The "Fiduciary Rule" and OEF Share Class Zoo

Unfortunately this Washington Post op-ed didn't distinguish between Registered Investment Advisors, who are required to have a fiduciary relationship with their clients, and brokers. The ethical standards that CFA Charterholders must adhere to in order to keep their designation are even higher. The unedited version of the following is available here: https://www.washingtonpost.com/posteverything/wp/2017/02/06/the-trump-administrations-misguided-attack-on-retirement-savers/?utm_term=.2033bc3e7d27

The Trump administration's misguided attack on retirement savers

By Jared Bernstein February 6

Jared Bernstein, a former chief economist to Vice President Biden, is a senior fellow at the Center on Budget and Policy Priorities and author of the new book 'The Reconnection Agenda: Reuniting Growth and Prosperity.'

If you needed any more proof that progressives stink at coming up with catchy names for things, consider that we're now defending something called the "fiduciary rule." But defend it we must.

I'm talking about a rule change from the late Obama era intended to reduce conflicts of interest between financial advisers and their clients saving for retirement. Most people are unaware that any such conflicts exist, but they do, and at significant costs to retirement savers. By requiring financial advisers (Brokers) to follow an established, fiduciary standard, the rule, which (RIAs like HCM already follow and) was slated to take effect in April, is simply intended to more closely align the interests and goals of those trying to do the right thing — save for retirement — and their advisers.

Last Friday, the Trump administration signed an executive order designed to undermine the rule before it takes effect. In an economy in which retirement security is already too precarious, doing so is a big policy mistake. But it is also a particularly blatant example of the phoniness of President Trump's populism. His order is a gift to financial markets and a slap at some of the people who voted him into office, most of whom, according to a recent poll, support the fiduciary rule (65 percent support; 17 percent oppose).

The rule insists that those who advise clients on where to invest their retirement savings must put their clients' interests ahead of their own profits. For example, when someone on the cusp of retirement rolls over their 401(k) into an IRA, the rule would generally prohibit the adviser from nudging the client into an investment product that gives the broker a kickback while hurting the investor's long-term yield. It would prohibit unnecessary rollovers, overactive buying and selling that generates brokers' fees at the expense of returns, and the kind of fee-generating overmanaging of funds that, with compounding, shaves real money off returns.

Over 35 years, a one-percentage-point-lower annual return will reduce your nest egg 25 percent. And that is, in fact, what academic research finds to be the annual hit from conflicted vs. non-conflicted advice.

A lot of claims about the rule's unintended consequences are predictably being tossed about. Critics claim that it would reduce the amount of advice given to savers, hurt the sellers of certain products, crimp the paychecks of hyperactive advisers and cost the industry billions in lost profits (one consulting firm claims the rule will reduce the industry's revenue by $20 billion just over the next few years).

To my ears, this says, "If we can't overmanage and overcharge, then we'll earn less!" These purported billions represent reduced costs for savers, a clear feature of the rule. I don't see the problem.

Another big complaint is that the rule would force current activist advisers to push clients to more passive funds. In fact, the rule forces no such thing: Advisers can recommend any product as long as they're not receiving conflicted compensation, such as commissions and bonuses, and even if they are getting such compensation, they can still recommend actively managed funds if doing so is in their client's best interest (e.g., if their client prefers active management).

Still, to the extent that the rule reduces active management, research on long-term returns shows that to be a feature, not a bug. One recent study found that for longer-term investing, passive index funds beat actively managed funds in 29 different asset classes. Even when the study took out the impact of the fees charged by the active managers, the passive funds still dominated. ...

At this point, we have two sources of hope. First, it will probably take many months for the administration to repeal the rule and/or issue an alternative proposal, either of which would require notice and comment procedures. On the other hand, according to this analysis, there are ways the administration could delay the rule's April start date.

Second, many decent folks in the industry saw this rule change coming, and some large institutions, including Merrill Lynch and Morgan Stanley, have long prepared to, if not fully implement the rule, at least reduce conflicts of interest, regardless of actions by the new administration (here's an informative fact sheet about these changes in action). And perhaps the dust-up over the fiduciary rule will prompt the 75 percent of consumers who mistakenly assume brokers must act in their clients' best interest to ask their advisers about such conflicts. ...

For you DIYers a 7 minute video from Morningstar on Open-end Fund share classes: http://news.morningstar.com/cover/videocenter.aspx?id=788936

The referenced article with our parenthetical comments are in red:

How to Choose Among Fund Share Classes

By Karen Wallace | 01-24-17

You may have heard some buzz recently about new share classes of mutual funds (T shares and "clean" shares) that are set to roll off the assembly line.

That's all we need, you might be saying. After all, the mutual fund industry has seen a proliferation of share classes in recent years, and it's become increasingly difficult to discern the differences among them.

Traditionally, share classes have represented different ways fund companies "package" their product. The basic product is portfolio management, but there are other benefits that are included in the fees, such as advice, fees paid to the fund's other service providers (such as its custodian), shareholder services, and more.

The Department of Labor's Conflict of Interest Rule has the potential to reshape the way funds are priced, however. Here is a rundown of the major share classes you are likely to encounter in the marketplace today, as well as some new types of share classes that may be poised to gain in popularity in a post DoL-rule era.

Load Fund Share Classes
Some fund families like Franklin, Oppenheimer, and American Funds sell mutual funds through financial advisors; these are so-called load funds because an investor typically pays a front-end load at the time of the initial purchase. Here are some of the share classes you would typically see offered by an "advisor-sold" or "load" fund shops:

A Shares
A shares typically carry front-end sales charges, or loads, which come right off the top of your investment when you buy. For example, American Funds Growth Fund of America (AGTHX) A shares carry a 5.75% load. That means that if you invest $10,000, you'll pay $575 in sales charges right off the bat, and only the remaining $9,425 will be invested in the fund. (It's also worth noting that some advisors opt to put their clients in load-waived A share classes.)

B Shares
B shares typically carry deferred sales charges, often called back-end loads. Unlike the A shares, you won't pay anything upfront if you opt for the B shares, but you might pay a charge when you sell your shares, depending on how long you hold them. B shares have declined in popularity in recent years, and in fact, a number of firms have discontinued them. B shares usually aren't the most economical option, especially for long-term investors, because their expense ratios--the fees that you'll pay year in and year out--are usually far higher than expense ratios for the A share class. Returning to the Growth Fund of America example, you'll pay 1.42% in annual expenses for the Growth Fund of America (AGRBX), whereas the A shares of the same fund charge less than half that much.

C Shares
You won't pay a front-end sales charge to buy C shares, commonly known as "level-load" shares, of a given fund. The maximum deferred sales charge you could be liable for--1.0%--is also much lower than it is for B shares, and it typically scales down much faster than the back-end loads of B shares. But C shares invariably have higher year-to-year expenses than do A shares, making them a bad bet for long-term investors. Growth Fund of America (GFACX), for example, charges an expense ratio of 1.46%.

T Shares
T shares could be a game-changer. As John Rekenthaler details in this article, owing to the DoL's Conflict of Interest Rule, Morningstar expects that every share class that now has an A share class will soon have a T share class. All T shares will be priced identically: 2.5% upfront (declining for larger purchases) and an ongoing 0.25% 12b-1 fee. In contrast to A shares, which can be higher or lower across fund categories and fund companies, T shares always have a 2.5% upfront load and a 0.25% ongoing fee. This dramatically changes things: A shares are used to be the most cost-effective choice for long-term investors who are using a commission-based broker to transact, but T shares halve that cost.

No-Load Fund Share Classes
Other fund shops do not require investors to pay sales loads at the time of initial purchase. These fund shops include Vanguard, Fidelity, T. Rowe Price, and Dodge & Cox.

No-Load Shares
The typical no-load fund doesn't carry any letters after its name, though no-load share classes are sometimes tagged as "retail" or "investor" shares. No-load means you won't have to pay a broker to buy and sell your

shares--you can execute the transaction yourself, buying directly from the fund company or from a fund supermarket such as Schwab, E*Trade, or TD Ameritrade.

Note that a retail investor may pay a 12b-1 fee, which is a difficult-to-define fee that goes toward fund marketing and distribution. The fee is part of the fund's overall annual expense ratio, and varies from 0.25% to 1% of fund assets (the fee is higher for B and C share classes).

Clean Shares
In another development that has the potential to be a game-changer, American Funds recently got the go-ahead from the Securities and Exchange Commission to issue F3 shares, or "clean shares"--so-called because they include management fees and administrative costs but are sold without a 12b-1 distribution fee. This way, brokers can set their own commissions for selling the shares. As explained here, unbundling the distribution fee from the expense ratio should give investors a better idea of what they're paying to brokers and asset managers for their respective services. Investors can also better compare the investment-related charges for clean shares of actively managed open-end mutual funds with exchange-traded funds.

Institutional Shares
Many fund shops also offer institutional share classes of certain funds--often tagged as I or Y shares. Such offerings are usually only available to investors or institutions who invest large sums--usually $1 million or more--and have some of the lowest expenses in the mutual fund world (they typically do not charge 12b-1 fees). If you participate in a retirement plan at work and your employer is a good-size company, there's a good chance you invest in the institutional share class of a given fund. (Whenever possible, HCM clients are invested in this share class. For example: BIICX, DDDIX, GPIIX, QMNIX and WIINX.)

Retirement Shares
Retirement shares--sometimes tagged with an R after the fund name--are share classes that are explicitly created for retirement plans, such as 401(k)s. The fees that these funds charge range widely. Some R shares bundle in the record-keeping and other administrative costs associated with running the plan. For example, the R2 shares (RGABX) of Growth Fund of America charge 1.40%. Meanwhile, others are ultralow-cost (no sales commissions or 12b-1 fees), such as the R6 shares (RGAGX) which charge 0.33%.

How to Decide
If you buy and sell funds through a commission-based broker and have a long time horizon, chances are the T shares will be the most cost-effective for you. Discuss the amount you'd like to invest, your time horizon, and your goals with your advisor; all are important considerations when determining the most appropriate share class.

If you're investing a large sum, it's also worth inquiring to see if you're eligible for a discounted sales charge. These discounts--often called breakpoints--kick in when your total investment across the fund family reaches a certain amount (for A shares, it's $25,000 or more). (As previously shared, one of our clients was formerly with an Edward Jones broker who chopped up their portfolio into enough nearly identical OEFs to stay just below the breakpoint in each.) Even if you don't meet the minimum asset level yet, you may still be able to qualify for the discount if you sign a letter of intent that states you plan to invest enough money to qualify for the discount within a specified period of time (usually 13 months). (For more on breakpoints, see this article on the Financial Industry Regulatory Authority website.)

Last but not least, if you're using a commission-based broker, make sure that you're satisfied with the quality of advice you're receiving. Morningstar has tended to be agnostic on the issue of whether it's better to buy a load versus a no-load fund. No-load funds may be cheaper and don't have sales charges, but if you're receiving good advice, that may be worth the extra cost (it isn't). If you don't want or need investment advice, you shouldn't buy the T, A, B, or C shares of a fund because you'll be paying for something (advice) you're not using.

Our thoughts

By now sharing any additional thoughts would be beating what should have been a dead horse long ago.