Mutual Fund Loads, Fees and Other Expenses

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Mutual fund fees are the costs of running a mutual fund. They are disclosed in the simplified prospectus. What investors don't readily see or comprehend and aren't readily explained by their salespersons is how the method of sale effects their ongoing trailer commissions and, of course, fund returns. The simplified prospectus does have a section "Impact of Sales Charges on Purchases of Mutual Funds," showing the amount of loads you would pay under different purchase scenarios covering 1-, 3-, 5- and 10-year periods. (Firms assume a 5% growth rate in order to calculate the future years impact.)

A controversial study that found Canada's fund fees are higher than 18 other countries has been a thorn in the side of the mutual fund industry ever since Peter Tufano, Ajay Khorana and Henri Servaes published it in 2006.

Here are some of the costs of owning an actively managed mutual fund:

Sales Loads

Front-end loads are similar to a sales transaction commission. For example, the salesperson might have the 5% sales charge deducted from your initial investment and the remaining balance is what is invested (a 5% front-end load on a $1,000 investment would see only $950 invested in the fund). Return figures published in print or Internet media do not include the effect of these fees when publishing fund returns.

A front-end load purchase of an equity fund usually means a 1% ongoing annual trailer commission being paid to your salesperson for as long as you own the fund. It is a combination of a sales commission and a service charge. Front-end load sales commissions are generally negotiable. Some salespersons and online brokers now offer these funds with a zero percent front load. Should an online broker get a full trailer? No, but they do anyway. Their compensation comes entirely from trailer commissions. There is no convincing evidence that load (front or back) funds provide unitholders with superior returns relative to no loads.

The back-end load charge or Deferred Sales Charge (DSC) is an alternative to a front-load sales charge. The deferred sales charge is usually expressed as a percentage. The fund company pays your salesperson the upfront sales commission of, say, 5% and 100% of your money buys units at the prevailing market price. Your salesperson will also be paid an ongoing lower annual trailer commission of 0.50% and the other half of that trailer commission will be used to pay off the 5% sales commission over time. This back-end load is a redemption charge the unitholder pays when redeeming (selling) these mutual fund units. These deferred charges typically decrease each year that you hold the fund until eventually after 6 or 7 years they reach zero. (DSC sold funds in a RRIF can be troublesome due to the minimum annual withdrawal requirement.)

Normally, you can switch among funds in the same family without facing an early redemption fee but you may be liable for income tax. (Some fund products employing capital class shares permit tax-free switches between different funds. See my January 2011 article, "Corporate Class Funds Worth a Look".) Also, you can usually redeem up to 10% a year without paying any early redemption fee but this privilege is not cumulative from one year to the next. Generally, it also won't apply if you switch to a different fund class.

The trailer commission is one of the main reasons Canadian MERs are higher than those in the U.S. Industry critics argue that this method of compensation leads to skewed "'advice". Investors should ensure they are getting real value for these ongoing trailer commissions. We add, parenthetically, that disclosure of actual fees paid in dollars and cents is rarely included in client statements, a long-standing issue between investors and the investment fund industry.

Some funds are sold on a "no-load" basis, which means you pay no sales charge when you buy or sell. No-load funds are typically available from banks, trust companies and a few management companies. No loads may have higher MERs. So do your homework. There is no free lunch in the investment world. Some banks will sell a lower MER version of a fund if it's purchased online. F-class funds have the trailers stripped out but they are only available to fee-based advisors – they are not sold directly to retail investors and the fees are negotiable.

The Management Expense Ratio

The management fee is the money paid to the manager by the mutual fund for managing the mutual fund and for supervision of the day-to-day administrative operations of the mutual fund. This covers the costs of paying the mutual fund company which decides how, and in which securities, the fund will invest. In many cases, it also covers compensation to the investment dealer and the salesperson who sell you the fund. A trailer is compensation that your salesperson receives from the mutual fund company. The amount of this trailing commission varies, usually from 0.25% to 1% of assets per year. Details can be found in the fund's prospectus. You do not pay trailer commissions directly – the mutual fund company pays them to the salesperson on your behalf. Out-of-sight and out-of-mind keeps most investors in the dark on fees.

The level of management fees in Canada varies widely depending on the type of fund, with fees charged by money market and index funds as low 0.1% while fees for equity funds may be 2% or more. In general, fees will vary depending on the level of effort required to manage the fund and the firm's profit goals. Management fees are generally expressed as a straight percentage of the net assets under management. For example, "an annual fee of not more than 2% of the average daily net asset value computed and payable monthly on the last day of each month." The management fee is subject to GST/HST, which is part of the MER.

Mutual funds also incur an administration fee (usually at a fixed rate) to cover their operating expenses. These include audit and legal fees, safekeeping and custodial fees, cost of providing information to unitholders, etc. These are charged directly to the fund. The total of all the fees charged to the fund as a % of Net Asset Value (NAV), excluding brokerage fees and taxes on income retained, if any, by the fund is called the Management Expense Ratio. The MER is calculated as follows:

$$\frac{\text{Aggregate fees and expenses payable during the year X 100\%}}{\text{Average net asset value for the year}}$$

The MER, typically 1-3%, is embedded in published fund unit price calculations daily. As such, it is hidden from view and underappreciated. More complex funds tend to have higher MERs because the manager needs to do more to effectively manage the fund, and these funds are more costly to run. Index funds usually have very low MERs because duplicating an index involves less research and less trading. For this reason, they often outperform most actively managed funds over the long term. Funds are required by regulation to disclose in the fund prospectus both the administration fee and the Management Expense Ratio for the last five fiscal years.

Since fund expenses are deducted from the value of a fund, they decrease the return to unitholders. If a fund reports a compound annual return of say 7.5% and has a MER of 2.5% it will have a gross return of roughly 10%. This means that the MER as a percentage of returns is 2.5%/10%=25%.

Trading Commissions

Brokerage commissions, which are not part of the MER, further add to costs especially for funds that trade actively. The Management Report of Fund Performance (MRFP) discloses the ratio of brokerage expenses to net assets resulting in what is known as the Trading Expense Ratio (TER). It will fluctuate, depending on the level of trading by the manager. The MER + TER are the total costs of owning a fund. The portfolio turnover rate percentage (included in the prospectus and MRFP) can provide a rough indication of a fund's propensity to trade a lot.

A number of research reports have concluded that the MER is the key factor in mutual fund investment decision making. To assess the impact that fees have on fund performance try using the calculator at http://www.getsmarteraboutmoney.ca/tools-and-calculators/mutual-funds/default.aspx.

Optional Fees and Expenses

So-called optional fees are in addition to the MER and are paid directly by individual unitholders. These include:

- Early redemption fees for DSC funds.
- RRSP/RRIF administration fees.
- Account set-up fees.
- NSF cheque charge (applies when you use a pre-authorized investment paid by cheque which doesn't clear).
- Fund switch fees (if applicable).
- Account closing/transfer fees.
- Systematic withdrawal plan fees.
- Asset allocation service fees.
- Short-term trading fee (typically 2%, if the fund is held less than 90 days).

A more detailed review of mutual fund fees can be found at http://www.mackenziefinancial.com/eprise/main/MF/DocLib/Public/MF3873.pdf.

Published rates of return and the Net Asset Value Per Unit (NAVPU) of investment funds are calculated after all fees and expenses have been deducted but exclude any sales load or optional fees. Returns are always presented pre-tax and assume the reinvestment of all distributions and that the distribution reinvestment is made tax-free. Obviously, this assumption does not hold for non-registered accounts.

With all these fees, it's not hard to see why ETFs, index funds and other less burdened investment vehicles generally provide superior returns with less complexity, less tax and greater cost transparency over the long run. Hopefully you can now be a smarter, more discriminating mutual fund investor.

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