Broker fees from mutual funds affect advice, predict worse performance, new study says

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Brokers are supposed to recommend investments that are in the best interests of their clients. But a study published in the February 2013 issue of the *Journal of Finance* has found that mutual funds offering higher broker fees attract the most investments, especially when the broker is not affiliated with the mutual fund company. Every additional dollar paid to a broker corresponds with another six dollars invested into the fund, and another fourteen dollars if the broker is an unaffiliated third party whose compensation depends exclusively on sales commissions.

It also found these payments are linked to lower investment performance , especially when the fees come from one-time sales loads rather than ongoing payments.

It is the first such study to explicitly show how broker fees affect Investments Into funds and how they subsequently perform.

The freedom mutual fund companies have to decide how to compensate brokers has "real consequences" for the brokers' clients, the paper says. The implication, it adds, is there's a strong case for clearly showing customers how much their broker receives from their investment recommendations.

Brokers are typically compensated in two ways. If the fund is a front-end load, the investor pays a one-time charge, taken immediately off the top of their initial investment as a predetermined percentage. The broker receives the bulk of that charge.

"For the most part, investors are completely unaware," how much of the load goes to their broker, says Susan Christoffersen, a professor of finance at the University of Toronto's Rotman School of Management, who co-wrote the study with Richard Evans of the University of Virginia, and the University of Pennsylvania's David Musto. "If it's revealed, it would be in the statement of additional information or the details of a prospectus."

Investors may also not realize how much their brokers continue to receive out of their investments, via ongoing "trailer fees." These fees vary but in Canada make up about 40% of the management expense ratio, or MER.

The study looked at data on the performance and asset flows of U.S. mutual funds between 1993 and 2009 and related these with the fees paid to brokers disclosed in N-SAR filings to the U.S. Securities and Exchange Commission. The requirement for these filings arose directly out of regulators' concerns of conflicts of interest and the effect of broker fees on the growth and size of mutual funds.

More information: papers.ssrn.com/sol3/papers.cf … ?abstract_id=1393289

Provided by University of Toronto

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