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OD Financial Planning

Andrew Baechler, CFA

Focus on Fees

What are the different types of fees associated with bonds and mutual funds? It is definitely a case of "buyer beware", as financial expert Andrew Baechler explains.

Most investors are either unaware of, or unsure about the different types and levels of fees they pay when investing in bonds, mutual funds and the recently popular principal protected note. The investment industry and regulatory bodies are partly to blame for this, as the average investor may find it hard to decipher information about fees in the prospectuses and financial reports available. I can tell you with absolute certainty that in the world of investments nothing is free, so knowing how and what fees you are charged is important.

Bonds

Contrary to popular belief, there is generally a fee charged when you buy or sell a bond through a broker. This fee, however, doesn't need to be disclosed to you on the transaction slip. Unlike stocks, most bonds do not trade on organized exchanges where price information is readily available. Instead, bonds trade on the over-the-counter market, which is essentially an electronic system linking the various participating banks, bond dealers and other financial institutions. Participating firms negotiate prices among themselves for the purchase and sale of various bonds held in their respective inventories at what amounts to a wholesale price. The broker from whom you buy the bond then marks up the wholesale price, which reduces your yield, and resells it to you at a retail price. The difference between the wholesale price and the retail price is the firm's profit and is akin to a fee. Due to Ontario's securities legislation, this price difference doesn't need to be disclosed to individual investors.

Mutual Funds

A study[1] released in 2007, conducted by three professors from Harvard, the London Business School and the Georgia Institute of Technology, reveals that Canada's mutual fund fees are the world's highest. According to the study, the average Canadian investing in equity funds paid approximately 2.56 percent in fund and management-related expenses. The Investment Funds Institute of Canada (IFIC), the national trade association for the Canadian mutual funds industry, has challenged the results of the study. IFIC contends that the study was not a true "apples to apples" comparison of the fees charged in Canada vs. the other 17 countries in the study. To me this challenge is a moot point; maybe Canada's mutual fund fees are not the highest in the world, but they are very high nonetheless and understanding how mutual funds charge fees is important.

Mutual funds can be broadly divided into three fee categories: front-end loaded (FE), back-end loaded (DSC) and no load. A FE fund charges investors a commission of one to three percent when they purchase the fund. A DSC doesn't charge a fee at the time of purchase but does charge a fee if the fund is redeemed (sold) within a prescribed time frame, generally five to seven years. DSC fees can be as high as seven percent and decline over time. No-load funds do not have sales charges, although a "penalty fee" may be applied if the fund is redeemed early as defined in the fund's prospectus.[2] Your advisor should always be willing to discuss which fee structure will apply to you whenever he or she recommends a fund for purchase or sale.

In addition to the above sales fees, mutual fund investors are also subject to the Management Expense Ratio (MER), an annual fee charged to fund investors, which was the focus of the study discussed above. The MER covers such expenses as:

- The fund manager's fees
- Trailer fees paid to commissions-based advisors (generally 0.25 percent – 1.0 percent)
- Administrative, legal and audit fees
- Brokerage commission fees for trades
- Marketing expenses (yes, as a fundholder you do pay for the fund's advertising expenses)

No matter how the fund performs, the MER is deducted directly from the fund's assets, so you may be unaware of what the actual year-over-year cost of holding the fund. Also, if you purchase funds through a wrap account you will be charged a wrap account fee, if applicable, in addition to the MER. (A wrap account is the term used to describe a number of investment services that are bundled together and covered by a single fee. These services can include commissions, management fees, account administration and other services.)

Principal Protected Notes (PPN)

PPNs are usually structured to qualify as an exempt security, which means they are generally not regulated by the Ontario Securities Commission. As an exempt security, a PPN can be sold without providing the buyer a prospectus in which, among other things, the fee structure is described. This information will generally only be available in the offering memorandum, which the salesperson doesn't have to provide to the individual investor and, unlike a prospectus, is not reviewed by securities regulators. The fees associated with PPNs can include commissions paid to the salesperson (commonly four percent), ongoing management fees (usually two percent) and performance fees (which can range between 18 percent and 20 percent).[3] I am not a fan of PPNs, partly due to the high fees and lack of disclosure.

The fees you pay directly reduce the overall returns, and small differences in returns can have a significant impact on the portfolio's value over time. You have the power to keep these fees in check, so be sure to investigate thoroughly the fees you pay for your investments. OD

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References

1. Khorana, Ajay, Servaes, Henri and Tufano, Peter, "Mutual Funds Fees Around the World" (July 23, 2007). HBS Finance Working Paper No. 901023.
2. *Note that a prospectus is a legal document institutions and businesses use to describe the securities they are offering to participants and buyers. Most financial products, issued in Canada, must file a prospectus at* www.sedar.com
3. Piergeti, Louis, Al-Samadi, Maysar, Boyce, Larry, Cockerline, Jon, Corner, Richard and Popovic, Alex, "Regulatory Analysis of Hedge Funds" May 18, 2005