Embedded mutual fund commissions hurt investors

A look at the case for and against trailer commissions, also known as trailer fees.

Welcome to the world of embedded fund commissions, of which Canada remains a leading global practitioner.

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When hiring lawyers, plumbers, hairdressers or just about every other service provider, the terms of engagement are straightforward.

You, the consumer, pay for services rendered. And if the service isn’t performed, you don’t pay.

In the mutual fund industry, that’s not how it normally works. Most brokers and dealers don’t charge clients for recommending what funds to buy or sell. Instead, they get paid by the fund companies. And get this: discount brokerages that provide no advice get paid just as much as those who do.

Welcome to the world of embedded fund commissions, of which Canada remains a leading global practitioner. Britain has banned mutual fund companies from paying commissions to salespeople. Australia’s ban takes effect in July. Meanwhile, Canadian securities regulators are actively looking into whether to follow suit.

Just about every Canadian mutual-fund company pays trailer commissions, also known as trailer fees. The cost is bundled in with the management fee that the fund company charges for portfolio management and other services.

The trouble with trailers is twofold. One is that they create an obvious conflict of interest. Advice-givers will tend to recommend funds only if they pay the going rate for trailer commissions, which is typically one per cent a year for equity funds and 0.5 per cent for fixed income funds.

Secondly, self-directed investors in mutual funds don’t have much in the way of unbundled choices. This results in discount brokers being paid trailer fees for services they aren’t providing.

Many fund companies have created lower-fee mutual funds — known as F series or F class — that are stripped of any embedded commissions. These funds are available only
through fee-based advisers who charge clients directly for their services, not through discounters.

At a June 7 panel discussion sponsored by the Ontario Securities Commission, which brought together fund managers, advice-givers and consumer advocates, views clashed sharply over whether trailer fees should be eliminated.

Industry executives like Joanne De Laurentiis, president of the Investment Funds Institute of Canada and Greg Pollock, president of Advocis, the Financial Advisors Association of Canada, contend that the bundled approach to mutual funds serves investors well.

Through trailer fees, they say, access to investment advice is available at a reasonable cost to small investors whose account sizes are too small to be served by fee-based advisers.

The mutual fund industry fears that banning trailers would cause some advisers to abandon mutual funds in favour of alternatives like segregated funds. These are insurance policies with an investment component. They also pay trailer fees.

Among those calling on the OSC and regulators to get rid of trailer fees and other embedded compensation were Ken Kivenko of the Small Investor Protection Association, Marian Passmore of the investor-rights foundation known as FAIR Canada, and Paul Bates, chair of the OSC’s investor advisory panel.

Bates, a former brokerage executive, expressed confidence that the advice-giving industry would be able to adapt and continue to serve small investors.

“If there’s a gap in the marketplace, an entrepreneur will fill it,” Bates told the OSC session.

One major fund company, Invesco Canada Ltd., offered to address the unfair treatment of do-it-yourself investors. While defending trailer fees, Invesco President Peter Intraligi told the roundtable session his firm is willing to make no-trailer-fee funds, or funds that pay a reduced trailer, available through discounters.

The problem, as noted by both Intraligi and FAIR Canada’s associate director Passmore, is that most discounters refuse to carry these low-cost choices. The limited number of unbundled funds, said Passmore, is evidence of a lack of competition. Banning trailers, she said, would allow for more competition and lower fees.

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