

Redemption Song: How Fees Help Mutual Fund Investors

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Once upon a time, [there was a mutual fund market timing scandal](#).

(Short version: Market timing a sort of short-term trading strategy centered on the fact that mutual fund prices are usually set once a day. WSJ reporter Tom Lauricella gave an example in a story from a while back. Consider a U.S. mutual fund that invests in overseas stocks. Now, perhaps U.S. stocks rally during the afternoon on a day when overseas markets — closed by the U.S. afternoon — finished flat or down. That means when the international stock fund prices its shares at 4 p.m. New York time, the value of the foreign stocks it owns only reflects the foreign trading day that finished before the U.S. rally got rolling. That means it doesn't incorporate the U.S. rally, which might boost prices of overseas stocks when markets open there the next day. If that seems like a good bet, a market timer buys the shares before 4 p.m. in New York, planning to turn around and sell for a quick gain the next day. Get it? Got it? Good.)

Anyway this somewhat problematic practice caused quite an uproar back in 2003. And, long story short, many mutual [funds adopted redemption fees](#), essentially fess charged when one sells shares of a fund, which were meant to limit marketing timing by making it costlier to move rapidly in and out of funds, and thus, less profitable. But did the introduction of redemption fees actually do anything?

That's the question at the heart of research by Iuliana Ismailescu and Matthew Morey at the Lubin School of Business at Pace University. Their paper "Redemption Fees and the Risk-Adjusted Performance of International Equity Mutual Funds" claims to be the first to look at the introduction of redemption fees on international equity mutual funds.

In sum, the answer is yes. The scholars lay out three key points:

1. Studying a group of 157 international equities they found that with the introduction of a redemption fee, there was a significant increase in risk-adjusted fund performance. Researchers looked at funds that were introduced at least three years before the market-timing scandals and three years after the scandals. The performance was higher after the redemption fee was introduced.
2. Funds that introduced larger redemption fees (the SEC caps redemption fees at 2%) had "significantly better" performance than other funds after they introduced the redemption fee.
3. But the main reason that funds fared better after introducing a redemption fee was because after introducing the fee, the funds held less cash. "People were essentially using mutual funds as ATMs," Prof. Morey says. "And that hurt long term investors, especially with international funds."

The idea for the paper came about, Prof. Morey says, when he was hit with hefty redemption fees while trying to invest in Brazil. "I was frustrated," he says. "And now I know that if you're looking for an international equity fund, you probably want to pick one with a redemption fee."