IGNITES

A Financial Times Service

Print | Close Window

Funds With Redemption Fees Post Better Returns: Study

By Peter Ortiz March 8, 2011

As more funds eliminate redemption fees — once touted as a best practice after the market-timing scandal — a new study finds that these fees mean better performance for international equity mutual funds.

The study, "Redemption Fees and the Risk-Adjusted Performance of International Equity Mutual Funds," concludes that redemption fees boosted risk-adjusted fund performance; that funds with larger redemption fees performed better than funds with lower fees; and that redemption fees enabled funds to hold less cash for required redemptions and to invest more in higher-returning securities.

While many funds have eliminated redemption fees, citing the use of other deterrents and monitoring systems to discourage market timing, the study bears out that 128 of the 157 funds examined had better performance in the three years after the redemption fee was put in place compared to the three years prior to the redemption fee's being enacted. The study's authors, Iuliana Ismailescu and Matthew Morey, finance professors at Pace University's Lubin School of Business, looked solely at funds where 75% of the assets are invested in international securities.

International funds were prime market-timing targets due to time-zone differences that allowed arbitrageurs to take advantage of material market events. Certain bond funds and small-cap funds, where pricing is not always transparent, also were vulnerable to market timing.

"Probably most of these funds would say… if you followed the trading restrictions in the prospectus, that would be enough to protect long-term investors," Ismailescu says. "We think that is a mistake."

Large-fee funds, which charged a 2% redemption fee, performed significantly better post-redemption-fee period versus pre-redemption-fee period. That compares with small-fee funds, which charged less than a 2% redemption fee, showing no significance performance boost post-redemption-fee period versus pre-redemption-fee period. The study, however, does point out that there were 143 large-fee funds compared to 14 small-fee funds in the total sample.

Many funds imposed redemption fees following the market-timing scandal, but gradually started eliminating these fees, citing more effective ways to stamp out market timing. This included the Securities and Exchange Commission's adoption of Rule 22c-2 in 2007, which required that funds enter into agreements with financial intermediaries to turn over information about underlying shareholder transactions.

As of Dec. 31, there were 4,413 open-end funds, including all classes of shares, with a redemption fee schedule, according to **Lipper**.

Putnam wiped out redemption fees for 40 of its funds last year. Other funds that have removed redemption fees include **Mainstay Funds**, **Henderson Global Funds**, **Morgan Stanley**, **Van Kampen**, **Franklin Templeton**, **Hennessy Funds**, **First Eagle**, **Pimco**, **State Street Global Advisors**, **Oakmark** and **Forward Funds**.

Niels Holch, president of the Coalition of Mutual Fund Investors, says the study confirms that redemption fees have been an effective tool for funds to deter excessive short-term trading activities. A methodology the study uses is the Sharpe ratio, which measures the excess returns for the extra volatility in holding a riskier asset.

"In my view, buy-and-hold investors are usually disadvantaged by market timing, so redemption fees are usually one method of protecting the interests of longer-term investors," Holch says. "What the study shows is, quantitatively, there is an increase in performance when a fund puts a redemption fee in place, as the fee reduces the amount of cash that a fund has to keep on hand for redemptions as well as serv[ing] as a deterrent for frequent trading."

However, Holch agrees with others in the industry that there are different tools that can discourage market timing. One is to use trading limits instead of redemption fees.

Andrew Gogerty, senior fund analyst at **Morningstar**, also notes various other ways funds have deterred market timing, including through their boards' diligence over fair pricing to ensure investors are not being harmed due to arbitrage opportunities with time-zone difference.

"Monitoring flows that come in from omnibus accounts and flagging potential malicious activities — those are viable routes too," Gogerty says.

Jeff Keil, principal at **Keil Fiduciary Strategies**, writes in an e-mail response to questions that a number of international and other "volatile funds added redemption fees shortly after the market-timing scandal hit as they thought the SEC would require them along with more rigorous fair valuation policies." But when this did not happen, they dropped the fees, he notes.