view, what risks are assumed when conducting an economies of scale analysis? What does your counsel view as the risks?
3. What diseconomy factors compromise or counteract scale that may be created?
4. How does economies of scale creation (or lack thereof) impact or contribute to profitability trends?
5. How have the movement of operating expenses over time impacted your ability to realize scale?
6. What cost controls or expense policies are in place?
7. Have the benefits from recent investments in your business been realized in the form of higher returns or is there a noticeable time lag which should be accounted for?
8. Providing scale has been created, demonstrate how and to what extent you have shared economies with shareholders.
9. Beyond or in lieu of advisory fee breakpoints, in what ways have you shared realized economies with fund shareholders, if any?
10. If economies have not *explicitly* been shared, e.g., fee breakpoints, waivers etc., discuss and/or justify why you feel this course of action is in shareholders' best interests.
11. If the fund's advisor feels that a full-scale economies of scale study is not worthwhile for the shareholder benefits it <u>may</u> uncover, please justify why the Board should not expect a full analysis.

With regard to an actual numeric analysis of economies of scale, a Board must first be cognizant of the potential for scale, i.e., does it exist? Second, a Board must understand the assumptions used to create any analyses. Third, a Board must realize that such an undertaking may be onerous for the advisor and, in some cases, be of limited value. Fourth, providing that an analysis is feasible and viewed as worthwhile, several hypothetical asset (growth and shrinkage) scenarios should be created. Fifth, a Board should confirm that financial data used for the analyses align with internal reports used to manage the business. Sixth, Boards should be comfortable with the process utilized to analyze economies of scale and confirm its comprehensiveness with counsel. Lastly, unless significant structural changes are implemented, economies of scale analyses should not be requested more than every, say 3-5 years, at the most frequent.

When reviewing responses to inquiries or scrutinizing economies of scale analyses, what might be some **red flags** of which Boards should be concerned?

- Responses to the above questions that show lack of business understanding or judgment, obfuscate any areas of concern, or generally lack substance or usefulness
- Lack of advisory fee breakpoints for funds of multi-billion dollar size and less-than-competitive expense rankings
- For a larger complex, denial that scale is created in any business segment or at any level in the business
- Rapidly rising profit margins coupled with above-average expense ratios and little evidence of scale sharing with shareholders and/or reinvestment in the business
- Inordinate, on-going reinvestment in an advisor's business with no tangible proof that added shareholder value is being created
- Recent fund mergers that apparently do not impact subsequent economies and profitability analyses
- Disconnects between internal financial data and Board scale reports
- Unwillingness or outright refusal by an advisor to either examine the economies of scale topic and/or share clearly proven economies of scale with shareholders

As with virtually all Board due diligence and related duties, Trustees are well-advised to seek out their legal counsel's input and request applicable reviews of all materials.

Concluding Remarks

For many fund business participants, the existence of economies of scale for fund complexes of significant size is a truism. Those that argue that scale is not created may argue that scale savings realized on one side of the business, e.g., investment advisory etc., are merely and frequently deployed in ways rather than explicitly shown in the form of breakpoints, waivers, or expense caps. Most fund business participants would argue that – at a certain complex size – reinvestment in a fund management business can be substantial if fund executives wish to keep up with technology, address rising shareholder expectations, provide portfolio management with cutting-edge securities market tools, meet regulators' requirements in stipulated timeframes, as well as a plethora of other strong business-based desires.

Yet, given the myriad of ways in which expenses may be allocated amongst funds and functions (to determine profitability by departments and/or fund), the constantly moving asset levels of funds (and resource dedication), shifting business needs, the unavoidable (and likely not predicted) maturation of the business, as well as other 'moving targets,' are economies of scale analyses really worthwhile?

Do they amount to a wildly unreliable guess? Perhaps, in some cases. Yet, ***without some type of even best-guess analyses, how can Boards apply business judgment to ascertain if scale is being created, to what general level, and if proportions of scale being shared are remotely reasonable***?

KFS clearly support the notion that "… some educated guesses as to scale creation, its level, and extent to which savings are shared are better than no data or information at all." After all, how can a board apply business judgment or judge fairness or reasonableness with – in most cases – nothing more than a general sense of business structure, overall profit margins, and a constantly changing business environment? The advisor clearly knows their business in greater detail and is in a position to assess economies of scale, if only to provide knowledgeable estimates and ranges of values that may be realized. Yet, ***in lieu of a full-scale, hypothetical economies of scale analysis, shareholder savings can definitively be measured by summing dollar savings through use of advisory fee breakpoints, advisory fee waivers, and total expense caps***. However, savings should be measured and given credibility only in the context of fee competitiveness, e.g., an advisor should not be given 'credit' for waivers when their fee was artificially or unjustifiably high prior to the reduction (waiver) etc. Business reinvestment figures (on the record) may also be useful.

Since an advisor's true ability to provide economies of scale analyses may <u>not</u> be a foregone conclusion, Boards should carefully determine their advisor's skill and wherewithal to assemble meaningful figures, whether full-scale analyses are worth the manpower dedicated (cost vs. benefit), and what Board actions may be beckoned by the conclusions that emerge. What may be worse than not performing any economies of scale analyses is creating labor-intensive, but potentially meaningful analyses that sit on a shelf or in Board meeting minutes upon which consideration is not given and therefore, no action is taken. At the very least, ***Boards should consider if raising the economies of scale analysis 'bar' is useful from a shareholder advocacy standpoint*** and Trustees should stand ready to take action as the analyses may dictate.

In the absence of the *Gartenberg* economies of scale factor, should or would Boards still seek to examine and understand scale creation? KFS fails to grasp the notion that Trustees could possibly assess and validate "reasonableness" and "fairness" without some sense of the balance between the level of resources which are required to generate shareholder value and what is being retained by funds' advisors as reasonable compensation for their expertise and business risks assumed. Perhaps most vital, what evidence exists of business investment prudence, scale, and cost control? Yet, would most Boards undergo such "brain damage" when it wasn't required? The answer should be "yes" in many cases, lest Trustees not fully understand how effectively and fairly their funds are being managed.

As a Trustee, can you honestly state that your complex's current economies of scale analysis and/or general considerations to date strongly uphold shareholders' interests and are sufficient to withstand careful scrutiny or even litigation? If not, should you not "raise the bar?" Ask not how marginally adequate your considerations have been, but how they can be elevated in the future.

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Keil Fiduciary Strategies LLC (KFS) is a fund business consulting firm owned and operated by Jeff Keil. KFS seeks to provide third-party opinions and assist fund boards with issues such as the advisory contract renewal process, fee and expense benchmarking, performance analysis, board/advisor relations, board self-assessments, required disclosures, litigation support, and documentation. 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).