

No-loads appear to be besting deferred-load funds; [2 STAR Edition]
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Abstract (Document Summary)

The deferred-load funds, however, never lived up to their promise. According to research conducted by Matthew Morey, an associate professor of finance at Pace University, the average deferred-load fund has shown no ability to outperform the average no-load fund. And by some measures, the deferred-load variety has performed worse.

Even if the original rationale has vanished for deferred-load funds, they may still be better choices in some cases - specifically, if their total expenses over the holding period are less than for another class of the same fund. But that is not often the case. Morey found that the average deferred-load fund imposed significantly higher 12b-1 fees - what a fund's distributor deducts for marketing costs. According to Morey, such fees for the typical deferred-load fund are almost 0.7 percent higher than for the average front-end fund and 0.9 percent more than for the typical no-load fund.

Full Text (709 words)

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More than 30 percent of diversified equity mutual funds now have deferred loads, or sales charges. Their popularity, however, is a mystery.

Deferred-load funds differ from front-load funds by imposing commissions when investors sell, not when they buy. In most cases, the deferred load gradually declines as the holding period increases. Once the investment has been held for the requisite number of years, it effectively becomes a no-load fund.

At one time, these funds had a performance-based rationale: Their managers could incur more risks and, it was hoped, achieve greater returns. Because investors would tend to hold their shares longer, the managers would need to hold less cash to meet unexpected

redemptions, and they could invest in less liquid securities, whose historical performance has been better.

If that reasoning had been correct, managers should have had no trouble outperforming the average no-load fund, whose management had to invest more heavily in liquid securities and maintain more cash.

The deferred-load funds, however, never lived up to their promise. According to research conducted by Matthew Morey, an associate professor of finance at Pace University, the average deferred-load fund has shown no ability to outperform the average no-load fund. And by some measures, the deferred-load variety has performed worse.

In his research, Morey studied the performance of 59 deferred-load funds from the beginning of 1995 through 2000, assuming that each was bought at the start of the period; by the end of that time, the loads of virtually all of them would have declined to zero.

Even if the performance-based rationale had been stronger, it would have disappeared by the late 1990s. By then, most fund families had begun to take advantage of a Securities and Exchange Commission ruling making it easier to offer multiple share classes of the same fund. More funds were offered in either front-end-load or deferred-load packaging but were otherwise identical, with the same portfolios and the same managers.

Consider the AAL Capital Growth fund. It is sold in three different ways: Class A is the traditional front-end-load version, with a maximum 4 percent initial sales charge. Class B is the deferred-load version, with no initial charge, and a back-end load that ranges from a high of 5 percent, if shares are held for less than a year, to zero if they are held for more than five years. Class I has neither a front-end nor a back-end load but has a very high initial investment minimum, \$500,000. AAL does not maintain three different portfolios corresponding to these three classes; all three are managed together as part of the same portfolio.

Even if the original rationale has vanished for deferred-load funds, they may still be better choices in some cases - specifically, if their total expenses over the holding period are less than for another class of the same fund. But that is not often the case. Morey found that the average deferred-load fund imposed significantly higher 12b-1 fees - what a fund's distributor deducts for marketing costs. According to Morey, such fees for the typical deferred-load fund are almost 0.7 percent higher than for the average front-end fund and 0.9 percent more than for the typical no-load fund.

Investors often do not notice 12b-1 fees because they are deducted before a fund's net asset value is calculated. Still, they are significant.

Funds have other expenses beyond 12b-1 fees, of course, and in many cases these are also higher for the deferred-load class than for the front-end-load or no-load versions. Overall, the expenses can quickly cancel any advantage created by not having to pay a front-end load.

Consider an investor who buys the deferred-load version of AAL Capital Growth and sells after five years. Superficially, it looks as if this investor is ahead of the game by avoiding the 4 percent load of the Class A shares. But the 12b-1 fee for the deferred-load shares is .75 percent higher than for the front-end shares, and other expenses are just over 0.2 percent higher. Over five years, these amount to well over 4 percent.

My guess is that, if you do a similar calculation for most deferred-load funds and holding periods, you will reach the same conclusion: Invest in another class instead.

Credit: New York Times