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It's Called 'Class A,' but Is It Best for You?

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INVESTORS who buy mutual funds with loads, or sales charges, must sort through a dizzying list of share classes with a variety of fees. Class A shares are sold more widely than the B or C shares — but it's not clear whether that is because they are best for the investor or best for the broker.

Conflicts of interest among mutual fund brokers have been the subject of considerable regulatory action. Investigations have turned up brokers selling funds at full price, without regard to “break points” — jargon for the purchase amount at which investors are entitled to a discount. Some brokers have recommended particular shares so that they can win exotic trips. Banks, brokerage firms and insurance companies have paid regulatory fines approaching \$85 million recently to settle such cases.

Yet biases remain a hurdle for investors who buy mutual funds with sales charges. That's because brokers and financial advisers selling these funds make different commissions, depending upon which share class they sell.

Class A shares are by far the most widely sold, perhaps because they are generally more lucrative for brokers when they make the sale. Class B shares often turn out to be a better deal for investors but are shunned by many brokers.

Despite four years of on-and-off work on the issue, the Securities and Exchange Commission has not yet enacted rules that might shed light on fund sales conflicts. As a result, these biases remain largely hidden from view.

“It is absolutely bewildering to try to figure this stuff out,” said Barbara Roper, director of investor protection at the Consumer Federation of America. “Brokers and fund companies use complexity as an excuse not to do good disclosure. Investors have not asked for that complexity, and it has not been adopted to benefit investors.”

Under current rules, fund prospectuses are permitted to show total return figures that do not factor in sales charges. Even expense ratios, the numbers that most investors look to as a proxy

for costs, do not indicate how much of an investment is actually being used productively in a fund, after deducting fees and sales charges.

Prospectuses for load funds make it even harder because, in most cases, they do not disclose the commissions brokers receive when they sell various classes of shares. These include Class A shares, with upfront loads that can run to 5.75 percent, B shares with deferred charges that start at 4 percent and decline over time, and C shares, with charges based on assets under management and the timing of redemption.

INVESTORS can avoid these problems by buying no-load funds from firms like Vanguard, T. Rowe Price and Fidelity. But sales of load funds remain high; according to the Investment Company Institute, the lobbying organization for the mutual fund industry, roughly one-third of new fund sales in the first three quarters of 2007 were load shares. It is those investors who are most exposed to hidden sales conflicts.

Class A shares are often assumed to be cheaper than other classes of load funds. The A shares generally have lower operating expenses, which can sometimes offset their upfront sales loads. New sales of these shares rose to \$420 billion in 2006, Investment Company Institute figures show, up from \$340 billion in 2000.

But Class B shares are often actually less expensive, especially for investors who place \$50,000 or less in a fund that they intend to hold for five years or so. One reason is that the high front-end load of the Class A shares means that investors have less money at work from the moment they invest.

And because brokers often waive the deferred loads when investors have to sell as a result of a divorce or disability or to meet required minimum distributions out of an individual retirement account, Class B shares become even more attractive.

The growth in Class A shares has followed a raft of regulatory actions, beginning in 2001, against brokers who sold Class B shares improperly, such as when another share class would have been more suitable. Such regulatory actions brought notoriety to the B share class.

As a result, some firms and fund companies have limited the amount of B shares that brokers can sell; others have barred sales of them altogether.

"Prohibitions against selling B shares may have been a mistake," said Russell E. Planitzer, chief executive of NewRiver Inc., a firm in Andover, Mass., that helps financial companies comply with regulations. "If you are a long-term investor, B shares are best in most cases."

In mid-2005, MetLife Securities revised its policies on the sale of B shares, prohibiting sales of \$50,000 or more in one fund family over a 13-month period. The next year, Morgan Stanley limited to \$25,000 the B shares its brokers can sell in the same fund family. Dreyfus halted sales of B shares to new investors in 2006, and last week, Nuveen Investments said it was eliminating them in four of its funds.

Not surprisingly, B shares accounted for only 4.7 percent of load shares sold in 2006. Back in 2000, that portion was 22 percent. To be sure, Class A shares are sometimes sold within 401(k)'s and in so-called wrap accounts in which loads are waived. But measured in dollar amounts, Class A shares sold with loads probably equal those sold without, fund analysts say.

While it is possible for investors to get a glimpse of how brokers are paid for each share class, it is complicated and tedious work. Here is how it might be done:

First, dig through fund documents — not just prospectuses but also the statement of additional information, or S.A.I. Investors can also consult the mutual fund expense analyzer on the Web site of the Financial Industry Regulatory Authority, the securities firm regulator. The analyzer allows investors to compare the costs of various funds and share classes for expected holding periods and estimated returns.

Consider what a broker earns selling \$40,000 worth of Class A shares in the Lord Abbett Affiliated fund, a \$18 billion value stock fund. According to its prospectus, which describes how sales representatives are paid, buyers of A shares are charged a 5.75 percent load. On \$40,000, that would amount to \$2,300, so only \$37,700 remains at work in the fund.

Of the \$2,300 sales load, according to the fund's documents, \$2,000 would go to a sales representative and his firm, while the fund company would keep \$300. Annual asset-based trailing commissions of 0.25 percent begin in the first year. After a year, if the fund earned 8 percent, the trailing commissions would be \$98. So during the first year the investor holds the Lord Abbett fund, the brokerage firm that sold it would receive \$2,098.

Now consider the commissions paid on the same size trade in the fund's B shares. With an upfront load of 4 percent, the brokerage firm takes away \$1,600; annual trailing commissions of 0.25 percent often do not start until the second year. And on C shares, the pay is even less in the first year — \$400 — with trailing commissions of 1 percent a year beginning in the second year.

Brokers split these payouts with the firms that employ them, typically earning 45 percent for themselves. Nevertheless, it is simple to see that in this example, Class A shares produce more

revenue for the firms and the brokers, even if investors hold their shares for less than five years.

A Lord Abbett spokeswoman declined to comment.

A second example of a fund that appears to pay considerably more to representatives who sell its A share class is the First Investors Growth and Income fund. On a \$40,000 investment, brokerage or advisory firms would receive almost \$2,000 on A shares, versus an estimated \$1,600 on B shares in the first year. The prospectus is silent on how sales representatives are paid, but the fund's statement of additional information discusses some information on A share commissions.

Robert Flanagan, president of First Investors, said the industry was moving away from B share sales because of regulatory actions against other firms.

Another example is provided by the AllianceBernstein Global Bond fund, a \$1.7 billion fund. Investors buying \$40,000 of that fund's A shares would pay \$1,700 to the brokerage firm or financial advisory firm in the first year. Buying B shares would cost them \$1,300, and C shares, \$400.

Increasing the potential for investor confusion, commission structures among different share classes sometimes vary even within the same fund family. For example, while AllianceBernstein Global Bond pays considerably more to those who sell A shares, its International Value stock fund pays essentially the same commissions on both A and B shares.

Indeed, on a \$40,000 investment, the fund would pay commissions of \$1,699 on A shares and \$1,703 on B shares. The commission on C shares would be \$400.

An AllianceBernstein spokeswoman said, "They are structured differently because of the return ability of bonds relative to the return ability of equities."

Interestingly, not all funds pay representatives more to sell their A shares. The American Funds Amcap fund, the \$25 billion large-capitalization growth stock portfolio, would pay the sales representatives' firms the same \$1,600 on a \$40,000 purchase of A shares or B shares. American Funds' prospectus also provides a detailed description of what it pays sales representatives.

Of course, if an adviser earns more money on a certain class of shares that is best for the investor, there is no problem. But load fund prospectuses do not state in plain English when

commissions might conflict with share class choices or how costly those conflicts can be, so investors are left in the dark.

MR. PLANITZER of NewRiver says that shining a light on conflicts in fund sales representatives' pay is long overdue. He urged the S.E.C. to put forward, after the past four years of discussion, regulations requiring brokers to give clients a document disclosing their commissions and outlining some potential conflicts. The document would be provided when the mutual fund shares are bought.

"Investors are entitled to a simple point of sale rule that says, 'Before I sell you something, I will disclose all this information,' " Mr. Planitzer said. "But until this rule shows up, investors should insist that their financial advisers provide them with this information."

A spokesman for Morgan Stanley said the firm would soon install a calculator system that would let its brokers analyze share class differences.

Using the mutual fund fee analyzer from the Financial Industry Regulatory Authority, as well as fund prospectuses, can help investors tell when Class A shares pay more to sales representatives than B shares. Investors who choose to buy load funds may want to ask their brokers or financial advisers how their pay differs among share classes. Brokers and financial advisers know what the various share classes pay. At the moment, investors need to do their homework to get the same information.

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