



HIDDEN COSTS OF INVESTING: THE A, B, C'S OF MUTUAL FUNDS

If you invest in the stock market, professional investment management can provide important advantages. An expert professional manager can structure a well diversified portfolio, designed specifically for you. Investors who are just starting out, or whose portfolios are of modest size, can access professional management and diversify their investments by pooling their assets with others in mutual funds and their investment company cousins (closed-end funds, unit investment trusts, and exchange-traded funds). Historically, these investment vehicles have been the principal means for smaller investors to realize these benefits. In 2005, some 91 million Americans had \$9.5 trillion invested in investment company shares, primarily mutual funds¹, for an average of just over \$100,000 per investor².

No one expects to invest in mutual funds for free, of course. But even though fund disclosures explain fees and expenses, many investors may not be aware of the full costs to them of holding these funds. Fund fees include sales charges (loads), management fees, fund expenses, and investor servicing, or 12b-1, fees. Mutual fund companies try to make these fees as painless as possible, usually simply deducting loads from your initial investment and collecting other fees from the fund itself. As a result, it's easy to underestimate their effect on your overall investment performance. Understanding these fees, however, is an important step in making sure the investment "advice" and "service" you receive through a mutual fund justifies its cost.

INVESTMENT INTERMEDIARIES

When you invest in a mutual fund, you are really engaging a professional investment intermediary to stand between you and the market. Presumably, the fund's seasoned investment professionals establish and maintain appropriate portfolio structure, control risk, and select securities within their particular investment areas. These professionals perform a valuable service (although without considering any investor's individual needs) and the management fee, a component of every mutual fund's overall expense ratio, compensates them for this service.

¹ This and other data from the Investment Company Institute 2006 Fact Book. This item is on p. ii. See http://www.icifactbook.org/pdf/2006_factbook.pdf. The Investment Company Institute is a mutual fund trade organization.

² The ICI factbook reports that institutional investors own about 12% of mutual fund assets, so the average per individual is a bit lower.

A mutual fund is a pooled investment with many owners, and this pooling generates overhead. The fund sponsor must maintain extensive, accurate records tracking each investor's share of the fund, and must value the fund frequently (generally daily) to ensure that investors making contributions or withdrawals receive the number of shares or the sales proceeds that accurately reflect their share of the fund. Funds bear administrative expenses for functions like portfolio accounting, legal services, the transfer agent's function (issuing, tracking, and redeeming shares), and so forth. A sliver of any mutual fund's expense ratio supports these functions³.

If you buy funds through your 401(k) plan, or buy no-load funds through a fund supermarket, say, then the management and administrative fees are likely all you'll pay. But if you work with a financial advisor, you should make sure you understand the structure of your advisor's compensation. Many people offering mutual funds call themselves "advisors," but if their compensation comes at least partly in the form of commissions and sales charges for selling investment products, they're brokers. Most of time, if you buy a mutual fund through your friendly financial "advisor" at, say, Citigroup (likely a former Smith Barney broker), UBS (likely from Paine Webber), Morgan Stanley (likely from Dean Witter), or another brokerage firm, you'll pay some combination of sales commission and client servicing fees, much of which will go to your "advisor." This broker is a second intermediary, standing between you and the fund manager, who in turn stands between you and the market.

You may regard the sales charges and servicing fees as a way to pay your broker for investment advice (like recommending certain funds to you), but there's something else at work here, too. The Investment Company Institute reports that at the end of 2005, there were 7,977 mutual funds in the US market.⁴ With that many offerings competing for investors' funds, distribution and sales channels become major business issues for mutual fund firms. Not surprisingly, mutual fund firms attach high value to maintaining their sales channels, and brokers that successfully sell funds can make a handsome living. Yet it isn't the mutual fund company that pays these brokers — it's you, the investor. The fees are entirely legitimate, and you can find details about them in the fund's prospectus—but do you really read through the prospectus to find them? Not many people do—even though they should prior to making the investment, if they want to know what their broker is earning by "selecting" that fund for them. The fund companies compete for the attention of the brokers by working to convince brokers that their funds are the ones that will make it easiest for them to capture your hard-earned dollars, and so earn them these hefty sales and servicing fees.

Unless your broker is also a registered investment advisor (RIA), he or she has no fiduciary obligation to recommend the investment that offers the best value to *you*. So long as they meet the "suitability" standard that governs brokers, your broker could recommend

³ For large, established funds, these expenses tend to be small relative to the size of the fund. Because these costs can be large in percentage terms for newer funds, fund companies often subsidize them by establishing a cap on total expenses. They agree to pay from their own coffers any expenses in excess of the cap.

⁴ ICI Factbook, *op. cit.*, p. 71.

investments to you on the basis of the commissions the *broker* would earn. This is the mutual fund load game—what we call the “A, B, C’s” of mutual funds.

MUTUAL FUND SHARE CLASSES

Sales charges and servicing fees come in three main varieties: front-end sales charges, or loads, which you pay when you make your initial investment; back-end loads, which you pay when you redeem your investment (unless you meet a holding period requirement, often five years); and ongoing client servicing fees or “12b-1 fees,” so called because Rule 12b-1 under the Investment Company Act of 1940 permits them. Many funds have designed different fund share classes, which apply different combinations of these fees. By market convention, they usually designate these share classes A, B, and C, and sometimes offer others as well.

Class “A” shares typically have the highest front-end loads. By law, these can be as high as 8%, but loads around 5% are more typical. Now, a 5% load means that for every \$100 you put up, \$5 goes to your broker, and only \$95 goes into the fund to be put to work. So the sales charge is 5.26% of the amount you actually get to invest. Perhaps that’s why sales loads on A shares are often reported as 4.75% or 5.75% — from the broker’s point of view, this looks like 5% or 6%. A shares also often have 12b-1 fees, usually around 0.25% per year. This fee is deducted directly from the fund as part of the fund’s overall expense ratio, and it also typically goes to your broker, as compensation for ongoing service — well, really as compensation for doing what it takes to keep you invested in the fund.

Many investors are understandably reluctant to pay high front-end sales charges, but brokers don’t want to sell investors funds that don’t pay them any sales commissions. These circumstances gave rise to “B” shares. These typically have no front-end sales load, but they do usually have “conditional deferred sales charges” — back-end loads that the fund assesses (and pays to the broker) if you withdraw your money too quickly. In B funds, these charges can be as high as 5% in the first year, usually declining to zero after five years. While you can avoid the back-end load by keeping your money in the fund long enough, in the meantime your broker collects a 12b-1 fee much higher than on the A shares — typically 1% per year. B shares often convert to A shares after a period of time.

B shares have generated enough sales and regulatory resistance to induce fund companies to create “C” shares. C shares also typically have no front-end load, and they also have high 12b-1 fees, often around 1% per year. They have back-end loads too, but these are usually relatively low, around 1%, usually disappearing after a period. C shares do not usually convert to A shares. Point-by-point, B shares are typically at least as expensive as C shares (at least until they convert to A shares), so B shares seem to be disappearing from the investment landscape.

Fund families often also include an Institutional (or “I”) share class. It’s important not to confuse these Class “I” mutual fund shares with iShares, the brand name Barclays uses for its

exchange-traded funds (ETFs). Class I mutual fund shares typically do not have sales charges or 12b-1 fees, but they are generally only available either to investors with very large balances, or through certain types of investment programs, such as some companies' 401(k) plans.

THE TRUE IMPACT OF SALES CHARGES

If you have spent any time discussing investments with financial professionals, you will have likely heard some discussion of the importance of compounding over time — that over long periods, the ability of one year's investment earnings to earn more money in subsequent years is a powerful engine of portfolio growth. The principle also works in reverse. If you pay excessive costs (including fees and taxes) on your investments, those dollars leaving your account lose their ability to generate additional earnings. As a result, excess fees, small though they may seem, can be a surprisingly heavy drag on your wealth over time.

Let's take a look at a specific fund, concentrating on the impact sales charges might have had on investors over the last five years. To keep the focus on costs, rather than on investment performance, let's choose, with the benefit of hindsight, a fund with a successful investment track record, the Legg Mason Partners Fundamental Value Fund. This is a large-capitalization US equity fund. The table below, adapted from Morningstar data, gives the expense ratios and sales charges for the A, B, C, and I share classes. Every share class has a management fee of 0.65%, and the overall expense ratios range from 0.67% for the I share class to 1.95% for the B shares.⁵

Legg Mason Partners Fundamental Value Mutual Fund Series Expenses				
	Class A SHFVX	Class B SFVBX	Class C SFVCX	Class I SFVYX
Front-end Load	5.75%	0	0	0
Back-end Load⁶	0	5%	1%	0
12b-1 fee/yr	0.25%	1.00%	1.00%	0
Mgmt fee/yr	0.65%	0.65%	0.65%	0.65%
Overall expense ratio/year	1.11%	1.95%	1.75%	0.67%

⁵ Mutual fund expense and performance data in this note are from Morningstar. Actual expense ratios reported are those that Morningstar has taken from the funds' most recent annual report. Some performance calculations are mine, based on quarterly data from Morningstar, and the calculation of allocation of dollar costs applies the most recent expense ratios back over the five-years history I'm studying. As such, they are my estimates. The overall expense ratio includes the management fee, 12b-1 fee, and other administrative costs.

⁶ B share back-end load declines from 5% in the first year to 0 after five years. Class C back-end load is zero after five years.

To see the effect of the sales charges and other expenses, we'll begin by looking at the performance of the Class I shares, using those data to measure the “pure” performance of the fund, without the effect of sales fees. According to Morningstar, the Class I shares have had an annualized total return, net of fees, of +6.36% for the five years to December 31, 2006. The S&P 500 Index returned +6.20% for the same period (Source: Standard and Poors). The portfolio, in other words, out-performed the S&P by just enough that even after deducting the 0.67% annual expense ratio, the net return was a bit better than the S&P 500. After fees, an investment of \$10,000 made into the fund at the end of 2001 would have grown to \$13,610 by the end of 2006. In the meantime, the investor’s share of the fund’s expense ratio would have totaled about \$338. And since the fees the investor paid during the early part of the period would not have the opportunity to earn more in the later part, I estimate that the investor would have sacrificed a further \$120 or so in lost growth — return not earned in later years on amounts paid in earlier ones. So if the fund charged no fees at all, the investor might have been able to earn an additional \$458 (\$338 + \$120), bringing the total ending value to \$14,068, for an annualized return of +7.07%. That’s +0.87% per year ahead of the S&P 500. The following chart shows the Class I shares’ performance for the five years 2002 – 2006, along with the small amounts of value lost to expenses and lost growth:



Investors fortunate enough to hold the Class I shares, then, could have enjoyed nearly the full measure of the manager’s success. But what about the other share classes? To analyze the impact of the fees, I’ve started with the same raw return, +7.07% per year, which I calculated for the Class I shares. From Morningstar, I took the actual, after-fees returns for the different share classes, and then calculated the total expenses including sales charges, and the shortfall due to lost growth. The table below summarizes the end results:

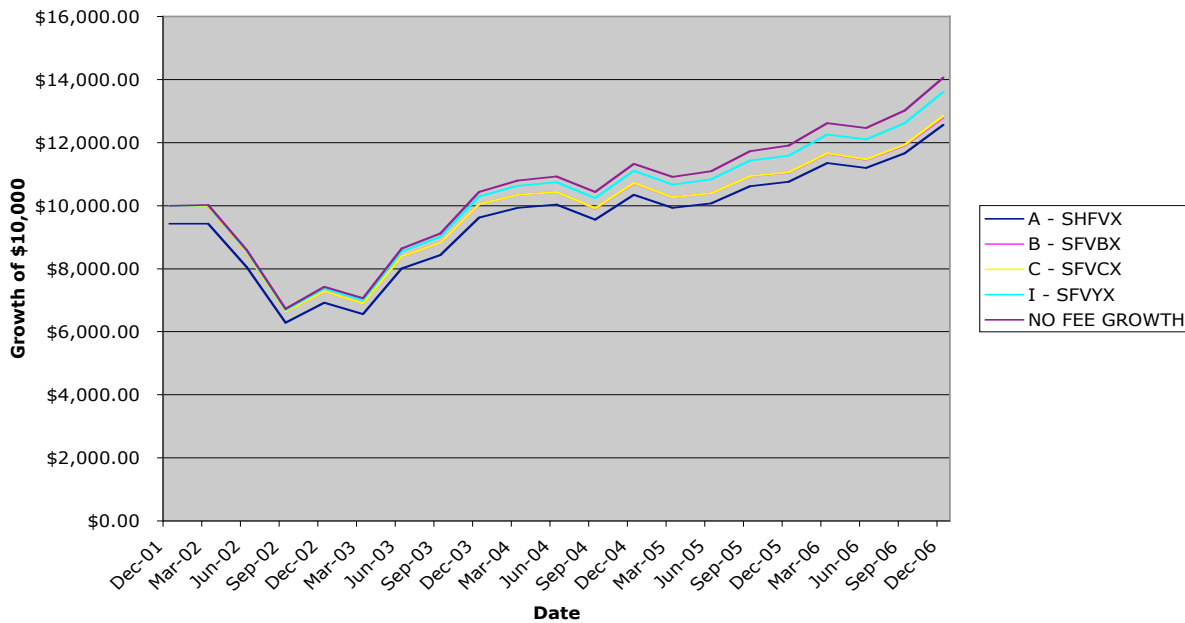
Legg Mason Partners Fundamental Value Funds Analysis of Impact of Fees and Sales Charges, 2002-2006				
	Class A	Class B	Class C	Class I
Gross Gain on \$10,000 (5 yrs)	\$4,068.85	\$4,068.85	\$4,068.85	\$4,068.85
Load and 12b-1	\$692.60	\$488.97	\$489.22	0
Mgmt and other expense	\$404.55	\$464.52	\$366.92	\$337.88
Lost Growth	\$400.82	\$314.44	\$369.63	\$120.33
Total value lost	\$1,497.97	\$1,267.93	\$1,225.77	\$458.21
Net gain to investor	\$2,570.88	\$2,800.92	\$2,843.08	\$3,610.64
Net annualized return	+4.68%	+5.06%	+5.13%	+6.36%
Portion of gross gain lost	36.8%	31.2%	30.1%	11.3%

Source: Author calculations, based on returns and current expense data as reported by Morningstar.

The key comparison is between the gross gain of just over \$4,000, calculated from the results and expenses of the Class I shares, and the net gain to investors, calculated from actual after-fee returns data, for the various share classes. In the end, the sales charges and 12b-1 fees in the A, B, and C shares turn a successful investment into a mediocre one. Combined with the loss due to the fact that fees paid can no longer earn returns, the expenses of the A, B, and C shares could have created a sacrifice of somewhere from 30% to just under 37% of overall return for an investor holding these funds from December 31, 2001 to December 31, 2006.

The graph below shows the growth of \$10,000 over the five years for each of the share classes. The Class A shares start at \$9,425, because of the immediate impact of the 5.75% sales load. Both the table and the graph assume that B and C holders avoid the back-end load.

Legg Mason Partners Fundamental Value Comparison of Share Classes, 2002-2006



CONCLUSION: WHERE DOES ALL THAT MONEY GO?

Investing always has costs, even if you manage your own portfolio. But to invest successfully, it's crucial to be sure that you understand your costs, so that you can evaluate whether or not you are receiving sufficient value for what you are paying. In the case of mutual funds, you can learn the details of management and administrative fees, sales charges, and 12b-1 fees if you are willing to dig through the fund's prospectus. You can also find summary information on fees through sources like Morningstar. If you are buying funds through a broker, the broker should also be willing to explain all the fees. Ask.

Sales charges and 12b-1 fees primarily compensate the brokers that sell mutual funds. While this is a normal, long-standing, and legal practice (and you may like your broker and recognize his or her need to make a living), it is worth understanding that when a broker recommends that you buy a certain fund, the advice may not be entirely disinterested. In most brokerage firms, a portion of the sales charges and 12b-1 fees go to the brokerage firm to cover overhead and regulatory supervision, and the rest goes to the individual salesperson. While brokers do legitimately perform a function in this market, it is worth being aware that this compensation is for sales, not advice. Hence, their selection of a particular fund for you may be influenced by disparities in fees paid to *them* by certain funds or share classes of funds, even if *your*



best interest might be served better by a different type of fund, share class—or even investment vehicle.

It is important to be aware of the actual amount of fees you are paying so that you can consider whether your broker's advice is valuable enough to justify its cost. In the world of load mutual funds, don't assume that by paying more fees, you will get better investment management of your portfolio, or that your broker will be selecting the best mutual funds for you. You, the investor, pay your broker his or her fees, but the mutual fund company whose product the broker is selling may value the broker's services more highly than you do. You can, at the very least, have your broker explain his or her reasons for recommending certain funds to you and, ultimately, you have the final choice. As in the case of the successful Legg Mason Partners Fundamental Value funds, that extra layer of "sales" intermediation can be surprisingly costly — staying in their Class A shares for the last five years could have cost you almost 37% of your total potential portfolio gain.

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Source of mutual fund performance and expense data: Morningstar. Graphs and tables include results of author's calculations, based on those data. S&P 500 index performance data from Standard & Poors.

*Tiemann Investment Advisors, LLC is an SEC-registered investment advisor based in Menlo Park, California. For more information, please send your request to information@tiemann.net or visit www.tiemann.net.
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