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FEE WAR

Fidelity Breaks New Ground With Zero-Cost Index Funds

Challenges competitors on other fronts, too—zero minimums and fees!

It's not exactly the shot heard round the world. But it was a salvo fired from Boston aimed squarely at its fund competitors near and far.



John Bonnanzio

Specifically, Fidelity's broad assault on competitors BlackRock, Schwab, Vanguard and anyone else hawking an index fund, took several forms. The most obvious was its rollout of two new zero-cost index funds. Used, in part, as a marketing tool to get fee-averse investors through the front door, **Zero Total Market Index** [ticker: FZROX] is a U.S. stock fund offering equity exposure to about 2,500 companies. Called a self-indexed fund, it uses a proprietary benchmark — constructed by Fidelity exclusively for Fidelity funds. In this way, Fidelity avoids paying a fee to index firms like S&P, Russell and other builders of benchmarks.

At the same time, Fidelity has also introduced **Zero International Index** [ticker: FZILX]. Again, a proprietary index has been developed for its use. As such, both it and its domestic counterpart are available to investors

for free — meaning there's no management fee and no fund expenses borne by either funds' shareholders. Of course, if you're wondering how Fidelity can make money on such an enterprise, it can't: back-office accounting and booking services are clearly expenses that Fidelity is willing to absorb.

There are several reasons why they'd do so. First, is that they are counting on bringing new investors to the company. And, once through the door, Fidelity is hoping that their suite of higher-margin, actively run funds will catch their attention.

If that weren't enough, as a true supermarket of financial services (and one with a highly robust web interface and nearly 200 Investor Centers for face-to-face contact), they have the confidence that their business model is simply superior. If nothing else, while some of their publicly owned competitors like BlackRock, Schwab and T. Rowe Price must answer quarterly to their shareholders, privately owned Fidelity does not. In theory, it can take its time building a new business model.

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CORPORATE CULTURE

Why Fidelity Took Its Time Indexing

It's hardly a secret that Fidelity missed the boat with respect to the wave (craze?) of index-fund investing that has swept the country. After all, why would one of the world's most successful fund companies have any interest in building a low-margin business that would eat away at the juicier earnings provided by their actively managed funds?



Abigail Johnson

And, of course, why would a company that built itself into the colossus that it is thanks to its legacy of investment icons ranging from **Magellan's** Peter Lynch to today's legendary managers (**Contrafund's** Will Danoff, **Growth Company's** Steve Wymer and **Low-Priced Stock's** Joel Tillinghast), want to risk tampering with that culture of achievement?

The answer, of course, is that markets change, and that both types of investing (passive and active) can peacefully coexist inside the same company.

In retrospect, Fidelity should have gotten into the index business in a far bigger way (and far sooner)

simply because that's what their customers want. Doing otherwise was akin to a supermarket not carrying milk because they can't make any money on the product.

However, former Fidelity Chair Ned Johnson reportedly understood the supermarket concept because he expanded his company into almost every area of the money management business. Innovation, along with shrewd stock picking, has also been central to the company's success. From check-writing on your money market fund to checking the value of your cybercurrency in a third-party's account, Fidelity has often been

Fidelity Culture *cont'd on p. 3*

Fidelity's New Fees Lower Than Comparable Vanguard Funds

| Fidelity Funds (ticker) | | Vanguard Funds | | Fid. Exp. Advantage |
|---------------------------------------|---------------|----------------|---------------|---------------------|
| | Exp Ratio (%) | | Exp Ratio (%) | |
| Domestic Stock | | | | |
| 500 Index | | | | |
| Investor Class (FUSEX) | 0.015 | Investor | 0.14 | 0.125 |
| Premium Class (FUSVX) | 0.015 | Admiral | 0.04 | 0.025 |
| Extended Market Index | | | | |
| Investor Class (FSEMXX) | 0.045 | Investor | 0.21 | 0.165 |
| Premium Class (FSEVXX) | 0.045 | Admiral | 0.08 | 0.035 |
| Mid Cap Index | | | | |
| Investor Class (FSCLXX) | 0.025 | Investor | 0.17 | 0.145 |
| Premium Class (FSCKXX) | 0.025 | Admiral | 0.05 | 0.025 |
| Small Cap Index | | | | |
| Investor Class (FSSPXX) | 0.025 | Investor | 0.17 | 0.145 |
| Premium Class (FSSVXX) | 0.025 | Admiral | 0.05 | 0.025 |
| Total Market Index | | | | |
| Investor Class (FSTMXX) | 0.015 | Investor | 0.14 | 0.125 |
| Premium Class (FSTVXX) | 0.015 | Admiral | 0.04 | 0.025 |
| Nasdaq Comp Index (FNCMXX) | | | | |
| | 0.300 | NA | NA | NA |
| Large Cap Growth Index | | | | |
| Investor Class (FSUIXX) | 0.035 | Investor | 0.17 | 0.135 |
| Premium Class (FSUPXX) | 0.035 | Admiral | 0.05 | 0.015 |
| Large Cap Value Index | | | | |
| Investor Class (FLCDXX) | 0.035 | Investor | 0.17 | 0.135 |
| Premium Class (FLCHXX) | 0.035 | Admiral | 0.05 | 0.015 |
| International Stock | | | | |
| International Index | | | | |
| Investor Class (FSIIX) | 0.045 | Investor | 0.17 | 0.125 |
| Premium Class (FSIVXX) | 0.045 | Admiral | 0.07 | 0.025 |
| Global ex US Index | | | | |
| Investor Class (FSGUX) | 0.060 | Investor | 0.23 | 0.170 |
| Premium Class (FSGDXX) | 0.060 | Admiral | 0.11 | 0.050 |
| Emerging Markets Index | | | | |
| Investor Class (FPENXX) | 0.080 | Investor | 0.32 | 0.240 |
| Premium Class (FPMAX) | 0.080 | Admiral | 0.14 | 0.060 |
| Total International Index | | | | |
| Investor Class (FTIGXX) | 0.060 | Investor | 0.17 | 0.110 |
| Premium Class (FTIPXX) | 0.060 | Admiral | 0.11 | 0.050 |
| Specialty | | | | |
| Real Estate Index | | | | |
| Investor Class (FRXIX) | 0.070 | Investor | 0.26 | 0.190 |
| Premium Class (FSRVXX) | 0.070 | Admiral | 0.12 | 0.050 |
| Bond | | | | |
| Inflation-Protected Bond Index | | | | |
| Investor Class (FSIQXX) | 0.050 | Investor | 0.20 | 0.150 |
| Premium Class (FSIYXX) | 0.050 | | | |
| Intermediate Treasury Bond | | | | |
| Investor Class (FIBIX) | 0.030 | | | |
| Premium Class (FIBAX) | 0.030 | Admiral | 0.07 | 0.040 |
| Long-Term Treasury Bond Index | | | | |
| Investor Class (FLBIX) | 0.030 | | | |
| Premium Class (FLBAX) | 0.030 | Admiral | 0.07 | 0.040 |
| Short-Term Bond Index | | | | |
| Investor Class (FNSJXX) | 0.030 | Investor | 0.15 | 0.120 |
| Premium Class (FNSKXX) | 0.030 | Admiral | 0.07 | 0.040 |
| Short-Term Treasury Bond Index | | | | |
| Investor Class (FSBIX) | 0.030 | | | |
| Premium Class (FSBAX) | 0.030 | Admiral | 0.07 | 0.040 |
| U.S. Bond Index | | | | |
| Investor Class (FBIDX) | 0.025 | Investor | 0.15 | 0.125 |
| Premium Class (FSITXX) | 0.025 | Admiral | 0.05 | 0.025 |
| U.S. Sustainable Index | | | | |
| Investor Class (FENSXX) | 0.110 | Investor | 0.20 | 0.090 |
| Premium Class (FPNSXX) | 0.110 | | | |

Fidelity Is Challenging Vanguard On More Than Just Expenses, Too

Whereas Fidelity and Vanguard have been jostling for years for bragging rights as to the true low-cost provider of index funds (see facing table), with Fidelity cutting fund minimums to zero from \$2,500 for its Investor shares classes, Vanguard now has some catching up to do on a second front, too.

Not only must it further reduce fund expenses, if it wants to remain as accessible to smaller investors, their \$3,000 Investor share minimum must also fall to zero. In addition, with Fidelity soon eliminating all its other share classes for larger investors, Vanguard's \$10,000 minimum on its Admiral shares, and their multi-million-dollar minimums for their institutional share classes, may also be on the chopping block. ■

Fee War *cont'd from p. 1*

Zero Expenses + Zero Fees

While the launch of two new, fee-free proprietary index funds may be “groundbreaking,” as Fidelity claims it is, the more important development is their decision to drop to zero as many as six other expenses and possible impediments to fund investing.

The first big change is that their tiered share classes of funds will disappear. In so doing, a new level field has emerged whereby the “mom and pop” investor with just a

few hundred dollars to put in the retirement plan is now being charged the same as a pension fund or insurance company with tens of millions to invest! As such, the two most widely used share classes by Fidelity’s retail investors (the Investor and Premium classes) have seen their expense ratios reduced to the Institutional share class level.

Other “zeroes” Fidelity is trumpeting include no minimum investment amounts to open accounts, zero account fees, no charges for domestic money transfers, and zero investment minimums on Fidelity’s

retail and advisor-sold funds, plus 529 plans.

Says Fidelity of its decision to confront the fund industry generally, and the index community in particular: “We are charting a new course ... that benefits investors of all ages — from millennials to baby boomers — and at all affluence levels and stages of their lives,” said Kathleen Murphy, president of Fidelity’s personal investing business. In their totality, she says, the company’s moves will “never have to compromise on great value or comprehensive service.” ■

| Fee Comparisons | | | |
|--|----------|--------------------------|---|
| Minimums/Fees | Fidelity | Schwab | Vanguard ¹ |
| Minimum Initial Investment | \$0 | \$1,000 | \$0 |
| Account Service Fee | \$0 | \$0 | \$0 |
| Proprietary Retail Mutual Fund Investment Minimums | \$0 | 100 ² | \$1,000 - \$3,000 Investor Shares \$10,000 - \$100,000 Admiral Shares |
| Funds Low Balance Fee | \$0 | \$0 | \$20 per year ³ |
| IRA Closeout Fee | \$0 | \$0 | \$0 |
| Account Transfer Out | \$0 | Full: \$50 Partial: \$25 | \$0 |
| Reorganization Fee | \$0 | \$39 | \$0 |
| Late Settlement Fee | \$0 | \$25 | \$0 |
| Bank Wire | \$0 | \$25 | \$10 |
| Insufficient Funds | \$0 | \$25 | \$20 |
| Stop Payment | \$0 | \$0 | \$15 |
| Bill Payment | \$0 | \$0 | \$4.95 per month ⁴ |
| Account ATM Fee | \$0 | \$0 | \$0 |

¹Certain waivers may apply; ²\$0 on Schwab's index funds; ³On balances under \$10K; ⁴Requires \$500k in Vanguard assets.

Fidelity Culture *cont'd from p. 1*

the first and the best in offering services and products that their customers want — or may not even know that they want or need!

But the days of dilly-dallying — at least with respect to indexing — are clearly over for Fidelity. And a good thing, too. For better or for worse, with trillions of dollars now invested in index funds, Fidelity’s Chairman, Abby Johnson, has jumped into indexing with both feet.

Knowing that such a move requires the company to scale-up in a big way, she’s removed all the

marketing impediments.

While Fidelity has, in their words, “unleashed the power of free,” they have actually been paving the way for this change for some time by strengthening its lineup of index-type funds with “Enhanced” funds, and by expanding their index offerings with socially conscious funds, and a short-term bond index offering.

That’s all in addition to their recent rollouts of low-cost equity offerings including **Large Cap Growth Index** and **Large Cap Value Index**. This year they’ve also introduced two more Factor ETFs (**High Yield Factor** and **Low Dura-**

tion Bond Factor) thereby increasing to 10 its lineup of so-called smart beta funds.

But the most significant move was Fidelity’s decision to take direct aim at longtime rival Vanguard. It did so by slashing fund expenses on several occasions to the point where its index funds are now cheaper than Vanguard’s (see table on page 2). Those earlier moves, coupled with their new zero-expense funds, clearly signals that, under Abby Johnson, the 72-year-old company’s culture — along with its competitive spirit — is being refreshed. ■

— John Bonnanzio