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MONEY MANAGEMENT

Fidelity fires major shot in war over fees

Giant manager dramatically reducing costs to investors in host of index funds

BY CHRISTINE WILLIAMSON · AUGUST 20, 2018

Fidelity Investments loosed the latest weapon in the long-running price war among passive managers — two free mutual funds — but sources said the better news for institutional investors is a dramatic reduction in fees for 21 of the firm's indexed mutual funds.

The Boston-based manager launched Fidelity ZERO Total Market Index Fund and a companion international version of the self-indexed fund on Aug. 3.

Fidelity's two new equity funds, managed with internally developed indexes, are only available to Fidelity retail brokerage account clients and do not require an investment minimum, the company said in an Aug. 1 announcement.

The move is strictly a retail play: Fidelity said it has no plans to offer zero-cost indexed mutual funds to institutional investors.

But institutional investors got a significant pricing break, sources stressed. Fidelity eliminated investment minimums and multiple-share classes for its stock- and bond-indexed mutual funds, effective Aug. 1, the company said.

The result is that all investors in the funds, regardless of the size of their investment, now are in the same lowest-cost share class.

Investment minimums also were abolished for all Fidelity mutual funds and 529 college savings plans.

Fidelity managed a total of $2.6 trillion as of June 30, of which 17% was managed in passive strategies with $402 billion run in indexed mutual funds, $26.5 billion in indexed target-date mutual funds, $8.5 billion in indexed target-date institutional commingled pools and $11 billion in passively managed exchange-traded funds. The balance of Fidelity's assets is actively managed.

Collapsing the former four-share class structure to one low-cost share class reduces the average asset-weighted annual expense across Fidelity's passively managed mutual funds by 35%, with an expense ratio as low as 0.015% for some funds, Fidelity said in its announcement.

"This is a seminal point in the industry. I never thought I would see such low-fee levels for mutual funds in my lifetime," said James T. O'Shaughnessy, managing partner of investment consultant Sheridan Road Financial LLC, Northbrook, Ill.

"An index fund food fight has been going on for the past few years and pricing has been completely leveled," Mr. O'Shaughnessy said, noting that pricing for investment in indexed mutual funds by small defined contribution plans and even startup plans over that past two to three years is much closer to that for much larger defined contribution plans.

'Levels the pricing'

The new pricing structure "levels the pricing between retail and institutional investors and between institutional investors of different sizes. There now is one price for large and small institutional investors," as well as for retail investors, said Scott O'Reilly, Fidelity's head of index funds, ETFs, sector and international product.

Fidelity's new index fund pricing could be a game changer for institutional investors, particularly for small- and midsized defined contribution plans, observers said.

"The biggest thing about Fidelity collapsing its index fund share classes is that it's going to drive some pretty big savings for defined contribution plans. It's a pretty big deal and important news for the industry," said Michael Francis, principal, president and chief investment officer of defined contribution specialist consulting firm Francis Investment Counsel LLC, Brookfield, Wis.

"With Fidelity's repricing and the elimination of investment minimums, DC plans will be getting a great deal," Mr. Francis said, noting that "there all kinds of fee breaks that small- and middle-sized plans with between say, $50 million and $100 million, aren't eligible for."

Shortly after Fidelity's announcement, Mr. Francis said he met with the administrator of one of the firm's clients, which has an $800 million defined contribution plan for which Fidelity is the record keeper, who asked about Fidelity's new indexed mutual fund pricing structure. He calculated that the client, which he declined to identify, could potentially save hundreds of thousands of dollars a year in fees for plan participants under Fidelity's new lower-cost index mutual fund pricing.

Discussion of Fidelity's new index fund pricing will be on the agendas for forthcoming quarterly meetings with the firm's DC plan clients, Mr. Francis said.

An ongoing skirmish

Fidelity's moves are the latest salvo in money managers' battle for assets in the face of the ongoing shift to passive strategies from active management, said Amanda Walters, a New York-based senior manager at money management consultant Casey Quirk, a practice of Deloitte Consulting LLP.

Ms. Walters said fee compression remains widespread in the money management industry and that many managers, like Fidelity, are getting creative about the pricing of their strategies.

"Our conversations with money managers lead with the passive vs. active investment dilemma and quickly turn to the cost of investment strategies," Ms. Walters said, noting that managers also are looking to "get clients in the door and try to persuade them to invest more in other strategies the firm offers, particularly higher-fee actively managed strategies and alternative investments."

Industry watchers said Fidelity's move to offer no-cost indexed retail mutual funds, low-cost passively managed mutual funds and collective investment trusts clearly is an effort to increase assets under management from investors of all kinds.

Fitch Ratings Inc. said in a news release that Fidelity's zero-fee mutual funds are "clearly intended to grow (or defend) its assets under management," adding "Fidelity is predominantly an active fund manager. The introduction of the zero-fee funds and the fee cut to other passive funds may help it more quickly increase passive market share relative to larger passive-fund platforms such as BlackRock (BLK) (Inc.) and Vanguard (Group Inc.) Fidelity's diversified business model, including wealth management and brokerage activities, may help reduce the impact of foregone management fee revenue."

Room to grow

With $448 billion in assets managed passively in all vehicles as of June 30, Fidelity has some room to grow to catch up with the money management industry's largest passive managers.

As of June 30, BlackRock (BLK) was the largest passive manager with $4.2 trillion, followed by Vanguard Group with $3.8 trillion; State Street Global Advisors, $2.2 trillion; and Northern Trust Asset Management, $577 billion, according to information provided by the firms.

Fidelity said in its Aug. 1 news release about its passive fund changes that the company will lose about $47 million in indexed mutual fund fees annually from the pricing change.

When asked in an interview how Fidelity will make up that lost index fund revenue, Mr. O'Reilly replied: "Fidelity is a large organization that increasingly is using its scale to lower costs for investors," adding that "being a privately held company allows us to do things like this."

Reaction to Fidelity's efforts to offer free and lower-cost indexed strategies from the firm's biggest competitors was sanguine.

Martha King, managing director and head of Vanguard's institutional investor group, said in an email, "Vanguard is the long-time champion of low-cost investing. Our commitment to low costs is not — and has never been — a marketing ploy. Our client-owned structure is unmatched in the industry, and enables us to lower costs across all products and for all investors — index and active, and across all share classes. And, if that drives lower costs across the industry, we see it as a win for investors everywhere."

Malvern, Pa.-based Vanguard managed a total of $5.1 trillion as of June 30, of which 75% is passively managed.

BlackRock spokesman Edward Sweeney said, "We use the scale of our platform to create efficiencies within our business that in turn allows us to deliver value for our clients," in an email.

New York-based BlackRock managed a total of $6.3 trillion as of June 30, of which 66% is managed in passive strategies.

SSGA is "constantly reviewing" its pricing structure and is careful to measure how its prices and services compare to competitors, said Scott Ebner in an interview, adding that the conversation about passive strategies "has been the same for a decade. The pressure comes down to price."

Mr. Ebner is a senior managing director and head of product in the Boston-based firm's global institutional group. As of June 30, SSGA managed a total of $2.7 trillion, 81% of which was managed in indexed strategies.