

**BEACON POINTE**

**ADVISORS**

**BEACON POINTE RESEARCH  
CASE STUDY**

**THE TRUTH ABOUT MUTUAL FUND FEES:  
*DO YOU KNOW WHAT YOU ARE PAYING?***

**JULY 2004**

***CONFIDENTIAL – PROPRIETARY***

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## BEACON POINTE INVESTMENT MANAGER RESEARCH

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### Introduction

Throughout our years in the industry, we have experienced a startling number of instances where clients are invested in portfolios of mutual funds with exorbitant price tags. Beacon Pointe has made it our policy to demonstrate to our clients complete transparency in portfolio fees, as we believe this is an ethical standard that should bear no exception. However, we have found this to be unique within our industry. We have found cases where there is a belief that portfolio costs are cheap overall, only because the client is unaware of the “hidden fees” being charged to the portfolio in addition to the relatively small price tag that they are shown by the advisor. In the interest of arming our clients with this invaluable knowledge, we have prepared this Case Study to reveal what you should look for within your own portfolios to make certain you are not a victim of this legal, yet in our opinion highly unethical plight.

Prior to the early 1970s, mutual funds held mostly equity securities, and served primarily to offer the small investor a way to participate in the stock market. They were sold much the same way as stocks were sold – by brokers who received a commission for executing the transaction. Most often, the shareholder paid a front-end load – a commission on the purchase transaction, similar to the commission paid on a stock purchase. These commissions amounted to as much as 8.5% of the purchase amount on a small transaction, with the commission rate decreasing as the size of the purchase increased. A small percentage of fund families, the no-load funds, sold their shares directly to the investors without any intermediary or sales commission, but in 1970, these funds accounted for less than 6% of the industry’s total assets under management.

The first major change in this pattern occurred after 1970, when no-load funds began to grow in popularity. Much of the growth in popularity of no-load funds closely correlated with the growth of the money market fund segment. In the late 1970s and early 1980s, money market funds exploded from nowhere to become almost 80% of the industry, driven largely by the artificial cap placed on banks’ ability to pay interest to depositors. Money market funds are, essentially, no-load funds. They compete against other short-term vehicles that carry no commissions, and investors move their money into and out of them quickly.

As investors moved their money to equity and fixed income funds in the mid-1980s, the proportion of the industry represented by money market funds declined. During the 1980s, many funds added 12b-1 fees amounting to an annual charge to pay for advertising and other marketing expenses. By passing on some or all of this fee in the form of a trail commission, paid out periodically to the brokers involved, a distributor could encourage the broker to keep the assets in the fund. Management companies also used 12b-1 fees to create contingent deferred sales charges (CDSC) funds, as an alternative to funds with front-end loads.

The SEC received many angry letters from investors and industry critics who complained that fund companies did not adequately disclose these 12b-1 fees they assessed, making it difficult to determine the real expense load the shareholder must bear. By 1993, the SEC had strengthened disclosure rules, forcing funds to explicitly describe all fees and loads, including 12b-1 charges, in tables at the front of fund prospectuses. The SEC prohibited any fund from terming itself “no-load” if it assessed a 12b-1 fee of greater than 25 basis points.

In a recent review of the fees being levied upon investors by equity mutual funds, Standard & Poor’s has determined that funds with lower than average expense ratios are continuing to outperform their more expensive peers over the long term. According to Standard & Poor’s database of over 17,000 US mutual funds, funds charging smaller than average fees to investors outperformed their more expensive counterparts in eight out of the nine investment styles over a one year, three year, five year and ten year annualized basis.

Beacon Pointe recommends that any mutual fund investor examine all fees within their portfolio with the utmost scrutiny. The professional team at Beacon Pointe Advisors stresses the importance of this issue to the value and success of any mutual fund investment portfolio. We would be happy to conduct a full fee analysis for you at your request, free of charge. If you would like any further information or to set up a consultation, please contact us at (866) 272-1272.

## BEACON POINTE INVESTMENT MANAGER RESEARCH

### CASE STUDY - EXAMPLES

Below are two actual portfolios that have been presented to Beacon Pointe by new clients. These will demonstrate the breakdown of fees within a mutual fund portfolio and the total cost these clients have endured as a result.



### CASE STUDY ONE

#### FEE ANALYSIS

Mutual Fund	Expense Ratio	12b1*	Front Load	Deferred Load	Total
Cohen and Steers Advantage	0.99%	0.00%	0.00%	0.00%	<b>0.99%</b>
Corporate High Yield	1.52%	0.00%	0.00%	0.00%	<b>1.52%</b>
ING Large Cap Growth	2.25%	1.00%	0.00%	5.00%	<b>7.25%</b>
MFS Emerging Growth A	1.33%	0.25%	5.75%	0.00%	<b>7.08%</b>
MFS Emerging Growth B	2.08%	1.00%	0.00%	4.00%	<b>6.08%</b>
ML Global Value Fund B	2.25%	1.00%	0.00%	4.00%	<b>6.25%</b>
ML Small Cap Value	1.33%	0.25%	5.25%	0.00%	<b>6.58%</b>
ML Small Cap Value B	2.10%	1.00%	0.00%	4.00%	<b>6.10%</b>
PIMCO PEA Renaissance	1.25%	0.25%	5.50%	0.00%	<b>6.75%</b>
Putnam Health Sciences	1.82%	1.00%	0.00%	5.00%	<b>6.82%</b>
State Street Research Aurora	1.25%	1.00%	0.00%	5.00%	<b>6.25%</b>



### CASE STUDY TWO

#### FEE ANALYSIS

Mutual Fund	Expense Ratio	12b1*	Front Load	Deferred Load	Total
Pioneer High Income Trust	0.88%	0.00%	0.00%	0.00%	<b>0.88%</b>
Aim Global Health Care	2.44%	1.00%	0.00%	1.00%	<b>3.44%</b>
Calamos	1.40%	0.25%	4.75%	0.00%	<b>6.15%</b>
Delaware Pooled Real Estate	1.13%	0.00%	0.00%	0.00%	<b>1.13%</b>
First Eagle Overseas	2.05%	1.00%	0.00%	1.00%	<b>3.05%</b>
Franklin Adjustable	0.88%	0.25%	2.25%	0.00%	<b>3.13%</b>
Income Fund of America	1.39%	1.00%	0.00%	5.00%	<b>6.39%</b>
Franklin Mutual Shares	1.78%	0.99%	0.00%	1.00%	<b>2.78%</b>
PIMCO PEA Renaissance A	1.25%	0.25%	5.50%	0.00%	<b>6.75%</b>
PIMCO Total Return	0.90%	0.25%	4.50%	0.00%	<b>5.40%</b>
PIMCO Emerging Markets	1.27%	0.25%	4.50%	0.00%	<b>5.77%</b>
Brokerage Aggressive Growth Fund	1.22%	0.25%	5.00%	0.00%	<b>6.22%</b>
Brokerage Total Return Bond Fund	1.04%	0.25%	5.75%	0.00%	<b>6.79%</b>
Brokerage Large Growth Fund	1.14%	0.25%	5.00%	0.00%	<b>6.14%</b>
Touchstone Inter. US Gov. Bond	1.85%	0.13%	0.00%	1.00%	<b>2.85%</b>
Touchstone Emerging Growth	2.25%	1.00%	0.00%	1.00%	<b>3.25%</b>
PIMCO PEA Renaissance B	2.00%	1.00%	5.00%	0.00%	<b>7.00%</b>
ING International Value	2.44%	1.00%	0.00%	1.00%	<b>3.44%</b>
FPA New Income	0.61%	0.00%	3.50%	0.00%	<b>4.11%</b>
Brokerage Fundamental Fund	1.15%	0.25%	5.00%	0.00%	<b>6.15%</b>

\* included in expense ratio

### Different Types of Revenue Sharing Fees

Revenue sharing occurs when mutual fund companies make cash payments to brokers and other advisors as a way of compensating these intermediaries for distributing or marketing mutual funds. The following are the various fees that mutual fund companies pay these intermediaries:

- ◆ **12b-1 Fees** are paid by a mutual fund distribution company to a broker, advisor, consultant, custodian, or record keeper out of the funds assets. Ostensibly 12b-1 fees are paid to cover advertising and marketing to new investors as well as shareholder service expenses. 12b-1 fees typically range from ten basis points (0.10) in the case of fixed income to 1.00% in the case of equity shares (see below discussion on mutual fund share classes and expenses). At Beacon Pointe, if there are 12b-1 fees, we recommend that plan sponsors recapture these fees to offset plan expenses benefiting the participant.
- ◆ **Front-End Loads** are mutual fund commission or sales fees that are charged at the time shares are purchased. Loads are added to the net asset value of the shares when the offering price is calculated. This fee is a sales commission; its supporters (who, strangely enough, are usually mutual fund salespeople) argue that a load is the price you pay for a broker's expertise in selecting the correct fund for you. Despite this reasoning, just about every study shows that load funds don't outperform no-load funds.
- ◆ **Deferred Loads** are sales loads that investors pay when they redeem fund shares. When an investor purchases shares that are subject to a back-end sales load rather than a front-end sales load, no sales load is deducted at purchase, and all of the investors' money is immediately used to purchase fund shares. Typically, a fund calculates the amount of a back-end sales load based on the *lesser* of the value of the shareholder's initial investment or the value of the shareholder's investment at redemption. For example, if the shareholder initially invests \$10,000, and at redemption the investment has appreciated to \$12,000, a back-end sales load calculated in this manner would be based on the value of the initial investment—\$10,000—not on the value of the investment at redemption. Investors should carefully read a fund's prospectus to determine whether the fund calculates its back-end sales load in this manner.

The most common type of back-end sales load is the "contingent deferred sales load," also referred to as a "CDSC," or "CDSL." The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor hold his or her shares long enough. For example, a contingent deferred sales load might be 5% if an investor holds his or her shares for one year, 4% if the investor holds his or her shares for two years, and so on until the load goes away completely. The rate at which this fee will decline will be disclosed in the fund's prospectus.

- ◆ **Sub-Transfer Agency Fees** represent a portion of the fund transfer agent compensation set aside for shareholder record keeping and accounting services. Typically, third party administrators perform these types of services in most 401-k or 403-b plans. Sub-transfer fees can be asset based or just a flat fee. Basis point payments can be up to 0.65% of assets and per head payment can sometime reach \$18 per person per fund per year! They also are negotiable.
- ◆ **Management Fee Rebates** are highly negotiable fee, not disclosed in the prospectuses, paid by the fund companies to brokers and 401[k] distributors.

### Different Classes of Shares

Mutual funds normally have many different classes and therefore varying external and internal expenses. These mutual fund class shares are as follows:

- ◆ **Class A Shares.** These shares are usually accompanied by a “load” or commission paid to the broker. Commissions can be as high as 5.75% of the investment but there are varying breakpoints for the commission charged by mutual fund companies. This information is detailed in the prospectus. There should never be any Class A shares in a 401k plan.
- ◆ **Class B Shares.** These shares charge commissions that are typically “back-loaded”. There is no up-front load, however a sales fee will be charged if the fund is sold within a certain period of time. This back-end load declines over time and usually disappears after six or seven years. However, Class B shares usually have very high 12b-1 fees of 1.00% which goes to pay a broker or perhaps the custodian of the assets.
- ◆ **Class C Shares.** These are known as level-loaded shares. Typically these shares will have a small (or no load) on the back end, but have a very high 12b-1 fee of 1.00%.
- ◆ **Class I Shares.** Sometimes labeled “ins”, these institutional class shares have no front or back loads as well as no 12b-1 fees. Minimum investment for institutional class shares may be as high as \$1,000,000.
- ◆ **Class R Shares.** This class of mutual fund shares sometimes have both a differed (back-end load) as well as a 12b-1 fee. R shares are used by 401k plan vendors to offset plan charges.