Brace for thousands of new DOL fiduciary-friendly mutual fund share classes

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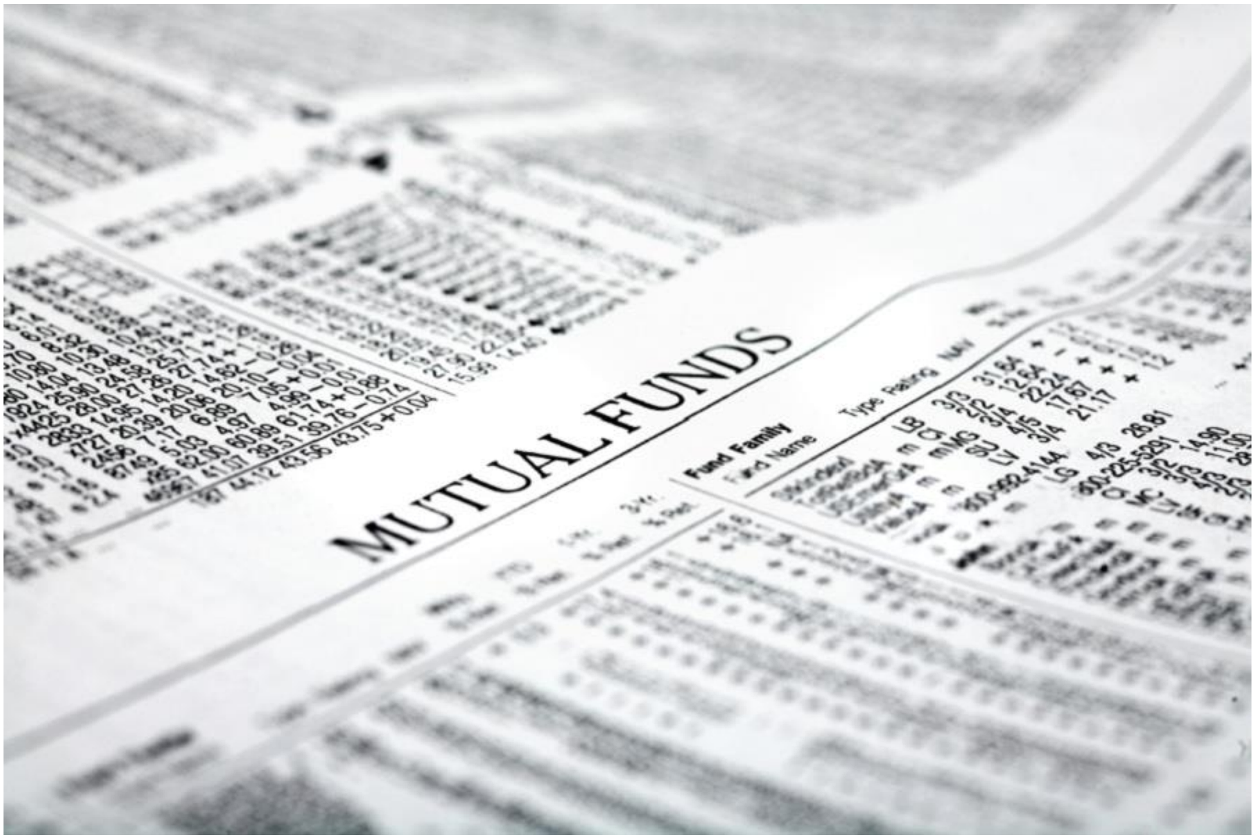

January 3, 2017 [By John Waggoner]

Expect a barrage of new, DOL fiduciary-friendly T share classes from the mutual fund industry this year, according to Morningstar.

The Chicago-based investment tracker says that as many as 3,800 new share classes — about as many as there are A shares — could make their debut in response to the new Department of Labor fiduciary rule.

The T shares would feature a uniform 2.5% front-end load and a 0.25% trailing 12-b(1) fee. The front-end load would decline for larger purchases, and no dealer reallowances would be allowed, according to Morningstar columnist John Rekenthaler.

Dozens of fund families have filed to roll out the new share classes. What's wrong with A shares? Typically, A shares charge a higher commission according to the product: Stock funds usually charge about 5.75%, while bond funds typically charge less.

The problem, under DOL logic, is that brokers would have an incentive to sell the higher-commission products at the expense of those with lower commissions. "After the legislation passed, money managers and brokers were trying to figure out what this means," Mr. Rekenthaler said. "Fund companies asked if the rule meant that commission trades would be eliminated. The DOL response was no, but you can't have a higher load on one fund than another."

Most of the distributors settled on the 2.5% sales charge and 0.25% 12-b(1) fee, Mr. Rekenthaler said, but companies are free to charge higher fees as long as they are the same across all funds.

For some stock-fund investors, this will result in lower sales charges, even including the 12-b(1) fee over time. Investors will also get more of their money invested upfront.

But there are drawbacks, too. Brokers also face the challenge of selling short-term bond funds with a 2.5% sales charge — roughly a year's interest in today's environment. And the new T shares could squeeze asset-based fees, Mr. Rekenthaler said. "For investors with a 10-year horizon, the customary advisory fee of 1% per year would need to be halved, to 0.50%, for the asset-based advice to match the price of transaction advice."

Both Fidelity and Janus have T shares of a different sort, Mr. Rekenthaler said. No funds currently have the new T shares, and their entire purpose could be in doubt if the incoming administration rolls back the DOL rules.

The brokerage industry has already rolled out T shares for nontraded real estate investment trusts . Rather than a 6% or 7% upfront sales charge, T shares on nontraded REITs will charge 2% with a 1% trailing service fee. The trailing fee is capped after a specified number of years.

The new T shares will be fearsome competition for funds that charge 5.75% for an A share. "As for A shares," Mr. Rekethaler writes, "it seems they must die." Many broker-sold funds have shown great flexibility in offering new share classes, however: The American Funds currently have up to 18 share classes for many of their funds , while Putnam currently offers eight per fund.