# Foundations for Fund Directors: In-Person Session

## CASE STUDIES

### Case Study #1: Frostmark New Jersey Bond Fund

Frostmark is a $10 billion mutual fund complex, specializing in taxable and tax-exempt bond funds. All Frostmark funds share the same board of trustees. Management has decided it can no longer sustain the 15-basis-point fee waiver for its $300 million Frostmark New Jersey Bond Fund (the “Fund”). Performance for the Fund has been strong, finishing in the top half of its peer group for the 1-, 3-, and 5-year horizons. Total expense ratio for the Fund is 60 bp, inclusive of the waiver. In management’s opinion, eliminating the waiver would make the Fund noncompetitive and not viable economically. Management does not want to liquidate the Fund and lose the assets under management.

Management has proposed merging the Fund into its $2 billion Frostmark National Municipal Fund. The national fund’s total expense ratio is 65 bp. The performance of the national fund has been slightly below the median of its peer group for the 1- and 3-year horizons, but above the median at longer horizons. If the funds were merged, the Fund shareholders would lose the ability to offset all investment income from New Jersey income tax. The top marginal tax rate in New Jersey is 8.97%.

In its presentation to the board, management said these small disadvantages would be more than made up by the greater diversification of the national fund arising from its investments in municipal bonds issued by a large number of states. Although the fee level of the national fund is expected to stay the same, its pro forma distribution rate (dividends paid to shareholders) and total return would initially decline due to the higher average credit quality of the New Jersey municipal bonds it would absorb, their associated lower interest rates and their lower duration.

Also, the national fund shareholders, including the new ones from the merger, would incur some onetime expenses as the portfolio manager liquidates most, if not all, of the newly acquired New Jersey bonds to restore the national fund to its previous mix by state, quality, and duration. Lastly, management's proposal assumes that the New Jersey and national muni funds would each pay proportionate shares of the out-of-pocket expenses required to consummate the merger (e.g., various legal expenses and the shareholder proxies).

Management has convened a meeting of the Fund trustees to consider and vote on management's merger proposal.

» As a Fund trustee are you comfortable with management's merger proposal? Why or why not?

» What do you anticipate saying to management at the meeting when asked your opinion of the merger?

» Is there other information you would want to receive from management before voting on the proposal?

» How will you vote on the proposal?

## Case Study #2: Approval of the Advisory Contract

The annual contract approval process is under way, and you are evaluating the performance of Green Tree Fund (GRTRX). GRTRX is a top performing mutual fund in the Forest Fund Complex. It seeks capital appreciation and investment income. It was first offered to the public on January 2, 2017 with $10 million of seed capital provided by the adviser. The particular strategy being used had been developed and tested with several million dollars for a number of years. The portfolio management approach uses proprietary quantitative models and fundamental research provided by the adviser's research team and outside vendors.

The new fund's performance was excellent relative to its benchmark, as well as its peer group, throughout its first year and has continued to be through the present. When the board of directors was asked to approve the new fund in 2016, the special investment process with its quantitative tools was discussed in detail as were the historical results with the several million dollars of the adviser's initial seed capital. In its approval, the board considered the overall advisory fees relative to other funds in the Forest Fund Complex, as well as peer funds with the same or very similar investment objectives and benchmarks. It accepted a slightly higher contractual fee than the peer group median due to the special process and associated resources being utilized for this fund.

The board also asked the adviser to subsidize the fund so that total fees did not exceed a certain level, which was also slightly above the peer group median. Due to its excellent investment performance and a major marketing effort by the adviser, the fund has experienced exponential growth and at the end of 2019 had over $1 billion in assets. The adviser's subsidy was able to be discontinued in the third quarter of 2019 due to this growth.

In addition, its prospects for continued growth are very high since, with its third anniversary, it is now eligible to go onto platforms of the major brokerage firms.

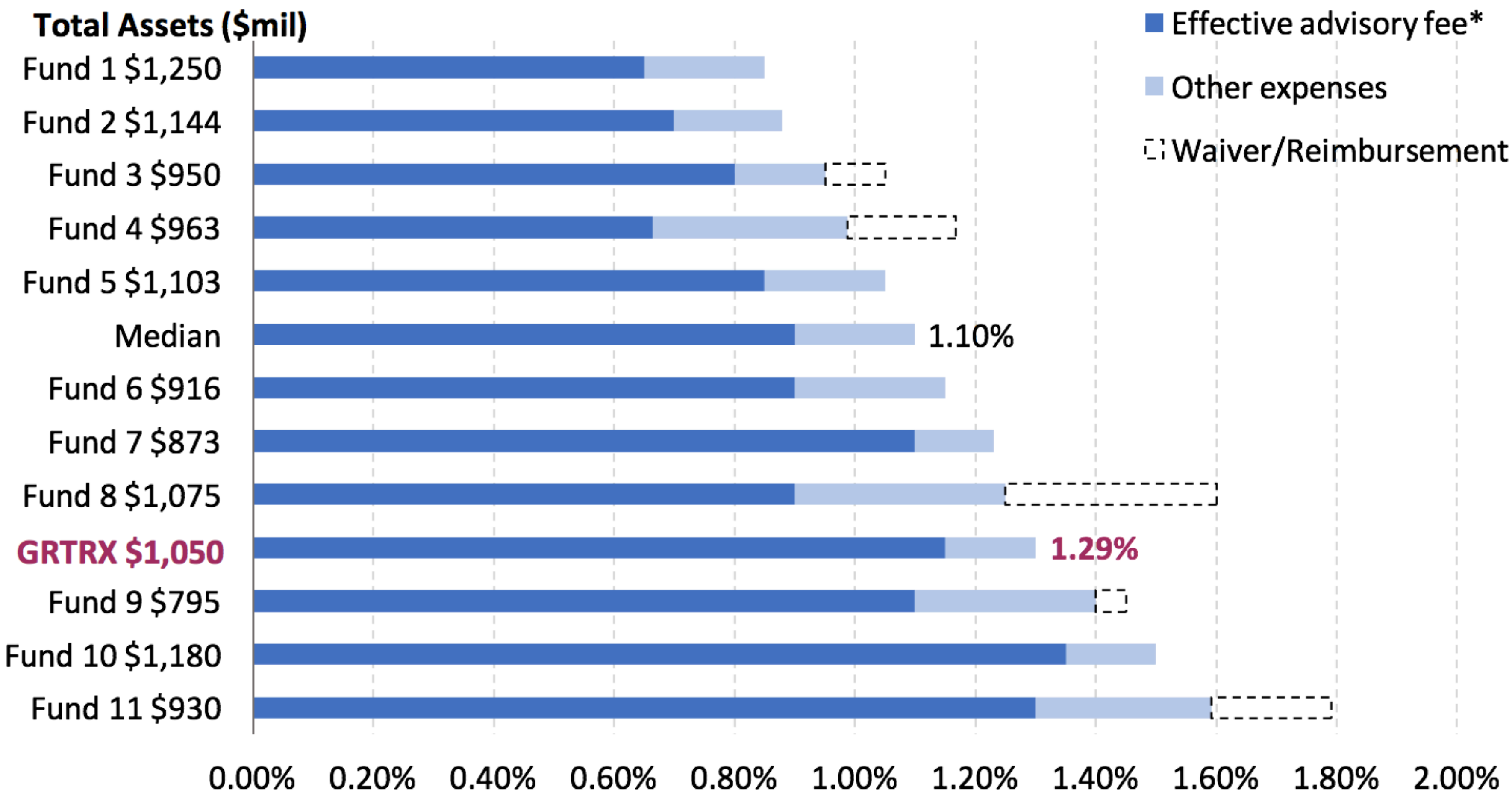
Review the attached charts, which compare the fund's fees and expenses to a peer group consisting of funds with the same or very similar investment objectives and benchmark and of a similar size. Also, note in the second chart that some funds in the peer group have breakpoints.

Consider the following in your discussion:

- In light of the significant increase in assets and strong prospects for growth, should the board consider negotiating for a reduction in the advisory fee at this time?
- If so, what type of a fee reduction might the board consider?
- What are some reasons the adviser might have for wanting to maintain the current advisory fee?
- What additional information would you want the adviser to provide to help you evaluate the appropriateness of a breakpoint or other form of fee reduction?

## ACTUAL TOTAL EXPENSES

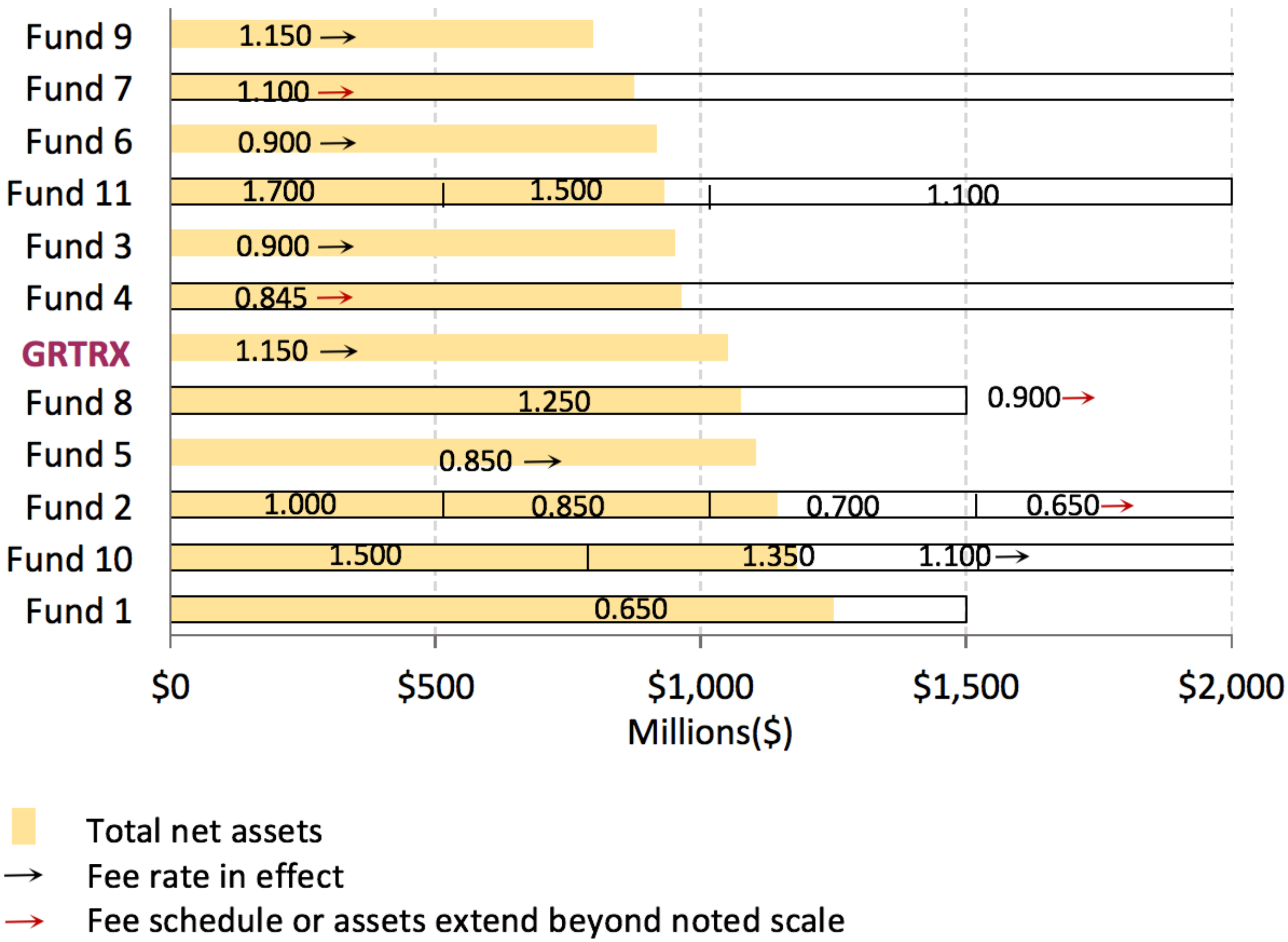
Expense Group




**Contractual advisory fee minus any waived/reimbursed expenses*

## CONTRACTUAL ADVISORY FEES

Expense Group




| Advisory fee at $1,000 million |
|---|
| 1.150% |
| 1.100% |
| 0.900% |
| 1.500% |
| 0.900% |
| 0.845% |
| 1.150% |
| 1.250% |
| 0.850% |
| 0.850% |
| 1.350% |
| 0.650% |

## Case Study #3: Minimac Alternative Investments Fund

Minimac Funds is a $50 billion fund complex of 22 open-end mutual funds. The investment team focuses on active management across a range of strategies, including US equity, non-US equity, and fixed income. The adviser wants to move into the alternative funds space, and is proposing to launch the Minimac Alternative Investments Fund. Many of Minimac Funds' competitors have launched similar funds in recent years and have seen significant inflows to those funds. The adviser wants to launch this new fund now to take advantage of the marketplace's strong interest in these types of products.

The Minimac Alternative Investments Fund would invest in equity securities, including those from frontier markets, and use put and call index options to manage the fund's equity exposure, acquiring downside protection with put options and generating income with call options. The adviser proposes to implement its strategy using a computer model it has developed for this purpose.

To evaluate the efficacy of the strategy, the adviser seeded the new fund with $8 million of the firm's capital to follow the strategy for the last year. The one-year actual record beat the benchmark by 100 basis points and exceeded the peer group median by 50 basis points (after assuming expenses equal to those of the peer group). The adviser also conducted back testing of its computer model using 10 years of historical market data. The 10-year historic back test beat the benchmark by 75 basis points.

Although the investment team has not managed a Minimac Fund with this investment strategy before, two portfolio managers have previously managed mutual funds using a similar strategy at other fund complexes. Management feels that members of the portfolio management team are highly educated and knowledgeable about all aspects of the capital markets.

Board considerations.

- » What questions would you have for the adviser? What additional information would you want?
- » Should the board approve the product at this time? Should there be any conditions to the approval?
- » If the board should not approve the product at this time, why not?

## Case Study #4: Risk Oversight

The fund's adviser (Enterprise) has notified the board of a significant incident that has affected the ability of certain funds to timely calculate their NAVs.

During a special meeting, Enterprise informed the board that the fund's administrator (August Administrative Services, a service provider unaffiliated with Enterprise) relies on another company's (September Company) software platform to calculate daily NAVs for the Forest Funds and many other fund complexes. Following September Company's routine maintenance of its software platform, a technical glitch arose that has prevented August Administrative Services from being able to rely on it to calculate NAVs. As a result, August Administrative Services has calculated the NAVs for each of the funds manually. The incident has resulted in late delivery of NAVs to normal recipients and late processing of sales and redemptions. It is not known for how long September Company's software platform will be unavailable.

Consider the following in your discussion:

- What questions or considerations might the board raise to understand the problem and the short-term steps to take?
- What processes might the board consider employing to stay informed and engaged during the risk event?
- After the immediate crisis is resolved, what questions might the board ask to learn about the impact of the risk event and the steps that could be taken to reduce the impact of such an event in the future?