

Fee Structure of Investment Trusts

Aligning Interests of Investors and Managers / Distributors

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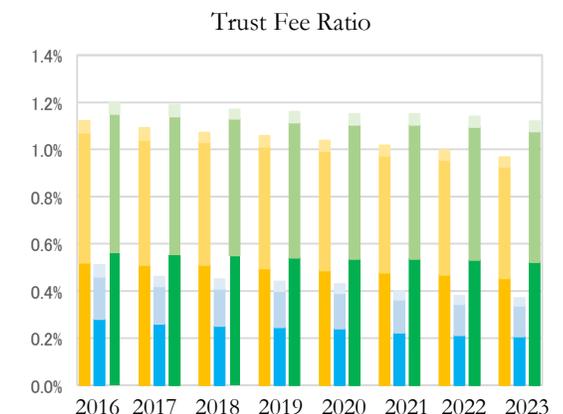
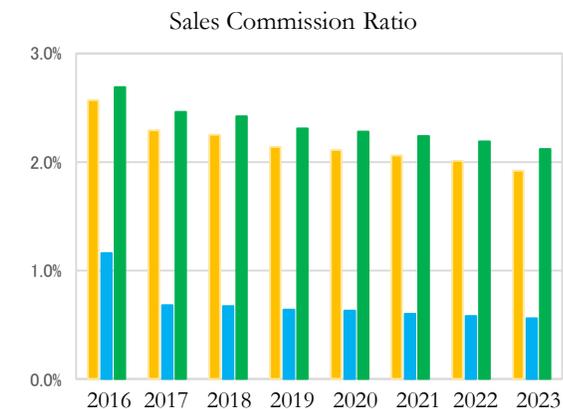
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Can the Cost of the Active Funds be Alienated with the Value for Investors?

- Passive funds attract more and more cost-sensitive investors.
- Amid rising NISA-related cost pressures on investment trusts, both investment managers and distributors face difficulties in increasing the revenue, especially the profitability.
- The role of active funds should not be underestimated merely for improving the profitability of players. It also contributes to the improvement of the whole capital market.
- Importantly, investors expect active funds to achieve higher returns after fees with the same risk compared to passive funds.

We tried to consider the fee structure where the revenue of investment managers and distributors aligns with the value delivered to investors.

From left to right: ■ Open-end equity fund ■ Index fund ■ Active fund



Each bar graph shows the stacked costs of asset management fee, trailers fee and custodian fee from the bottom up.

Source: Japan Investment Trusts Association Fact Book

Are Current Fee Structures Fair for Investors?

The fee structure of usual publicly offered investment trusts in Japan are summarized as the following equations:

$$\text{Initial Investment and Balance: } A_0 - SC + R - TF = A_t$$

$$\text{Net Return: } A_t - A_0 = R - SC - TF$$

$$\text{Sales Commission: } SC = A_0 \times S\%$$

$$\text{Trust Fee*}: TF = (A_0 - SC + R) \times T\%$$

*Trust fee is comprised of an asset management fee, trailers fee and custodian fee.

Where:

A_0 = Initial investment

A_t = Balance at time t

R = Gross return

SC = Sales commission

TF = Trust fee*

$S\%$ = Sales commission ratio

$T\%$ = Trust fee ratio

- - Sales commissions and trust fees are always positive.
- If R is negative or less than $SC + TF$, $A_t - A_0$, the net return, is negative.

Investment managers and distributors receive fees and commissions even if their customers suffer losses.

Proposed Fees to Align the Interests between Investors and Managers / Distributors

- Fees based on the performance compared to benchmark already exists in Japan as an effort to align the interests of investors and financial institutions.
- However, these do not penalize poor performance and are not fulcrum.
- IOSCO once pointed out that “a performance fee should theoretically be calculated for each single investor, based on his date of entry into the fund.*”

Based on these, fees charged as follows for each investor would be fairer:

$$SC = \bar{C} + R \times SC\%$$

$$TF = \bar{C} + R \times TF\%$$

Note:

\bar{C} = Fixed fee for infrastructure and personnel expenses

By the performance fee based on the return targeted by investors, the goals of the both investors and managers / distributors become aligned.

Continue to Pursue the Best Interest of Investors

- In the current fee structure of investment trusts, only investors face the potential for negative returns, while investment managers and distributors always gain profits.
- A fee structure allowing loss sharing deters excessive risk taking aimed at earning excess fees.
- While distributors do not contribute to returns of funds, they should select better funds, incentivized by the fee structure linked to returns of investors.
- Constructing a fair and feasible fee structure is challenging but achieving it can demonstrate that financial institutions prioritize the best interest of investors and lead to trust in the excess returns of active funds.

When realizing the best interest of investors, it is inevitable to take account of a fee structure that harmonizes interests of investors and managers/distributors.

We welcome your comments on promoting sound investments!

For further information, please visit the following URL: <https://www.toushin.or.jp/statistics/Tsumiken/reports-r/> to view Report No. 17.

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