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Mutual Fund Share Classes
Conflicting Messages, Competing Interests

by Stuart J. Speckman

The significant role of mutual funds in the world financial markets is undisputed. Per the Investment Company Institute (ICI), these funds now manage over $12 trillion in assets for 90 million investors.[1]

The importance of mutual funds is underscored by the fact that households are the largest group of investors. These investors have a dazzling array of funds from which to choose. Competition is intense for their assets. Nearly 700 firms compete in the U.S.[2]

Many retail investors rely on a financial advisor to identify promising opportunities. When that advice involves the selection not only of a fund, but also a share class, a conflict of interest may exist. An adviser may have a financial incentive to recommend one class over another. In fact, ***three*** NY Times articles,[3] a book,[4] and white paper[5] recently were published that concern various types of mutual fund conflicts-of-interest.

With respect to two of the NY Times articles, the overall claim is that conflicts encourage the sale of unsuitable share classes. The oft-maligned B- and C-shares are, for most investors, the best share class. However, conflicts of interest encourage the sale of less suitable A-shares. That specific claim is the focus of this paper.

The problem is most acute for load-paying equity fund investors with under $50,000 at one fund firm. To varying degrees, all load fund firms are affected. No load firms aren't really affected.

Conflicts-of-interest actually go fairly deep. They exist at the:

- Financial adviser level. Advisers often receive very different commission payments for each share class. The differences may encourage the sale of an unsuitable share class.
- B roker-dealer ("B-D") level. Like advisers, they receive very different revenue streams. It can appear that B-Ds encourage the sale of less-suitable shares in order to maximize revenue.
- Fund firm level. Profits are far higher for some shares than others. If the most profitable share differs for the firm and investor, prospectuses should disclose it in order to avoid appearances of impropriety.

For perspective, buying the wrong share causes losses that are at least five times larger than those due to late trading or market timing activities. Aggregate losses for those activities were large. For the issue at hand, they are far larger.

First, we will review how the situation got to this point. We start with the development of the share class structure. We then review past problems that related, in part, to conflicts of interest. Last, we will review the math of sample trades and evaluate the conflicts individually. We will look at the exact trade mentioned in the NY Times articles.

More Choices and More Complexity

Prior to 1980, investor choices were limited to "load" and "no load" mutual funds. Financial firms selling load funds, which featured a front-end sales charge, received of a portion of that charge as compensation. Investors understood that the amount of a sales charge depended on the amount invested and would be deducted at the time of sale.

Two developments had a major impact on compensation. In 1980, Rule 12b-1, permitted a fund to bear expenses in connection to the distribution of its shares.[6] Later, Rule 18f-3 was adopted in 1995.[7] Inadvertently, the rules increased the complexity of compensation arrangements. Funds could now offer shares with different pricing structures.

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Today, investors clearly could benefit from a better understanding of their choices. In a book published earlier this year, Professor Louis Lowenstein of Columbia University pointed to Rule 18f-3, noting that "the level of complexity [inherent in the multiple class structure] defies almost any description."[8] In a recent New York Times article, Gretchen Morgenson observed that investors who buy load mutual funds must sort through a "dizzying list of share classes with a variety of fees."[9] Barbara Roper, Director of Investor Protection at the Consumer Federation of America, commented that "it is absolutely bewildering to try to figure this stuff out."[10]

Following are descriptions of the typical attributes of the most common retail share classes.[11]

• A-shares have a "front-end" sales charge (deducted at the time of purchase). It declines as the size of the investment increases and "breakpoints" are achieved. Typically, 5.75% is the maximum charge. These breakpoint discounts are specific to each fund. In general, A-shares are marketed as a long-term investment choice.

• B-shares have a "back-end" or contingent deferred sales charge (CDSC) of up to 5%. Often it declines to zero over six or less years. If shares are redeemed early, unless waived, a CDSC is assessed according to the methodology established by that fund. B-shares have higher ongoing expenses than A-shares but may convert to A-shares if held for six to eight years.[12] B-shares are marketed as a mid-term to long-term investment.

• C-shares have a 1% CDSC that expires after one year. Like B-shares, C-shares have higher expenses than A-shares. Unlike B-shares, C's do not convert to a lower cost share. So, C-shares are marketed as a short-to-mid-term choice.

Perspective on Investor Losses

A few years ago, high profile regulatory actions related to market timing and late-trading. While aggregate losses were large, per-investor losses were small. The evidence – albeit anecdotal – suggests that "harm" was roughly 0.10% per year. On a $40,000 trade, about $40 in account value was lost per year.

Other actions related to shelf-space arrangements. Fund firms paid, of its own assets, 0.10% to 0.25%/yr of assets held at a B-D in order to make a so-called "Preferred List." The B-D encouraged the sale of funds from that firm without properly disclosing the "pay-to-play" arrangement. The B-Ds' financial advisers were held-out as being impartial with respect to their mutual fund recommendations. Ostensibly, investors were receiving unbiased advice.

While conflicts of interest existed, quantifying a loss is hard. This author has seen no reliable estimate of direct, causative harm. Also, "biased" is not synonymous with "unsuitable." Math-wise, nothing precludes a biased recommendation from being beneficial to investors. If investors bought funds from firms that were not on a preferred list, returns would not necessarily have been higher.

If a conflict encourages the sale of an unsuitable fund or share class, that's a different story. It's the focus from here.

Problem for Investors Defined

Load fund investors often choose the wrong share class, which causes account values to be unnecessarily low. They select too many A-shares when B- or C-shares would be best for any holding period. The problem is systemic and includes trades from most major load fund families.

The best share is the one that generates the highest account value. It is not necessarily the least expensive share class. There are myriad examples of a share class being most expensive and best performing, odd as that seems. Simply, cost is no proxy for account value. For low cost to equal highest value, all else must be equal. For load funds, it's not equal. B-shares convert, but not A's. A-shares have a breakpoint schedule, but not B's.

Consider the Times' example of $40,000 in the $18 billion Lord Abbett Affiliated Fund – a fine fund from a fine firm. After 5 years at 8%/yr, account values for A-, B-, and C-shares are $53,230, $54,292, and $54,692.[13] The C- to A-share differential is $1,462, or roughly 3.65% of the initial $40,000 investment. That loss is about 0.70%/yr – ***seven times the estimated harm due to late trading.*** The B- to A-share differential is $1,062, or 2.65% of the initial investment. That loss is about 0.50%/yr – ***about five times the late trading harm.***

We will use this trade size throughout the paper since it was used by the NY Times. However, we are concerned with all trades below $50,000 at one fund firm, which covers most investors, per the ICI.[14]

Some studies suggest that the issue is of little consequence. One claims that sales of loaded A-shares are below 10% of all load trades[15] Thus, we should not care about share class choice. This conclusion may not be entirely correct.

True, 10% of all trades in a load fund may be in an A-share with a front-end sales charge. (The other 90% are in load-waived A's, B- and C-shares, and other shares.) However, 40% to 50% of ***dollars*** – not trades – have an associated front-end load; i.e., the A-share load is paid. Fund documents show the dollar volume of sales where A-share loads apply. It is clear that investors commonly pay a front-end load for A-shares.

Assume nine investors use load-waived A-shares in a 401(k). They make four $300 purchases a year. That's 36 load-waived trades and $10,800 (9*4*$300). Investor ten buys $10,000 in loaded A-shares. Overall, 90% of investors use load-waived shares (9/10) and 97% of trades are load-waived (36/37). However, 48% of dollars are loaded ($10,000/$20,800).

Conflicts at the Advisor Level

The multiple class structure provides financial advisers and broker-dealers with options for structuring compensation in connection with the sale of mutual funds. Therein lies the potential for a conflict of interest.

Investors should understand that financial incentives can motivate an advisor or B-D to recommend one share class over another. The release published in connection with Rule 18f-3 noted that investor understanding of sales and service charges had been a source of concern to the SEC.[16]

The complexities attendant to the multiple class structure require financial advisers and B-Ds to exercise diligence in making share class recommendations. Interestingly, the regulatory scrutiny received by sales of B-shares in the early 2000s resulted in an industry bias in favor of A-shares.

New York Times columnist Gretchen Morgenson questioned this apparent bias. She wrote: "Class A shares are by far the most widely sold, perhaps because they are generally more lucrative for brokers when they make the sale. Class B shares often turn out to be a better deal for investors but are shunned by many brokers."[17] For trades totaling under $50,000 at one fund firm, she says advisers often earn higher commissions on A-shares than on B- or C-shares. The differential in pay may encourage them to sell a less suitable share class to investors.

She may be right. In general, for trades below $50,000, advisers are paid 4.75% to 5% of the sales load, plus a 0.25% asset-based trail commission. For B's, it's often 4% plus a trail starting in year two. C's pay 1% per year and, over the long-term, are most lucrative for advisers.

For the $40,000 Affiliated Fund trade, year one gross commissions ("GDC") are about $2,098 (i.e., ~5.25%) for A's vs. $1,600 (i.e., 4%) for B's. A's pay about $500, or 31%, more than B's. The differential is fairly constant over time. Is $500 an incentive for advisers to sell A-shares, merits aside?[18]

If A's are best in terms of account value, a conflict is of no import. For many funds, including the Affiliated Fund, A-shares ***never*** are best under $50,000. Still, sales of A's exceed those of B's and C's combined for this fund, and many others.[19] Even to $99,999, for most funds, and typical 4 to 6 year holding periods, B's or C's are best, not A's.

Ms. Morgenson referenced prospectuses from three firms. Interestingly, Affiliated's prospectus did not fully detail pay until April 2008. Now, it does a good job at detailing how advisers are paid for selling various share classes. So does American Funds. In contrast, First Investors prospectuses offer no details on advisor pay.

One solution is to more clearly disclose advisor pay. Using the standard trade of $10,000 invested at 5%, prospectuses could estimate gross pay for 1-, 3-, 5-, and 10-year holding periods. Secondly, trade confirms could list commissions for all share classes of a certain fund. Now they are shown only for the share class sold.

Conflicts at the B-D Level

Problems are exacerbated when B-Ds set sales limits for B- and C-shares that are too restrictive. It can appear that they encourage advisers to sell a less-suitable share class because the B-D's revenue is higher.

Consider again the $40,000 Affiliated Fund trade. We saw that A-shares were best for the advisor in terms of pay. But what's good for an advisor is good for the B-D. Assuming a typical 45% advisor payout, year-one revenue to the B-D is $1,154 for A's, $880 for B's, and $220 for C's.[20] In year one, B-D revenue is 31% higher with A's than with B's. It is highest, over time, with C-shares. C-share sales, however, are relatively low.

For trades to $50,000 in this fund, B- or C-shares are best for investors for all horizons and returns. At most B-Ds, however, at least 80% of the time, the trade is done in an A-share.

Sales limits must be set fund-by-fund. The relationship between a fund's A-, B-, and C-share pricing profiles dictate the proper limit. As every fund firm prices funds differently, a one-size-fits-all policy on B- or C-shares is not optimal for investors. Consider two fund firms mentioned in the 4-6-08 NY Times article. For B-shares from First Investors, the proper limit should be $99,999. In contrast, B's from American Funds make sense, generally, to $24,999.

Incredibly, the proper B-share limit is $249,999 for over 500 funds.[21] Often the limit is set at $50,000 by a B-D. Those who invest over $50,000 often buy the wrong share as a result – i.e., A-shares.

Conflicts at the Fund Firm Level

For typical trades, not hypothetical ones held for ten years, fund firms often earn higher profits with A's than with B's or C's. Due to the economics of commission fronting, B's and C's are less profitable in the short-term, which is six or less years. In general, those shares are more profitable in long bull markets.

Most investors hold shares for four to six years.[22] In that period, for almost every equity fund trade below $100,000, C-shares are best; B's are second best. A-shares almost never are best.[23] Currently, prospectuses do not provide estimates of account values for various holding periods.

If fund firms and investors are best-served by the same share class, no conflict exists. Most small trades

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would go into B- or C-shares. They don't. Every fund publishes its share class sales figures each year, so we know that most dollars go to A-shares.

Look again at the Affiliated Fund. Assume CDSCs are waived, cost-of-capital is 11%, and inflation 3%. Our estimates of cumulative discounted revenue, after year 5, are $1,143 for A's, $628 for B's, and $626 for C's. Revenue derived from A-shares is 82% higher than from B-shares. If a 1% CDSC is collected, the B-share figure rises to $983.

This disparity in interests should be disclosed. A fund firm revenue example, akin an expense example, might work. Otherwise, investors may buy the share that is most profitable for a fund firm but not best for them.

Conclusion

Conflicts of interest must be disclosed if they are material to an investor's share class choice. For small trades, the share class that is sold most often (A-shares) pays the most commissions to financial advisers, revenue to B-Ds, and profits to fund firms.

Fortunately, the solution to the problem is easy: more complete and accurate disclosure at various levels. At the advisor level, estimated cumulative pay should be disclosed for various holding periods, such as for one, three, five and ten years. That includes up-front pay plus 12b-1 payments. A prospectus should contain this information.

At the B-D level, sales limits should be set fund-by-fund. Setting across the board low limits on B- and C-shares belies the fact that, for many mutual funds, those shares are best for most investors. The required analytics are readily and affordably available.

At the fund firm level, a little extra prospectus disclosure will go a long way. For the typical small trade, investors should have some understanding of how much a fund firm earns on a trade.

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3a. Unscrambling the Alphabet of Fund Fees. Gretchen Morgenson, New York Times January 20, 2008.
3b. It's Called 'Class A,' But is it Best for You? Gretchen Morgenson, New York Times April 6, 2008.
3c. Some Mutual Fund Numbers Look Great, but for Whom? Harry Hurt III, New York Times, April 20, 2008
4. The Investor's Dilemma: How Mutual Funds Are Betraying Your Trust and What to Do About It. Louis Lowenstein. Wiley, 2008
5. Some Inconvenient Truths. Tim Price, PFP Wealth Management, 4-25-08, newsletter at www.pfpg.co.uk
6. See *Bearing of Distribution Expenses* by Mutual Funds, Release No. IC-11414, October 28, 1980. Rule 12b-1 prohibits registered open-end investment companies from financing an activity that is primarily intended to result in the sale of its shares, except pursuant to a distribution plan that conforms to the rule's requirements.
7. See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Release No. IC-20915 March 2, 1995, 60 FR 11876 (Adopting Release).
8. Lowenstein. See note 5.
9. Morgenson, April 6, 2008. See note 3b.
10, Id.
11. The description of retail share classes reflects characteristics that this author believes to be common in the industry. Specific attributes of any share class will, of course, be specific to a particular fund. Some funds may offer additional shares that are available only to certain classes of investors. This paper does not consider them.
12. The point at which Class B shares "flip" to A-shares varies, depending on the fund under consideration, and is of critical importance to the share class suitability analysis.
13. Estimates by author using proprietary software, based on fund expenses found in the 2007 prospectus. The CDSC applied for year five is 1%, not 2%, as the holding period requirement was met.
14. 2007 ICI Fact Book. Characteristics of Mutual Fund Investors. Section six, page 58. Investment Company Institute. Median assets of mutual funds was $48,000. The average was substantially higher. If holdings of other types of packaged products were included, like ETFs and annuities, all figures would be higher.
15. Strategic Insight Finds Front-End Loads Going Out of Fashion Fast. Erin Kello, Mutual Fund Wire, May 29, 2008. Based on the research entitled "Fund Managers Focusing on Intermediary Sales: Trends in the Use of Share Class Pricing and Distribution Channels." Strategic Insight, 2008.
16. Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares; Disclosure by Multiple Class and Master-Feeder Funds; Class Voting on Distribution Plans, Release No. IC-20915 March 2, 1995, 60 FR 11876 (Adopting Release).
17. Morgenson, April 6, 2008. See note 3b.
18. Estimates of the author using proprietary software. The fund's 2007 prospectus was used to derive figures.
19. See various filings with the Securities and Exchange Commission: www.sec.gov. Search for "Load Abbett Affiliated" under the Search For Company Filings link then the Mutual Fund Prospectuses link.
20. Estimates by author using proprietary software. Estimates based on a typical 45% advisor payout and the fund's 2007 expense figures.
21. Estimates by author after reviewing hundreds of funds from the top twenty fund firms in terms of assets. Results then were extrapolated to reflect the overall industry.
22. "Expectations Investing: Reading Stock Prices for Better Returns," 9/06, p 62. Michael J. Mauboussin, Chief Investment Strategist, Legg Mason Capital Management, CFA Conference Proceedings Quarterly. "The average holding period in the 1950s and 1960s was five to six years. Today, the average holding period is less than one year." See also "Investor Retention Rates at 20-Year High," 4/5/2005. Joe Morris, *Ignites.com* "The survey by Dalbar finds that shareholders held on for an average of 4.2 years in 2004, compared to 3.3 years in 2003. It was the highest retention since Dalbar began tracking the activity in 1984."
23. Estimates by author using proprietary software and the FINRA Mutual Fund Expense Analyzer: http://apps.finra.org/investor_Information/ea/1/mfetf.aspx.

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