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Clients paying funds to bring in business

By Robin Robinson

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In the past 10 years, the number of no-load mutual funds has grown more than four times to 1,265 funds and the total number of funds has grown at a slightly slower pace to 4,320.

No-load funds do not charge broker commissions when shareholders buy in, unlike front-load funds. Before the 1980s, the front-end load mutual funds were the norm, charging commissions of 5 percent to 8 percent.

No-load funds gained momentum in the past decade. They are marketed directly to consumers through media advertisements and direct mailings, cutting out the broker and his commission. There are a couple of reasons for the popularity of no-loads, besides their lower cost, said **Andre Ratkai, president of Praxis Advisory Group**, a small investment adviser in Denver.

"People see there may be a possible conflict of interest by working with a broker who's getting a front-end fee," Ratkai said. "Also, there's a lot of sources of information about mutual funds that weren't around 10 years ago."

Front-end load mutual funds tried to fight the competition by lowering their commissions to between 3 percent and 6 percent, or only charging commission when a shareholder cashed out of a fund, and adding fees.

Two fees added are the 12b-1 and custodial/shareholder service fee.

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The 12b-1 fee is named for a section of the Investment Company Act of 1940. The fee is a euphemism for marketing expenses, Ratkai said, and it is climbing. The U.S. Securities and Exchange Commission allows fees to range from 0.1 percent to 1 percent to cover the cost of advertising and mailing information to prospective shareholders.

Whether investing in a load or no-load, there could be a 12b-1 attached: 55 percent of the funds in Morningstar Inc.'s mutual fund listing have a 12b-1 fee, regardless of whether they are front-end or no-load mutual funds, Ratkai said.

"It's perfectly legal, nothing criminal, but what tends to happen is the current clients are paying the fund to bring in new clients," Ratkai said. "If I'm an investor and the guy did well with \$200 million under management, is it in my interest to

Please see **NO-LOADS** on 5E

Current clients paying funds to bring in new customers

NO-LOADS from Page 1E

pay these guys to bring in \$1 billion under management? Most guys tend to do well when assets are relatively small - less than \$500 million - and bigger ones lose flexibility.'

"Second, a lot of that money gets paid to brokers as an ongoing commission."

The other area, custodial/shareholder services fees, covers the cost of doing the paperwork for existing shareholders and sending mail to them.

"You can imagine as these funds have grown - Janus Funds, for example, has grown from a couple hundred million dollars to \$8 billion - they have to send out statements and updated prospectuses, and that all costs a lot of money and postage," Ratkai said. "That's an area where I tend to think that the growth of the assets under management is way ahead of the ability to manage that growth efficiently.

"Lots more back office people were hired, and people are an expensive asset to have. I think in time those costs will level off, and you might even see them come down as the technology is implemented," Ratkai said.

Before starting Praxis 18 months ago, Ratkai had been a portfolio manager, and prior to that, a financial analyst, determining the desirability of a particular investment, usually a mutual fund or limited partnership. One of the aspects

of his analysis was to consider the fees managers or partners paid themselves to run a fund, partnership or other investment project.

"The interesting thing about this business is you have a more or less uniform fee structure. If you

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President, Praxis Advisory Group

look at 10 different funds, you'll find a lot of similarity amongst the fees, rather than differences.

That's a function of a great deal of competition. It's not like you're inventing the mutual fund in 1993."

As the mutual fund industry mushroomed, its marketing and distribution expenses and its custodial/shareholder services expenses have kept pace, Ratkai said.

"There's a diseconomy of scale there that's kind of strange.," Ratkai said. "We were taught in school that with increasing competition, costs are forced down, and in fact, they haven't been."

Ratkai offers three explanations for this exception to economic rule:

"If you have more funds out there fighting for the same basic amount of dollars, you have to

throw more marketing dollars at the public to get their attention.

"Second, there are a lot of new funds out there, and they need to spend proportionately more to get their names out there." Almost half of the mutual funds in existence today were started after 1987, he noted.

"The third thing is about half of the funds managed less than \$100 million. Expense-wise, a smaller fund is more expensive to run," Ratkai said. "With computers today, you can run a \$500 million fund with a few people, so a \$100 million or \$50 million fund is proportionately more expensive to run."