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How Mutual Fund Sales Are Compensated In Canada

May 11th, 2008 • Related • Filed Under

In Canada, most mutual funds pay what are known as 'trailers' to firms and advisors. It is a cost that can be embedded in the MER (Management Expense Ratio) of a fund through the 'service fee'. While there are a handful of mutual funds that do not charge a service fee (and resulting trailers), most of them do. (Note that F-Class funds represent versions of mutual funds that have the trailers stripped out of them so that they can be held in special 'fee-based' accounts where the service fees are charged separately.)

For the funds that do have service fees, there may be five different versions of the same fund: Front-End Load, Back-End Load, No-Load, the newer Low Load (sometimes referred to as Level Load as well), and finally the F-Class versions.

Let’s examine the differences by seeing how a representative sample fund can be sold under each option.

The Representative Sample Fund

Our sample fund is a Canadian Equity mutual fund that has a management fee of 1.25% and ‘other fees and expenses’ of 0.25% (brokerage costs, administration expenses, etc). Therefore the mutual fund manufacturer’s fee to operate this fund is 1.50%. The manufacturer is the company that actually picks the investments and runs the portfolio.

The manufacturer also adds a ’service fee’. It is this service fee from which commissions are generated. The typical ’service fee’ is 1.00%, with a few exceptions as noted below.

To make a long story short the MER of this fund would be 2.50% which is made up of the management fee and other operating expenses (1.50%) plus the service fee (1.00%).

Front-End Load Mutual Funds

A front-end load version of this mutual fund pays an ongoing trailer to the advisor of the typical 1.00%. This means the advisor will receive 1.00% of the average value of your investment in this fund over the course of every year. The reason that it is called a front-end load version is because the advisor additionally has the ability to charge you a front end sales charge between 0% and 5% which gets deducted from your investment immediately. In many cases, fund companies will limit this to a maximum of 2% instead of 5%. (Further, many advisors will sell a front-end version of a fund with a front-end fee of 0% - they would do this when there is no specific ‘no-load’ version of the same fund available and they would like the features associated with that type of version of fund.)

As an example, if you invested $100,000 into a front end load fund with a front end load of 2%, your initial investment would be docked $2,000 which goes to the advisor leaving $98,000 to be invested and your advisor would further earn a 1% trailer per year of the amount in your account.

DSC Funds or Back-End Load Mutual Funds

Most commonly known as DSC funds, and also as Deferred Sales Charge funds and Declining Sales Charge funds.

Many funds are sold on a DSC basis - the reason for this is because it allows for the biggest up-front commission of any of the other versions (except for the advisor who would actually charge a 5% front-end load - which is pretty rare). It is important to note that DSC funds pay your advisor an up front commission of 5% even though this is not subtracted from your initial investment deposit. Rather, the fund manufacturer pays the advisor in advance for the future service fees that will be generated. The ongoing trailer fee to the advisor is reduced from 1.00% to 0.25% in exchange for the lump sum, up-front commission.

It is also important to note that if you sell out of these funds you are subject to a redemption fee for the first 7 years (plus or minus depending on the fund company). The redemption fee normally starts at 5.0% in the first year and then gradually declines to 0% after 7 years, hence these funds sometimes being referred to as ‘declining sales charge’ funds. After the 7 years there would be no fees to sell out of these funds.

This redemption fee is basically the fund company’s assurance that the up front commission to the advisor will be accounted for should the investor sell out before the future service fees can be generated. Basically, if you sell out of your fund after year 1, you pay a 5% penalty that covers the fund company’s initial commission to the advisor.

The service fee charged by the fund remains at 1.00%. The service fee shouldn’t be confused with the trailer fee the advisor receives, which for DSC funds is 0.25% as mentioned above. This means there is a 0.75% surplus the fund company is running every year and it is from this ongoing surplus that the up front commission liability is paid off over the course of a little more than 6 years (hence the 7 year redemption fee schedule).

If you invest $100,000 into a DSC fund your advisor generates a $5,000 commission right away, and you still have $100,000 invested. The advisor additionally receives an ongoing trailer fee of 0.25% of the average value of your investment every year. If you sell out of your funds within the first 7 years, you are charged a redemption fee which goes to the fund company to offset it’s up front payment to the advisor.

Essentially you are making a promise that you will stay invested for 7 years otherwise you will pay a penalty. Because the fund company has this guarantee from you, they can afford to pay a large lump sum to the advisor right away.

No Load Funds

No load funds have no initial front end fees, nor do they have any DSC fees. In other words you only have to worry about paying the ongoing MER for as long as you hold the funds. The advisor will generate a 1.00% commission every year based on the average value of your investment - they receive no up-front commission for no-load funds, just the ongoing trailer fee.

If you invested $100,000 to a no-load fund, you will have nothing deducted from your initial investment and you advisor will not earn an up-front commission but they will still earn a 1.00% commission based on the average value of your investment every year.

(In some very rare cases, a no-load fund may have a higher trailer than other versions of the same fund - which means it would have a higher service fee as well.)

Low Load Funds (Sometime referred to as Level Load)

Just think of these as a scaled back version of DSC funds, with a bit of a twist. The up front commission is lower, averaging 3% versus the DSC's 5%. The redemption fees start at 3% and decline to 0% after 3 years instead of the fees starting at 5% and declining to 0% after 7 years for DSC funds. But here is the twist: while the trailer fee is initially set to 0.25%, it increases to 1.00% as the redemption fee schedule expires. This is why it is also known as 'level load'.

If you invested $100,000 into a Low-Load fund (or Level Load fund), you are not docked any money up front. Your advisor receives $3,000 as an up-front commission and 0.25% of the average value of your account in the first year. He or she will receive 0.50% of the average value of your account in the second year, 0.75% in the third year and then 1.00% every year thereafter.

F-Class Funds

The 'F' stands for 'Fee based accounts' funds. These are relatively new types of accounts that charge clients a transparent fee that is easily seen on statements (called the Client Advisory Fee). This was introduced to address complaints of investors not knowing what they were paying their advisors as the compensation was essentially hidden and not well disclosed. For the F-Class version of a fund there is NO service fee. So for our sample fund that would mean that the MER of the fund has been reduced from the 2.50% in all the previous cases to 1.50%. BUT to make an apples to apples comparison, you would need to add the Client Advisory Fee to this amount to determine your all-in cost. While a fee-based account provides more transparency, it may not necessarily be cheaper. Typically the Client Advisory Fee for F-class funds is set to 1.00%, therefore it is exactly the same as a no-load fund in terms of cost and flexibility (i.e. no charges to buy and sell), although a bit more transparent.

There is one important advantage of fee-based accounts for non-registered investment portfolios in that it is possible to claim the Client Advisory Fee as a tax-deduction on your tax return (you need to have your accountant verify this for your own situation to be sure). In this case, if your marginal tax rate was 40%, then the after-tax Client Advisory Fee would be effectively 0.60% instead of 1.00%, meaning your out-of-pocket costs for an f-class version of a fund in a non-registered account would be 2.10% versus 2.50% for all the other fund versions.

If you invested $100,000 into an F-class mutual fund, your initial investment would not be docked any up-front charges, and your advisor would not receive any up front commission. The advisor would receive a percentage (typically 1.00%) of the average value of your account every year. There would be no cost to sell out of the f-class fund. For non-registered accounts, your Client Advisory Fee may be tax-deductible (check with your accountant).

The Commissions and Trailers are Split by the Advisor and His/Her Firm

As a final note, all the commissions noted above may not necessarily go to the advisor but may be split between the advisor and the advisor's firm. Depending on the situation the advisor normally receives between 40% - 80% of the commissions generated, although percentages below and above this range is also possible in certain situations.

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1. *Comment by MillionDollarJourney* on 11 May 2008:

   Another great article Preet. I enjoy the "insider" type posts.

2. *Comment by Four Pillars* on 11 May 2008:

   It's amazing how much more we pay for mutual funds than Americans do.

3. *Comment by Michael James* on 11 May 2008:

   Nice post. It can be difficult to write a brief summary without leaving out important details, but I think you've done it. I think I'll try to put together a 1000-foot view for readers who might get lost in the details.

4. *Pingback by Welcome Globe and Mail Readers… : WhereDoesAllMyMoneyGo.com* on 9 August 2008:

   [...] Noreen Rasbach contacted me earlier this week after having read some articles posted on this blog and she indicated that the column would be running in today's Globe and Mail. You can click on the following link to see the article posted on this blog that she quoted as being useful, How Mutual Fund Sales Are Compensated in Canada.

[...]

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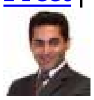
-  @ Joe - you may find very well determine that plain vanilla index tracking ETFs are good enough for you ...
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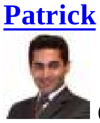
-  @ Melissa - thanks for your interest, but unfortunately the July contest is over - the next one will be ...
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- Of the choices remaining, I've only seen the original Ocean's Eleven. It's a stylish film that inspired the remake. Please ...
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-  @ Joe - thanks for the compliment - cheque is in the mail! :) As you will probably notice shortly, I ...
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  - Congratulations Preet and thanks for the plug as well. I've added my vote. A more permanent link to the story ...
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