The Case For Clean is Clear

September 2017

While T shares were first out of the gate in responding to the U.S. Department of Labor's conflict of interest rule, or fiduciary rule, another new type of share class, "clean" shares, are not far behind. And while T shares could have a limited lifespan, clean shares may well be more enduring. Indeed, it may be that clean shares not only establish themselves as a lasting type—they may also compel the industry to reconfigure every other share class, if they don't eventually displace them altogether. Put another way, T shares may well be a transitional phase leading to a new clean share that not only replaces A shares, but all other share class types as well, eliminating the current alphabet soup that runs from A1 to Z, with stops for multiple versions of R and some Roman numerals to boot.

Exchange-Traded Funds: Popular for a Reason

To understand why clean shares may be the future and all other share classes may be on their way to obsolescence, consider an investment-industry newcomer, the exchange-traded fund. The attractions of ETFs from an investment perspective are easy to see. Like traditional index funds, these vehicles either cover a broad swath of the equity or bond markets, or, like stock baskets and individual bonds, they can cover a small portion of the market precisely. They work well for long-term investors and traders; retail investors with $10,000 or global asset managers running billion-dollar portfolios; alone or as part of a managed portfolio. And relative to traditional mutual funds, their costs are low.

In fairness to the traditional mutual fund industry, one reason that ETFs seem cheap is because they are "unbundled" while a traditional mutual fund is "packaged" with a set of services in addition to asset management. Investors purchasing ETFs get asset management, period. If investors want or expect any of the other services that come with a mutual fund, they must pay separately. That's where clean shares come in. In terms of cost, a clean share—which many asset managers don't yet offer—is directly comparable to an ETF: both deliver asset management, asset management, and nothing but asset management. All other expenses are unbundled or externalized. That doesn't mean those other expenses are free, of course, but it does mean that from the investor's perspective, a clean share makes it much easier to see who is paying how much to whom, and for what.

Consider, in contrast, the factors that make a traditional A share "unclean," only some of which are addressed by T shares. First, part of the investor's initial and subsequent investment goes toward a sales charge, or load. Some of that money goes to the fund company, some goes to the advisory firm, and some goes to the individual advisor. How much goes to each? That depends on the fund, the fund family, and the advisor's business model, and those variances are what makes A shares suspect from a best-interest perspective. The conflict of interest in a traditional A share is apparent: If more money from the load goes to any of those parties for Fund One A share than for Fund Two A share, then the fund manager, the advisory firm, and the advisor all have reason to prefer Fund One over Fund Two for reasons other than its qualities as an investment.

[1] For a view of how T shares can improve investor outcomes relative to A shares, see Aron Szapiro and Paul Ellenbogen, Early Evidence on the Department of Labor Conflict of Interest Rule, April 13, 2017

T shares are an attempt to avoid some of the conflicts inherent in an A share.[1] To qualify as a genuine T share, every fund, in every category, from every manager, must have the same load and distribution (or 12b-1) fee. That way, there is no financial incentive to offer one fund over another, and conversely the choice of a fund can be driven by investment quality alone. (Quality in this sense can also include the advisory fee and other elements of the net expense ratio.) Though arguably cleaner than A shares, T shares are not clean. First, the existence of a load, even if it is the same (2.5%) for all funds sold to all investors at a broker/dealer, still provides an incentive to transact, even though the best interest of the investor may be to not transact and hold an existing investment rather than purchase another one. Moreover, the 12b-1 fee, variously described as a distribution or service fee, is still greater than zero, which is what an advisor or advisory firm would receive from an ETF. (It should be noted that a few ETFs do have 12b-1 fees). Finally, though the rules are unsettled, T shares can still contain indirect payments that can influence whether an investment is made available to investors.

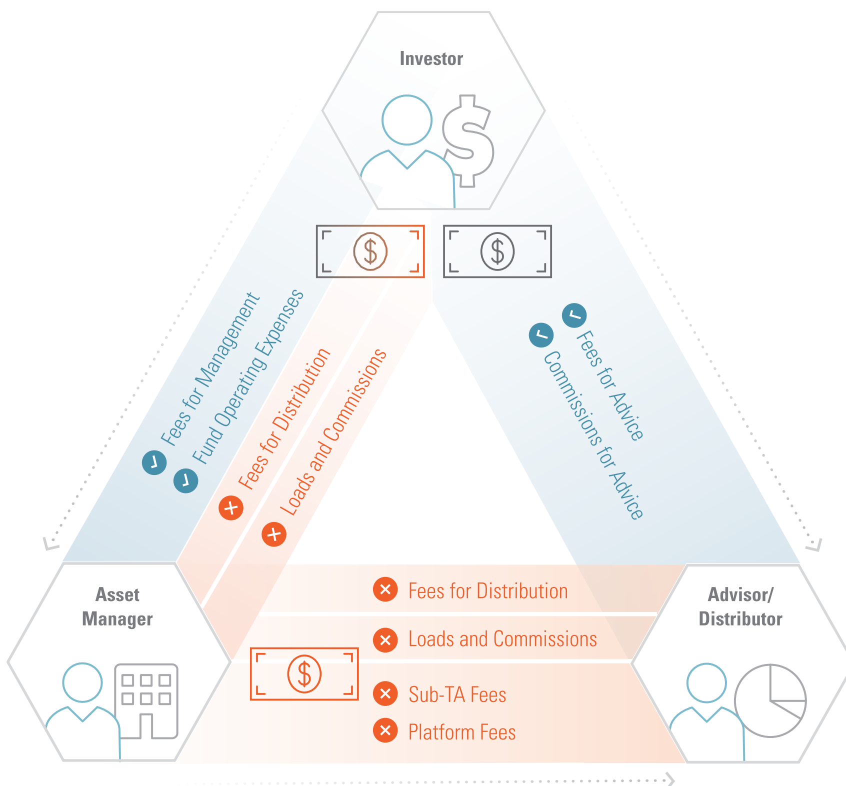
Other Troubles With T Shares

What's unclean about T shares, aside from the load? T shares still contain two potential "inducements" that could make them more attractive to a financial intermediary than a clean security that might be just as good, if not better, for an investor. The first is explicitly contained in a fee sometimes labeled "transfer agent," "administrative" or "shareholder service." Transfer agent fees are not supposed to be a profit center for fund companies, which assess the fee as part of a fund's expense ratio and then pay for various shareholder services via an affiliate or third party. Make no mistake: transfer agent services are of value to an investor. The transfer agent, for example, makes sure that funds paid in actually purchase shares and that dividends paid out reach their appropriate destinations. Transfer agents can also provide services that investors don't pay for explicitly but value, such as a website or 800 number and making sure that assets are titled properly.

As recent cases have shown, however, TA fees can also be used to pay for "shelf space," whereby firms make securities available to investors only if some portion of the TA fee makes its way to the distributor in exchange for a place on the "product shelf." Nominally, these "shelf-space" payments are supposed to cover the costs of making the funds conveniently available to investors. But the fact that the extent of these payments varies by firm, with lesser-known asset managers paying more and well-established firms paying less, suggests that these fees are paid by the investor, to the fund company, for the fund company's own benefit, and are thus not in the investor's best interest.

There are also fees that are disclosed, both in fund company filings and in the documentation of broker dealers, retirement plan providers, fund "supermarkets," or other distributors. Usually called "revenue sharing," the payments in this case come from the investor, go to the fund company, and then move back out to a service provider to pay administrative, operational, or other costs. Put another way, the revenue that is "shared" is in fact redistributed among various parties other than the asset manager, supposedly for the benefit of the investor. Our view is that these payments, however labeled, are in fact an inducement to offer one investment rather than another for reasons apart from investment quality, which makes that share class "unclean."

What Makes Clean Shares Clean?



Asset-Management Fees

Truly "clean" shares should only include fees that go directly from the investor to the asset manager (without any additional payments that flow from the asset manager back to the advisor/distributor).

Obscured Payments

Conflicted "back-door" payments exist whenever money flows from the asset manager to the advisor/distributor, especially if the relationship between the advisor and asset manager is obscured.

Payment for Advice

Investors should pay their advisor for the value of financial planning and investment advice, but this should be between the advisor and investor, not embedded or obscured in fund charges.

Clean Shares produce straight lines of payment leading from the investor to the service provider. "Unclean" share classes, in contrast, involve indirect payments, originating with the investor, passing through the fund company, and going out to service providers.

Moreover, sometimes these different expense categories can be distinguished; more often they lack their own line in a fund's balance sheet (the statement of operations).

Going Clean

What, then, would a "clean" share class look like? One suggestion is that institutional share classes could be designated as clean. At first blush, that seems plausible: institutional share classes have no sales loads and no 12b-1 fees, eliminating those two potential sources of conflict. Most institutional share classes, however, also have administrative and/or TA fees, if lower ones than retail share classes, which can make them more attractive to fund distributors than "pure" institutional funds. And while some institutional share classes have no such administrative or TA fees, institutional share classes are altogether unavailable to retail investors, either directly (unless the investor happens to have $10 million, and sometimes not even then); or indirectly, such as through an advisory platform offered by a registered investment advisor. Consequently, we say that a share class that is inaccessible to a retail investor is unclean, not because of its fees, but because of its eligibility requirements.

Some fund companies have suggested that they could convert an existing retirement share class, generally known as R6, or the cheapest share class, to "clean" by expanding eligibility to IRA investors. Is that really clean? The answer is "maybe." Some retirement share classes are indeed free of fees other than asset management, but this cannot simply be a matter of declaration. To be certified as clean, an independent observer such as Morningstar would need to be able to verify the absence of nonmanagement fees by reference to regulatory filings and the prospectus (or by extension the statement of information), with confirming details in the annual report's statement of operations. Eligibility would also need to extend beyond IRAs to taxable accounts, which may or may not be intended for retirement.

Finally, there are "true no-load" funds that have no 12b-1 fees but do have embedded administrative and distribution fees. In these cases, it might be necessary for firms offering these "almost clean" share classes to explicitly specify the absence of charges for anything except asset management. It is also likely that ETFs, while presumptively clean, would need to document the absence of any inducements, either explicitly in their expense ratios, or implicitly through indirect payments of investor assets to third parties.

Now that we have established what makes a fund or share class unclean, what would a clean share class look like? Paradoxically, a clean share class doesn't look like a share class at all. Share classes are generally defined by eligibility (who may buy them, and in what amounts); which fees the investor pays to own the shares (depending on the situation), whether in the form of sales loads or distribution fees; and what services, other than asset management, are rendered to the investor by an affiliate or third party. We say that a clean share is one in which eligibility, fees, and services are entirely determined by the distributor and paid for separately, and explicitly, by the investor.

Working backward, we can see how clean shares may well displace all other share class types. Here's why: Clean share classes are often defined by what they lack (sales loads, 12b-1 fees, revenue sharing, etc.), but it is equally plausible to say that every existing share class is a clean share plus other things. In that sense, we can anticipate that clean shares could be the basis of a new system in which the additions to the 'base' clean share determine the share class type. In that sense, there could be as many "share classes" as there are distribution channels.

In that way, a clean share, unlike existing share class types, would not be limited by distribution channel (retail, institutional, or retirement). Instead, like ETFs, clean shares would cross distribution channels. For ETFs, a retail investor could purchase a given fund in a brokerage account and pay a transaction fee on each purchase or sale as well as account fees for holding the assets and other fees for advice. An institutional investor could purchase a large block of shares, paying trading costs, fees for custody, and the like. A retirement plan could purchase the ETF for use in a target-date collective trust, and so on. Each use of the ETF—in a retail, institutional, or retirement context—would have its own set of costs and benefits, but those costs would be external to the ETF. When we apply this idea to clean shares of traditional mutual funds, you would evaluate the cost of a clean share in each context, rather than assessing the cost of an A, I, or R share.

To see how the existence of a clean share class could potentially eliminate all others, consider the current state of retirement share classes. In the United States, we have identified at least six share classes, called R1- R6. The use of this numbering system is by no means consistent: What some firms would call an R share would be an R1 for a different firm and an R3 for another. The most consistent name is R6 (though it is sometimes denominated “K”), which is generally referred to as either a “no rev share,” or 0/0 (for no load and no 12b-1) fee, or the “cheapest” retirement share class. In practice, the R6-type share class is usually available only to the largest retirement plans, typically those with $200 million or more in assets. For smaller plans, the “cheapest” share class is something with higher fees: As we define it, an R5 share class is an R6 plus administrative fees; an R4 is R5 plus a 0.25% 12b1 fee; an R3 adds a 0.50% 12b-1 fee; an R2 adds a 0.75% 12b-1 fee; and an R1 adds a 1.00% 12b-1 fee. (In some cases, the 12b-1 amount might be assessed partly under that name and partly under shareholder service or share-class-level administrative fees.)

What if, instead of these various arrangements, every size plan used R6 share classes (the closest thing we have to clean shares) and then varied, according to plan size, in terms of the fees assessed on top of that? As it stands, a plan’s size is used as a rationale for using a more expensive share class. Importantly, it is not the fund manager that imposes rules about the use of more expensive retirement share classes in smaller retirement plan, it is the plan sponsor. The advisor fee for every share class is the same, and all other fees go to an affiliate or third party. The plan sponsor, on the other hand, uses the fee components over and above the advisor fee to pay the plan’s various administrative and operational costs. In a retirement context, clean shares would have the advantage of enabling participants to understand how much they are paying, to whom, and for what.

Under the current multiple-retirement-plan share-class regime, it is notoriously difficult to tell which size plan qualifies for which price share class: Unlike other fee breakpoints, these are not publicly listed. As a result, investors cannot figure out how much of what they pay for a given fund actually goes toward managing their money and how much goes to pay for plan administration and operations, since these fees are grouped together. Moreover, because of the bundled nature of share class expenses for other than R6 share classes, retirement plans have become a means by which investor A often unwittingly subsidizes investor B, and, contrary to the spirit of ERISA law and the best-interest standard, investments are chosen for their revenue-sharing potential rather than their investment quality.

The use of a clean share class in retirement plans would also help address a persistent and yet unanswered question: If ETFs are such a great deal for investors, why aren't they readily available in qualified plans, such as 401(k)s? The most plausible answer is that, unlike mutual funds, ETFs are clean—free of fees besides those for asset management, which means they produce no revenue to be shared among the plan's service providers. Being clean, in this sense, is an asset for investors (who pay lower fees), but a liability for plan providers (who need to find that fee revenue somewhere). If traditional mutual funds were also clean, however, then the administrative and operational costs of a qualified plan would have to be externalized (outside of the expense ratio) for both, and asset managers and plan service providers could compete directly for investor dollars, rather than having to share expenses in a way that distorts the choice of investments available in a plan.

Clean shares would also ensure that fees for any services rendered to the investor would be clearly labeled—and charged—as what they are, not folded into confusing and innocuous headings such as "distribution," "administration," or "other." In markets where clean shares are not only present, but mandatory, it is now much easier to present a client a bill, stated in currency terms, that lists what was paid for asset management; what was paid for administrative services, such as recordkeeping; what was paid for operations, such as transactions; what was paid for distribution, which is, in effect, the price to be paid for buying a few shares at a time rather than thousands; and what was paid for financial advice.

The latter factor, advice, is especially important in a best-interest context because, absent clean shares, the lines between advice and "other" services get very sloppy. Is someone using C shares paying 1.00% for advice, in an advisory relationship, or is the 1.00% transactional? What is someone paying 10 or 25 basis points more for an "advisory" share class (relative to an institutional share class purchased through an RIA) getting for that additional fee, and how is it related to the separate fee for advice? Is there any reason that fees for financial advice should be tied to either assets under management or assets purchased, rather than the value of services rendered to the client?

In our view, a clear advantage of clean shares and the main reason they are not just another share class, but rather a way to revolutionize investing in the United States, is that they make possible a much wider variety of planning models. That seems especially important in an environment in which the value of financial advice is less and less about investment selection, or even the arrangement of investments through asset allocation, and more about Gamma, or the value added by advice itself, however paid for. If we can establish the benefits of financial advice but can't isolate its costs, we will not be able to know its value. Clean shares offer a unique opportunity to clearly distinguish the value of asset management, shareholder services, and advice.

What About Sub-TA Fees?

One of the most persistent questions about whether a share class is clean or not concerns sub-TA fees which, like many fund expenses, have a name that does not accurately reflect their role. Sub-TA fees might better be labeled "platform" fees because without them, a fund cannot be offered on a particular brokerage, supermarket, or retirement-plan platform. Some law firms that specialize in the Investment Act of 1940 Act believe that such fees, while permissible, do not represent the cleanest possible arrangement. We think that sub-TA fees can function as an inducement to offer one fund (or family of funds) over another, and because the decision as to which fund an investor receives is based on something other than investment quality, it is not in the investor's best interest. Sub-TA fees may be small, perhaps five basis points, but in a $14 trillion mutual fund market, that amounts to several billion dollars, all of which comes out of the investor's pocket. Like any fund expense, sub-TA fees ultimately detract from investor returns, both directly, by reducing NAV, or indirectly, by compelling a suboptimal investment choice. We do not deny that the services investors receive in exchange for sub-TA fees are worthwhile, but we think that is all the more reason that they should be an external fee, paid on a straight line from the investor directly to the service provider, and not a bent line going from investor to fund manager to intermediary.

Clean Share and Non-Clean Share Expense Components

Expense type	Clean	Level	Traditional
Management fee	Yes	Yes	Yes
Fund operating expenses	Yes (fund-level only)	Yes (fund-level only)	Yes (fund-level only)
Share class level administrative fees:			
TA	No	Yes	Yes
Sub-TA	No	Yes	Yes
Distribution fees (12b-1 and other)	No	No	Yes
Loads and commissions	No	No	Yes
Transaction and other operational fees	No	No	Yes
Revenue sharing, platform, or other access fees	No	No	Yes
Fees for advice or planning	No	No	No

©2017 Morningstar. All rights reserved. These materials are for information and/or illustration purposes only. The Morningstar name and logo are registered marks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription or other use, by any means, in whole or in part, without prior, written consent of Morningstar is prohibited.