Lower Mutual Fund Fees? Yes, If the SEC Has Its Way

By Jane Bryant Quinn | Aug 26, 2010 | 0 Comments

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The Securities and Exchange Commission is preparing to break the high fixed prices you pay in sales charges when you buy and sell mutual funds. It wants to clear the way for discount brokers to offer funds at a lower cost.

To that end, the commission put out a sweeping proposal earlier this month to change the industry's structure. Financial advisors, brokerage firms, and insurance companies are filing hundreds of objections, hoping to scuttle or water down the rule. For investors, however, the changes would be a plus. You should be sending comments in support.

The SEC's proposal comes in two parts. The first part reduces the 12b-1 fee that many investors pay now. 12b-1s are paid out of fund assets, so the higher the cost, the lower your investment return.

There are three ways of paying for a broker's advice, depending on the class of shares you buy.

With A shares, you pay a commission up front — ranging from 4.5 percent to 5.75 percent — plus an average 12b-1 fee of 0.24 percent a year, according to Morningstar. The commission drops for people who invest large amounts. For long-term investors, this is the cheapest way to buy.

With B shares, you pay a high 12b-1, averaging 0.95 percent, which often (but not always) drops after five or six years. There's also a fee for selling your fund within that period of time. You get no break for investing a large sum of money. B shares are on the decline and some firms don't offer them at all.

With C shares, the 12b-1 also averages 0.95 percent. You pay it every year, for as long as you hold the fund. There's no exit fee after the first year but also no large-investor discounts. C shares can be better than A shares for investors who hold funds for only a few years and then switch to something else. They're worse, however, for investors who buy and hold for the long term. Long-term holders might pay more than the maximum 6.25 upfront load that the regulations allow, says Barbara Roper, director of investor protection for the Consumer Federation of America.

The SEC thinks that everyone who buys a particular fund should pay the same sales commission. To that end, it plans to divide the 12b-1 into two parts.

One part, to be called the "marketing service fee," would cover ongoing services such as bookkeeping. Funds could charge up to 0.25 percent, on all share classes.

The other part, to be called the "ongoing sales charge," would help pay the sales commissions and other marketing expenses. Investors could choose to pay it upfront or over the years they own the shares, just as they do now. But everyone would wind up paying the same percentage amount.

As an example, say that A shares cost you 5 percent upfront. A buyer of C shares would pay 1 percent a year for five years and then the sales fee would end. In theory, that should make pricing more competitive, because the commission could no longer be hidden inside the 12b-1. Also, C-share owners won't be hooked into paying excessive fees.

Brokers love C shares for the steady income they provide. To maintain their income, they'll try shifting their clients into mutual-fund advisory accounts, according to the trade publication, Investment News. Advisory accounts cost an average 1.1 percent, so investors who leave C shares could wind up paying more.

On the other hand, many investors will resist the change, Roper says. Consumer choice should drive prices down, once the sunlight shines on your options and fees.

Now for the second part of the SEC proposal. It would encourage mutual funds to make themselves available to brokers at what amounts to wholesale cost. They could still impose a 0.25 percent marketing service fee, but that's all. The brokerage firms themselves would then decide the size of the ongoing sales charge. A large firm might charge the equivalent of 5 percent. Discounters such as Charles Schwab could charge less.

"This is the first, crucial step in unbundling the cost of money management from the cost of distributing funds," says Mercer Bullard, founder of Fund Democracy, which advocates for shareholders. "Right now, investors are paying a lot of money for services they're not using or that should cost them less. They'll resist high fees, once they can actually see the costs."

The SEC's proposal leaves only fee abuse untouched. It doesn't require funds to disclose the amount they pay in what's called "revenue sharing."

Revenue sharing subverts the free market. It's a fee that a brokerage or advisory firm charges mutual funds for a place on its recommended list. You might think that your broker sells only funds that are the best performers. In fact, they might be mediocre and expensive. The broker recommends them because he or she is paid extra to do so.

Neils Holck, founder of the Coalition of Mutual Fund Investors, estimates that mutual funds pay nearly $2.1 billion a year in revenue sharing — a cost that's passed on to you in higher administrative fees. If 12b-1 fees go down, the firms could compensate by raising the amount they charge the funds in revenue sharing. Instead of driving costs into the sunlight, that pushes them further underground.

Nevertheless, the SEC is moving in the right direction, Holck says. Administrative and 12b-1 fees currently cost investors $6.4 billion a year, he says. Competition might knock down that price by half. The SEC could tackle revenue sharing next.

Twenty-five years ago, the end of fixed commissions for buying and selling individual stocks saved billions of dollars for investors. It's time to apply competitive capitalism to mutual funds, too.

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