F-class mutual funds fail to take the market by storm

Tepid response is the result of pricing and the growing availability of other fund classes

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By Gordon Powers

Manufacturers of mutual funds continue to release a steady stream of F-class funds to appeal to advisors who would rather charge fees for their services and clients who prefer to see fees broken out and clearly stated. To date, however, this fund class has received only limited take-up.

As of Dec. 31, 2006, F-class assets under management had grown to $8 billion from $6.3 billion a year earlier, and the number of sponsors offering F-class units had increased to 32 from 29, reports Toronto-based **Investor Economics Inc.** However, with only 1.1% of mutual fund industry AUM, the sector is still short of the modest 1.6% it represented back in 2004.

Goshka Folda, managing director of Investor Economics, attributes this flat response to a combination of factors, including pricing, the greater availability of fund classes overall and the inability of some dealers to process this particular line of business adequately.

"F-class funds have clearly not met sponsors' growth expectations, which may have been optimistic," Folda says. "In recent years, it has been low-load arrangements that have moved to the forefront."

Low-load funds, which have two- or three-year redemption schedules and pay advisors commissions of 1.5%-2%, were the growth leaders in each of the past three years, with an average annual compound growth rate of 45%, more than triple the overall mutual fund industry's growth in that period.

F-class units — which were introduced in 2000, with just three firms offering them — strip commissions out of their cost and, as a result, offer clients lower management expense ratios. Advisors then add their fees in discussion with the clients. Typically variants of A-class funds, F-class units have the same holdings and investment mandates as their higher-MER cousins.

The target audience for F-class units is advisors at large investment dealers who have been moving to fee- or asset-based accounts and away from transaction-driven business. The units can easily be combined with other securities within an account. F-class funds also appeal to higher net-worth clients looking to assess the value of the advice offered and to negotiate fees.

But the biggest attraction for well-heeled clients isn't necessarily lower fees, says Dave Paterson, president of **Paterson & Associates**, a Toronto-based consulting firm that provides fund research to advisors. The advantage comes with the unbundling of those fees and the resulting transparency.

"You avoid any ambiguity using F-class units within a fee-based model," he says. "There's no doubt about who is paying what to whom, and this appeals to the more affluent segment of the market."

It's all about the value proposition, agrees Dan Hallett, president of **Dan Hallett & Associates Inc.**in Windsor, Ont.: "Successful businesses have to demonstrate what makes them unique and then explain how this benefits their clients. Being fee-oriented allows advisors to do that."

However, advisors with mid-sized books who may be interested in shifting into a fee-based business often find it difficult to completely forgo up-front commissions, Folda notes: "This group tends to view the low-load option as the stepping stone to a fee-based model. For many, F-class units are a bit of a jump."

Most low-load structures have a tiered trailer set-up in which, at the end of the redemption schedule, the trailer fee increases to match that of the front-end version of the fund.

The industry takes the position that F-class funds can be sold only through advisors compensated by charging their own fees. As a result, the funds remain unavailable to self-directed investors who use discount brokers. Three years ago, **E*Trade Canada Securities Corp.** attempted to make F-class funds available to these investors, but the deal was scuppered when the few fund firms who had initially expressed an interest pulled out.

One exception is **ASL Direct Inc.** , a small Toronto-based mutual fund dealer that sells F-class funds and regular A-class funds. (Trailers are rebated at *www.asldirect.com.*) ASL is considered a fee-based advisor, as it charges a monthly subscription fee and offers advice, albeit on a limited basis.

Kleinburg, Ont.-based **Agora eClient** offers a similar service for self-directed clients. "But," says Roy Vokes, a partner in **Agora Financial Services Inc.** , "it's a very small part of our business."

Vokes does, however, use F-class funds with several of his full-service customers. "It all depends on the size of the account," he says, "and what works for the client."

Some no-load manufacturers have added an F-class option to their funds to broaden their reach into the advice channel.

Last year, Toronto-based **Saxon Financial Inc.** hired wholesalers for the first time and now offers its fund family, with the exception of Saxon Money Market Fund, in an F-class series.

Phillips Hager & North Investment Management Ltd. of Vancouver has also added a new series of funds that pay trailer fees, as well as an F-class option.

In all these cases, F-class pricing is more complex than simply stripping out dealer compensation. In fact, distributors and manufacturers disagree on what constitutes a fair management fee.

According to a recent Investor Economics survey, the consensus view is that an F-class Canadian equity fund should have an MER of 90 basis points or less, with two-thirds of respondents suggesting 75 bps or less.

In practice, F-class equity funds' MERs range from a low of 0.45% to a high of 3.1%, depending on asset class and size of the fund, Investor Economics reports. The median F-class equity fund's MER is 1.49%, vs 2.67% for the corresponding A-class fund — a 118-bps gap.

Although F-class MERs recently have dropped slightly, says Folda, "The question remains about whether they are competitively priced for fee-based brokerage accounts, the platform for which they were originally created."

Folda expects the current trend toward lower MERs to continue as competition intensifies and scale drives down costs. Pressure will also come from the demand side if investment returns revert to single digits, she adds.

Folda predicts these pressures will support the growth of fee-based business in the full-service channel: "High-end and fee-based brokerage opportunities for funds will depend on how well fund companies adapt to these segments' pricing expectations."

But pricing is only part of the equation, says John De Goey, a fee-based advisor at **Burgeonvest Securities Ltd.** in Toronto. Although he applauds any move toward fee-based thinking and lower costs for the client, he believes advisors who look to F-class funds are offering clients a "poorer mousetrap."

"It's difficult to understand why a fee-sensitive advisor would be selling funds at all," he says. "Even with F-class units, funds are still expensive and a poor proxy for the asset class they represent."

Instead, De Goey believes advi-sors should be looking at exchange-traded funds: "If you compare ETFs with corresponding funds, virtually all of [the ETFs] would be in the first or second quartile on a long-term basis. And they have the added bonus of liquidity."

Add in tax efficiency and you take funds, including F-class, out of the equation, he says: "We're at the point at which you can build a fully diversified portfolio using ETFs." Even advisors who are not yet ready to make the leap toward a fee-based practice can find some attractive options, he adds.

ETF providers such as **Claymore Investments Inc.** of Toronto offer diversified products that pay trailers but are still priced competitively with F-class funds, De Goey notes.

However, because ETFs trade on stock exchanges, advisors who sell them have to be licensed to sell securities — a limited segment of the industry, says Hallett: "For most fee-oriented advisors, F-class funds will remain the preferred option for the moment." **IE**