

Fast Flippers

Issue: Investors and reps cannot quantify how B-to-A conversion terms (or “flips”) affect share class choice.

Background: This esoteric pricing feature has a major impact on share class choice. When B-shares convert to A’s, the B’s expense ratio drops sharply, often by 0.75%. The drop reflects the differential in 12b-1 fees, which are often 0.25% and 1% for A’s and B’s. Fund firms use 12b-1s to recoup a rep’s fronted commission on a B-share sale.

Short flips benefit B-share investors as returns improve sooner. If B-shares outperform until a flip, they do so forever, as expenses then are equalized. A-shares may not have enough time to overcome the impact of a sales load. Higher loads are worse for A’s, all else equal. Typical flip terms occur on day one of year seven or nine. Flips differ among funds and fund families. Since it has no bearing on risk, investors should favor funds with a short flip term.

Result: Investors reap higher returns without more risk. The odds improve that they select the right share class.

Example. An investor considers two funds: X and Y. All else is equal except for the flip term. He analyzes a \$20,000 trade and one at \$90,000. He’ll buy the fund that’s projected to grow the most by year ten.

B-shares of Funds X and Y flip on day one of years 7 and 9. For both funds, expense ratios for A- and B-shares are 1.25% and 2%. A-share loads are 5.75% to \$24,999, 5.25% to \$49,999, and 4.75% to \$99,999. CDSCs are ignored per the long horizon. Pre-expense returns of 8%/yr and -8%/yr are tested.

Results. The fund with the shortest flip wins, regardless of return or invested amount (under \$100,000). Results reflect 8% returns to year 10. Fund X (denoted X, 7) has a short B-to-A flip term. Fund Y (Y, 9) has a long one.

At \$20,000, B-shares always beat A-shares. X’s B-share wins by \$541 (\$36,483 to \$35,942). Y’s B-share wins by \$6 (\$35,948 to \$35,942) as it flips later. (1st image.) At \$90,000, though a 2nd breakpoint is hit, X’s B-share still wins. In contrast, Fund Y’s A-share wins by \$1,687 as its flip is later and two breakpoints are hit. (2nd image.)

The investor picks Fund X's B-share & invests \$90,000. It beat Fund Y’s A-share, though Y hit two breakpoints!

