



# To Fee or Not to Fee

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**F-class mutual funds** -- why now is a good time to take a second look

By Marc Lamontagne, CFP, R.F.P., FMA, CSA

Quick, what dubious distinction does Canada's mutual fund industry have compared to the rest of the planet? If you said we have the highest Management Expense Ratios (MER) in the world, then you would be absolutely right (according to the Tufano study *Mutual Fund Fees Around the World* (May 2007)!

Now imagine, if you can, explaining that to a client. Not fun. But what if you could offer a way to reduce their cost without negatively affecting their rate of return, or severely limiting their investment options, or even affecting your compensation? What would your client say to that? Probably, "Tell me more."

You can do all this with F-class (Fee) mutual funds. First introduced in 2001 as cousins to A-class (Advisor) funds, there are now over 1100 F-class (sometimes called F-series) mutual funds.

With all those benefits, you'd think they would be wildly popular but, according to iINVESTOR ECONOMICs, F-class had only garnered about 1.1% of the advisor-sold mutual fund market by the end of 2006. Compare that to low-load funds with a 3.6% market share.

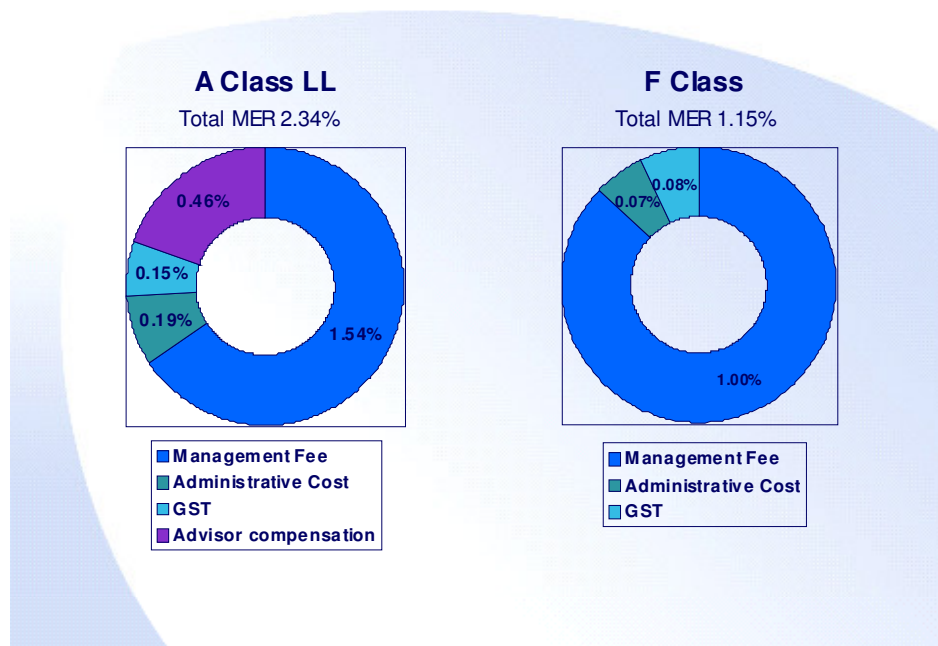
This may be due to the popularity of other products favored by fee advisors.

"Wrap accounts and index products such as Exchange Traded Funds (ETFs) are competing in that market space," says Stephen Koury, a fee-only financial planner with Inter-Equity Asset Management who primarily uses the F-class versions of DFA funds. "It may also be because most MFDA Dealers don't have a fee-based platform."

Ross Kappel, President of GGOF | Guardian Group of Funds, echo's Koury's statements, but also suggests the poor sales are because "There is more of an interest at IDA firms in their robust proprietary-managed accounts than non-discretionary fee-based accounts, in which you would hold F-class mutual funds."

Another possible reason why sales of F-class have not taken off may be pricing misconceptions. F-class funds are not clones of an A-class with the advisor compensation stripped out. They are built from the ground up as a distinct class. Now mind you, advisors are used to seeing several versions of the same funds, (FE, DSC, LL, T-class to name a few) and they all have pretty much the same

MER. So we can be excused for this small ignorance. In the case of the F-class though, they are not simply built on an A-class MER chassis.



Source: Aim Trimark

So let's look at some pricing examples. The A-class GGOF Enterprise fund has an MER of 2.74% and the front-end (FE) version pays a 1% trailer. After deducting the trailer fee the net MER is 1.74%. One would expect to see a similar MER on the F-class, but it is not.

The F-class version has an MER of 1.25% resulting in a savings of 49 basis points to the client if you charged the same 1% in a fee-based account. What is really interesting is this fund is managed by Mawer Investment Management and investors could buy the Mawer New Canada fund directly, which has the same manager and mandate, prior to it being capped at a MER of 1.5%.

	A-Class MER	F-Class MER	Mawer New Canada MER
<b>GGOF Enterprise</b>	2.74%	1.25%	1.50%
- Trailer	-1.00%	n/a	-0.20%
Difference	1.65%	1.25%	1.30%

Source: Paltrak

Another example of this seemingly anomalous pricing is the TD Canadian Bond fund. The A-class MER is 1.33% and the FE version pays a 50 basis points trailer, which results in a net MER of 0.83%. The F-class has an MER of just 59 basis points, though again the Investor-class sold by the bank branches is 48 basis points higher, resulting in an MER of 1.07%.

	A-Class	F-Class	Inv.-Class
<b>TD Canadian Bond</b>	1.33%	0.59%	1.07%
- Trailer	-0.50%	n/a	-0.35%
Difference	0.83%	0.59%	0.72%

Source: Paltrak

Let's be perfectly clear, not all mutual fund companies have priced their F-class so aggressively, but there are a few good reasons why some have. The first is because of the target market. Some fund companies assume that advisors using F-class will tend to deal in the HNW market, meaning the individual tickets will be larger than average, so they can afford to keep costs down and price F-class part way to being an i-class (institutional).

Stephen Koury also believes, based on his research, that mutual fund companies can save an average of 20 to 30 basis points on the F-class structure (depending on the fund company, the asset class, and the load structure) because "they save the cost of handling, financing, and the distribution of commissions."

There may also be some administrative cost savings according to Scott Sinclair, President of MRS. In order to charge a fee based on a percentage of assets under management, most advisors hold their F-class mutual funds in a nominee account. Sinclair's observation is that the fund company will save an average of 25 basis points when mutual funds are held in a nominee account versus a client named account. "Of course that is a rule of thumb, and that can vary from company to company, and account type to account type."

A less tangible reason for the savings may have to do with "the expectation that Canadian advisors will follow the trend in the U.S. and Australia" to a more transparent fee-based compensation model, according to Koury. "Fee advisors need to justify their value, so by spending more time finding lower-cost products, that will certainly help show your worth to the client."

By pricing the F-class more competitively, those mutual companies will gain greater market share with this growing segment of the advisor market.

"At least that is the reason in our case," says GGOF's Kappel. "Also, every time we come out with a new fund, the Dealers are demanding that we have it available in every single class including F."

From the advisor's point of view, the advantages of switching to F-class mutual funds include gaining control of your compensation. You can set a fee based on managing the portfolio and not be influenced by the trailer fee of one asset class versus another. You can also introduce tiered-pricing, which has the added benefit of rewarding your clients for the size of their relationship with you.

The final point is that there was a time when clients could not buy A-class funds through their bank or discount broker. So one of the many advantages of dealing with a Financial Advisor was that they had access to a larger product shelf. As we know that is no longer the case.

One exception today is the restriction of F-class shares to the advisor channel, giving you sole access to a great cost reduction tool. So for advisors who are not comfortable with a pure indexing strategy, the first step toward saving your clients some money is to take a second look at F-class mutual funds.

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