The “Profoundly Serious” Problem That May Be Lurking in Your Mutual Funds

Description

Around the world, mutual fund trailer commissions (aka trailer fees) are beginning to be phased out, notably in the U.K. and Australia. Until recently, they seemed entrenched in the Canadian market—but it appears the dam is about to break even here.

It turns out the final nail in the coffin for trailer commissions may be a report for the Canadian Securities Administrators written by Schulich School of Business finance professor Douglas Cumming.

In a recent article in Investment Executive, Neil Gross, executive director for the Canadian Foundation for Advancement of Investor Rights (FAIR), noted that despite rising evidence to the contrary, “the investment industry has persistently refused to acknowledge that trailing commissions harm investors.”

But that refusal is now a moot point because the research gathered by Cumming and two colleagues over more than 10 years is pretty definitive, if not damning. The 43 mutual fund companies they scrutinized account for some two-thirds of all mutual fund assets under management in Canada.

Cumming focused on three points that are what critics have been assuming all along:

1. Mutual funds that *don’t* pay trailer commissions may manage to receive some inflows from investors as long as well as the funds do well and will lose inflows if they don’t perform well. Sadly, however, **if funds pay advisors trailer commissions, investment inflows will continue into the funds even if their performance is poor.**

2. **This so-called gravitational effect becomes even more pronounced for funds that pay higher trailers.**

3. If funds keep attracting investment inflows without having to generate strong performance, **their performance will deteriorate further over time**, particularly in funds that pay trailers.

This matters—a lot

The result is hardly a victimless crime. As Gross puts it, “trailers warp investment flows by letting something other than what's best for the investor drive sales, and this channels many investors toward suboptimal funds. Trailers also harm investors, and the market as a whole, by facilitating deteriorations in fund performance. These are profoundly serious findings."

This comes as no surprise to the consumer advocates who have been warning of just these trends since well before the Stromberg Report was delivered to the Ontario Securities Commission in 1995. I'm thinking of voices in the wilderness like the Frugal Bugle's Joe Killoran, whose monomaniacal zeal about the perils of trailers unfortunately caused many to stop listening to the warning. Those who did listen long ago fled mutual funds and their high fees and switched to index funds or exchange-traded funds (ETFs), often purchased at discount brokerages.

Conflicts of interest

But for the many folks still in mutual funds, trailers continue to create obvious conflicts of interest: as the cynics put it, they warp the client/advisory playing field, so that in effect the advisor is looking after his or her own retirement as much or more than he/she is looking out for the best interests of the client.

When you consider that investors are paying for what should be objective advice that's in *their* best interests, the case against trailers is pretty compelling. Investors end up unknowingly paying high costs for product recommendations that are compromised.

It's little wonder that trailers have already been banned in a handful of countries. Cumming's findings prove trailers are contrary to the public interest and Gross says "they ought to be banned in Canada as they have been in the U.K., Australia, and elsewhere."

While many thoughtful investment professionals are beginning to concede this, Gross warns that those who continue to oppose the ban of trailers will "look avaricious, biased and unprofessional. … From this point onward opposing a ban will make the opponent appear unfit to be an advisor, destroying their entire value proposition."

Still, many industry people will continue to be blind to this

There's an old saying that those whose livelihoods come from a particular activity tend to be blinded by it. Gross sites one such weak argument that banning trailers could trigger a so-called advice gap that will cause smaller investors to lose access to investment advice altogether.

Indeed, the industry group Advocis made a variant of this argument in a recent blog for my own Financial Independence Hub. Supposedly, small investors can't afford to pay for advice. Gross responds that this is self-contradictory—and that it's unlikely that small investors currently receive significant amounts of advice in the first place, so there's little to lose. And finally, and most tellingly, he notes that "an advice gap will arise only if the investment industry fails to innovate and develop new ways to serve small investors."

But innovation is already happening, as we've seen with robo-advisors, which are often built on the same ETFs that do-it-yourself investors purchase directly. A big focus of robo-advisors is millennials with only small amounts of money to invest (less than $50,000).

From what I've seen, the basic robo-advice on ETF selection and monitoring, asset allocation, and rebalancing is quite appropriate for those investors and comes at a much lower cost than mutual funds and their trailer commissions.

In other words, ETFs and robo-services are the future. Mutual fund trailers are the past. Even if they're not banned outright, investors will—and should—continue to vote them off the island.

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jchevreau