



CALLAN INVESTMENTS INSTITUTE

2009 INVESTMENT MANAGEMENT FEE SURVEY

QUALITATIVE AND QUANTITATIVE OBSERVATIONS FROM U.S. INSTITUTIONAL FUND SPONSORS AND INVESTMENT MANAGEMENT ORGANIZATIONS

SEPTEMBER 2009

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Executive Summary

Callan Associates' 2009 Investment Management Fee Survey provides institutional investors a current report on U.S. fee payment practices and trends. This report includes comparisons with Callan's 2006 survey along with observations reflecting both long- and short-term trends. Asset classes new to the survey include U.S. mid cap active equity, high yield fixed income, global active equity, real estate, private equity and hedge fund-of-funds.

Forty fund sponsors and 160 investment management organizations provided detailed fee practices and data on 14 asset classes to compile this report. Results were supplemented by actual and published fee information sourced from Callan's Fund Sponsor and Global Manager Research Databases, as well as industry sources.

Key Findings

Investment manager fees represent nearly 88% of fund sponsors' cost of doing business¹ and are an important area of focus. Fees were heavily scrutinized due to litigation and regulatory issues prior to the 2008 credit crisis and market collapse. While fees remain a meaningful component in the decision to hire and/or retain an investment manager, the focus on fees has declined as other factors—namely risk management and impressions of key people—gain significance. Other key findings from this survey include:

- ▶ Fees, along with asset values, drive investment manager revenues. In aggregate, investment managers report that fee revenue has declined each year since 2006. Both fee revenue and pre-tax profit margins are estimated to fall in 2009.
- ▶ Across traditional asset classes, published fees increased for actively managed U.S. large cap, small cap and non-U.S. equity products for larger account sizes but declined for U.S. broad market fixed income strategies relative to 2006. Published fees for passively managed U.S. and non-U.S. equity portfolios were down slightly since 2006, while passive fixed income fees held steady during this time period.
- ▶ Actual fees for active U.S. large cap, small cap and non-U.S. equity portfolios declined for the largest accounts relative to 2006, whereas fixed income fees were flat over this period. On average, actual large cap U.S. equity fees represent 85% to 90% of published fees, and actual small cap and non-U.S. equity fees comprise 83% and 70% to 75% of published fees, respectively. Actual U.S. broad market fixed income fees—which declined the most among the asset classes examined in this report—represent 70% to 85% of published fees.

¹ Callan Investments Institute's 2009 Cost of Doing Business Survey: U.S. Funds and Trusts, February 2009.



Executive Summary (continued)

- ▶ Performance-based fees are growing in popularity as an alternative to standard fee schedules. Fifty-nine percent of fund sponsors use performance-based fees for at least one account and 64% of managers offer them.
- ▶ The vast majority of investment managers infrequently alter their published fee schedules; 80% of respondents report making changes no more than every two to four years and one-fifth indicate they never change their published fees.
- ▶ Nearly one-third (31%) of fund sponsors review fees annually while 17% never review fees.
- ▶ Consistent with 2006, fund sponsors negotiate fees with 66% of their managers on average. Across asset classes, fund sponsors and investment managers report the most frequent fee negotiations in U.S. large cap equity and core fixed income.
- ▶ Thirty-one percent of investment managers do not give fee discounts to clients for whom they manage multiple portfolios, up from 21% in Callan's 2006 survey. More than one-third of investment managers provide a "relationship discount" by applying a discount to the sum of all individual fees.
- ▶ Over the next 18 months, fund sponsors expect to consolidate the number of managers in U.S. small, mid and large cap equities and U.S. core plus fixed income. By contrast, investment managers reveal few intentions, if any, for product consolidation. Fund sponsors intend to add managers in global and non-U.S. equities, other fixed income, real estate, private equity, hedge funds and hedge fund-of-funds. Managers foresee the greatest opportunity for product expansion in global equity followed by real estate.
- ▶ Perceptions of value-added for fees frequently mirror the performance of the broad market. Fund sponsor perceptions of value-added for fees paid are down substantially from 2006—50% feel their fees are justified and 33% indicate that industry-wide fees are justified versus 71% and 47%, respectively, in 2006.
- ▶ Fund sponsors' greatest fee-related concerns are: (1) ensuring that fees paid are competitive with the marketplace; (2) that different fee structures used for alternatives are aligned with fund goals and are reasonable; and (3) whether active managers are providing the value-added needed to justify fees.
- ▶ Investment managers' top concerns relating to fees are: (1) fee and margin compression, especially given lower asset values and higher operational costs; (2) fee consistency given most-favored-nation arrangements; (3) pressure from lower-fee strategies and distribution channels; and (4) performance-based fee arrangements.

Fee Revenue Generation and Profitability: Perception versus Reality

Callan asked investment managers about their change in year-over-year fee revenue for a five-year period, and fund sponsors about their perception of investment managers' revenues over this time. The results are shown alongside historical data from our previous survey.

Changes in investment management fee revenue growth peaked in 2006 between 21% and 30% and have fallen each calendar year thereafter. It is not surprising given declining asset values that fee revenue changes were negative in 2008, below levels last seen in 2002. Investment managers estimate their year-over-year fee revenue will fall further in 2009 to between -10% and -20%, on average. In 2008 and 2009, managers attributed a smaller portion of fee revenue changes to new cash flow.

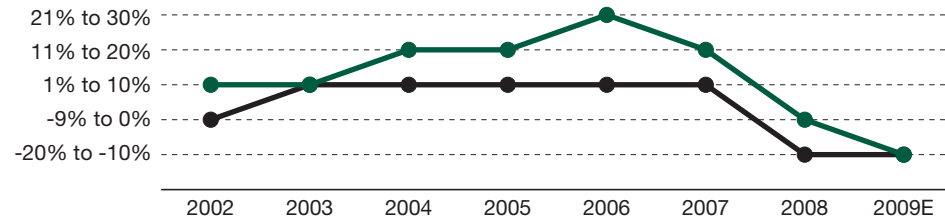
Average investment manager pre-tax profit margins held steady from 2005 through 2008 within the 21% to 30% range. However, manager respondents anticipate pre-tax profit margins will be lower in 2009—between 11% and 20%.

Fund sponsors' perception of investment management firms' fee revenue—both revenue changes year-over-year and the percentage change in fee revenue due to new cash flow—is generally 10% to 20% lower than reality, although perception follows the same revenue trends as reported by investment managers. Fund sponsor estimates of pre-tax profit margins from 2002 to 2007 are inline with investment managers' responses, but are lower than actual 2008 and expected 2009 profit margins.

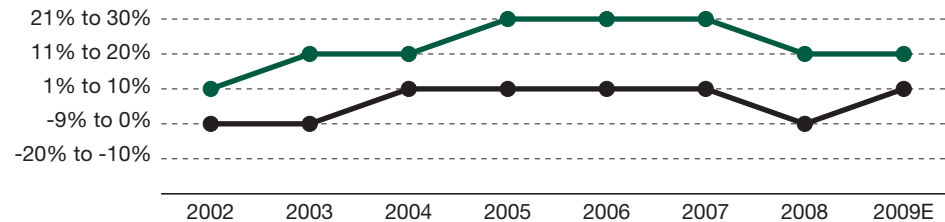
Calendar Year Fee Revenue and Firm Profitability^A

● Investment Manager Response (Reality) ● Fund Sponsor Response (Perception)

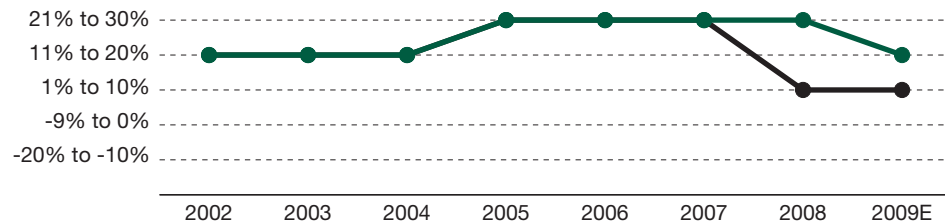
How has your firm's calendar year investment management fee revenue changed from the previous calendar year?



What do you estimate is the percentage change in fee revenue generated from new cash flow (either existing or new accounts), as opposed to fee increases due to performance influences?



What do you believe were investment management firms' pre-tax profit margins for each calendar year?



^A Average responses.

