Mutual funds on a rocky road

Harry
Nerlich
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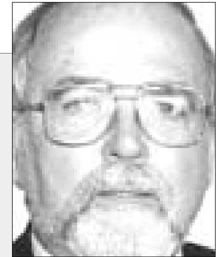

nerlich0374@rogers.com

In the past, regulators have fiddled around with the way mutual funds calculate expense ratios and reimburse sales agents.

Every change, seemingly, has worked to the disadvantage of investors. Possibly what looms ahead will reverse this trend.

Canadian mutual funds have long been criticized for having expense ratios considerably higher than their U.S. counterparts. South of the border the annual fee levied by mutual fund managers is seldom more than 1.5 per cent of net asset value, and may well be less than one per cent. In Canada a basic annual levy of 2.5/3.0 per cent is more the norm.

The smaller shareholder base from which the Canadian fee is extracted can explain a portion of the differential. Another factor is the extra cost of bilingual prospectuses and quarterly and annual filings mandated by Canadian law. But, the most heavily weighted factor is the retention commission paid each year to sales agents.

This outlay, which averages about one per cent of net asset value, is intended to encourage sales agents to continue advising clients of the merits of any given fund, with the expectation that those clients will maintain present holdings and perhaps buy more. There is very limited proof that salespersons carry out this function; instead they cheerfully pocket the retention commission. Unfortunately, too many mutual fund unit holders are unaware of this ongoing grab from their returns.

In the U.S., where retention commissions are not as widespread, and where the annual payout is considerably less, federal regulators are recommending that mutual fund retention bonuses be ruled inappropriate. Passage of such a regulation would likely reduce expense ratios to one percent or less. The mutual fund industry argues that removal of the bonus will impair future sales potential, but so far the regulators are holding firm to their convictions. Canadian regulators have been mainly silent on this development, but it is clear that investors north of the border will demand similar action.

The Canadian mutual fund industry is already under heavy pressure from ETFs and i-shares, whose expense ratios seldom top 0.5%, and often dip as low as 0.25%. Moreover, mutual funds domiciled in both Ontario and British Columbia will be exposed to provincial sales taxes on their expense ratios when Harmonized Sales Tax is implemented in each province on July 1, 2010.

In addition the range of available ETFs and i-shares far exceeds the diversification offered by mutual funds, whether they be money market, laddered bonds, commodities, or domestic and foreign equities. Another advantage to ETFs is their tradability throughout market sessions, while mutual funds can only be bought or sold at prices established at the previous day's market closing.

Last Sunday's New York Times questioned why anyone would want to buy U.S. money market or bond mutual funds when the expense ratios ate up so much of the potential return to investors. If they had examined the Canadian scene they would have been dumbfounded to discover that from time to time in recent months such funds have yielded a negative return.