FINANCIAL SERVICES REVIEW

Financial Services Review 14 (2005) 1–20

Financial advisors and multiple share class mutual funds

Michael A. Jones[a], Vance P. Lesseig[b], Thomas I. Smythe[c,*]

[a]*Department of Marketing, University of Tennessee-Chattanooga, Chattanooga, TN 37403, USA*
[b]*Department of Finance and Economics, Texas State University-San Marcos, San Marcos, TX 78666, USA*
[c]*Department of Business and Accounting, Furman University, Greenville, SC 29613, USA*

Abstract

The development of multiple share class mutual funds has complicated the investment decision for individual investors such that the advice of financial advisors is heavily relied upon to make the best choice. However, there have been accusations that advisors are influenced by factors other than the client's best interests. This study surveys financial advisors as to their compensation and recommendations with respect to multiple share class funds. Our results suggest that advisors may not be sufficiently informed regarding the relationship between share classes, investment size, and investment horizon. We also find that advisor compensation appears to influence the frequency of sales of various share classes.

Jel classification: D14; G24; M31

Keywords: Multiple share class mutual funds; Financial advisors

1. Introduction

As investors direct money into mutual funds instead of individual stocks and bonds, they are doing so primarily with the help of financial advisors. The Investment Company Institute (ICI) finds that 72% of fund purchases outside of retirement plans involve a financial advisor.[1] The advisor's role has also become increasingly important with the advent of multiple share class (MS) mutual funds. The MS structure provides investors with choices regarding the payment of commissions. However, this payment choice directly impacts the returns investors receive in such a way that even the National Association of Securities

* Corresponding author. Tel.: +1-864-294-3312; fax: +1-864-294-2990.
E-mail address: thomas.smythe@furman.edu (T.I. Smythe).

1057-0810/05/$ – see front matter

Dealers (NASD) admits the complexity inherent in the choice (see NASD *Notices to Members 95-80*). Thus, it is incumbent upon financial advisors to understand the financial impact of different share classes when assisting investors.

This study surveys financial advisors regarding their selling of and compensation from MS mutual funds. While previous studies examine mutual funds along varying dimensions [e.g., performance (Carhart, 1997), costs (Dellva & Olson, 1998), tournaments (Chevalier & Ellison, 1997), and flows (Jain & Wu, 2000)], little research exists examining the practices of financial advisors. Bigel (1998) measures the ethical development of financial advisors in general, but does not specifically address the selling practices of advisors. Additionally, Benson, Rystrom, and Smersh (1995) investigate brokers at one brokerage firm to test the effects of compensation on sales volume. The issue of advisors and MS funds is particularly timely. As of this writing, Morgan Stanley has been charged by regulators for reportedly using inappropriate commission structures (i.e., share classes) to make sales of in-house mutual funds—essentially placing investors in the wrong classes of MS funds (Lauricella, 2003).

The information we hope to discover should be valuable to investors, regulators, and financial service firms. For investors, the results should provide an indication of advisors' selling tendencies relating to MS funds. The results could also be beneficial to regulators who must determine if advisors are meeting the fiduciary responsibilities expected with regard to MS funds. Financial services firms could also use the study's results to better assess current advisor practices relating to MS funds, which could then be used to improve employee training.

Our findings indicate that the compensation structure the financial advisor receives is related to their recommendation among different fund classes. Specifically, higher commissions are positively related to the frequency of a particular class being sold. Additionally, an advisor working for a firm offering proprietary funds tends to recommend the class that is most profitable for the firm. Finally, we show some confusion exists among advisors regarding the optimal fund class over various holding periods—especially intermediate periods.

The next section of this paper provides background on MS funds and motivation for the study. Section three describes the survey method and sample characteristics. Sections 4 and 5 provide the results of the study, and Section 6 concludes the paper.

2. Background and motivation

The mutual fund is the vehicle that has democratized capital markets. Fund growth is often attributed to the move by corporate America away from defined benefit to defined contribution retirement plans, where mutual funds are a primary investment choice. However, there has also been strong growth in fund purchases outside of retirement plans. In a 2002 study, the ICI finds that investors owning equity in mutual funds outside of retirement plans grew 3.2% from 1999 to 2002, while ownership of individual stocks declined by 4.1% over the period. Additionally, the ICI finds that during the same period, a growing number of

investors made their first equity investment through a mutual fund as opposed to direct investment.[2]

As mutual fund investing has become more common, the industry has developed innovative ways to distribute shares. The thrust of the innovation has been in the areas of fund and fee structure, and has primarily occurred with funds marketed through financial intermediaries. With this innovation has come increasing complexity, with much of the complexity related to the MS fund structure.

2.1. Multiple share class structure

MS funds are funds having a common pool of underlying assets with different investor/share classes distinguished solely by fee structure. Smythe (1999) demonstrates the impact the new structure made on the industry between 1995 and 1997. During this period, only 40% of funds identified as "new" by Morningstar represent new portfolios. The remaining observations are new share classes created for existing portfolios.[3] Additionally, the year-end 2000 edition of Morningstar's Principia Pro tracks approximately 11,800 separate observations but in fact, there are only 5,600 distinct portfolios. The remaining observations are additional share classes for one of the unique asset pools. Thus, while fund assets have grown and the number of investment choices has increased since 1995, much of this growth is attributable to the creation of new fund classes rather than the establishment of new asset portfolios.

Funds fitting the MS structure generally have two to four classes. Most have a front-end load class and a contingent deferred sales charge (CDSC) class. More recently level load classes and institutional classes have been added to the selection. Institutional classes have no commissions and are limited to high net worth investors or retirement plans.[4]

The front-end load class has a commission paid by investors at the time of purchase. Loads average around 5.25% of the purchase amount, of which advisors usually receive 4.5%, with the balance going to the advisor's employer.[5] Front-end load classes also usually have 12b-1 fees of 0.25%, which provides a trailing commission for advisors.

The level load class has a back-end load of 1% or less usually. The load is assessed if investors sell shares before a pre-specified period, usually one-year. The characteristic of the level load class differentiating it from the front-end load is that most of the advisor's compensation is deferred. While advisors receive a small commission at purchase, these funds have ongoing 12b-1 fees of 1% to compensate advisors over time, where each year's compensation is based on investor assets.

The CDSC class is a hybrid of the previous methods. CDSC classes have back-end loads of approximately 5% in the first year after purchase, which declines to zero over five to six years. The load is assessed if investors sell shares before the pre-specified time horizon. Even though a load may be assessed at redemption, advisor compensation is similar to that for the front-end load class. A commission is paid to the advisor by the fund distributor at purchase based on the purchase amount and is equal to approximately 4% of the purchase. The key difference between the CDSC and front-end load classes from the investor's perspective is that all of the investment is put to work when purchasing the CDSC class. Sponsors recoup up-front commissions paid to advisors by charging higher 12b-1 fees over time, usually 1%

of assets. Because the 12b-1 fee is 75 basis points higher for the CDSC class relative to the front-end load class, investors choosing the CDSC class have their shares converted to front-end load shares after eight years to benefit from lower 12b-1 fees. This is done at no cost to investors and with no tax consequences.

The SEC and self-regulatory bodies such as NASD have recognized the complexity that MS funds present. However, they have provided little formal structure to guide financial advisors in their dealings with the public. Specifically, in *Notices to Members 95-80,* the NASD recognizes the potential problems MS funds present investors and advisors:

> . . . The NASD has observed, commensurate with the increasing complexity of the structure of mutual funds, an increase in the varieties of sales charges and service charges associated with fund sales. The NASD is concerned that investors may not understand the distinctions among and the ramifications of these various products, their fee structures and charges. *It is imperative that the associated person recommend the most suitable mutual fund, based on the goals, investment objectives, and financial status of the investor, without being influenced by incentive arrangements* (emphasis added) (p. 2).

While mutual fund purchases continue to grow and demands on advisors become increasingly important, academic literature has been largely silent on the role of intermediaries in the investment decision process. Previous research (e.g., Dellva & Olson, 1998; Carhart, 1997; Brown, Harlow & Starks, 1996) has focused on the direct link between fund companies and investors. Alternatively, Chordia (1996) develops a theoretical argument for why funds have loads, which ignores the role of loads as a source of compensation for advisors. Instead, Chordia argues that loads reduce/discourage trading by investors, which allows fund managers to hold less liquid securities that generate higher returns. Morey (2004) examines the Chordia hypothesis in the context of MS funds and finds that any advantages load funds possessed have disappeared.

Previous research has treated financial advisors as exogenous, implicitly assuming away any potential agency issues that may arise between intermediaries and investors because of potentially diverse economic incentives. For example, previous research (O'Neal, 1999) shows that various share classes have differing impacts on investor wealth. Conversely, advisors may have financial incentive to recommend a share class that is not optimal for the investor (Clements, 2003; Lauricella, 2003c). Because of these potential conflicts, Brennan (1995) and Allen (2001) suggest that researchers must take the next step of including the role of intermediaries in all facets of financial research. We begin to fill this void by investigating financial advisors' selling of MS funds.

2.2. *Financial advisors and multiple share class funds*

Because this work is one of the first to empirically examine the behavior of financial advisors with regard to MS funds, one goal is to provide a general overview of the frequency of selling various share classes as reported by advisors. In addition, we seek to address specific questions related to MS funds and (1) advisor compensation, (2) "in-house" or proprietary funds, and (3) customer characteristics.

2.2.1. Advisor compensation

As previously discussed, advisors selling front-end load and CDSC shares are compensated at the time of purchase, whereas level load sales compensate advisors over time. However, while front-end load and CDSC classes pay advisors at the time of purchase, the commission percentages differ between classes. Advisors receive approximately 0.75% below the stated front-end load but a fixed 4% for selling CDSC shares.[6] With an average front-end load for equity funds of approximately 5.25%, advisors would receive a commission of 4.5% on front-end load classes, but only 4% for CDSC.

Advisors would seem to have greater incentives to sell front-end load classes because of higher commissions relative to CDSC and the more timely compensation relative to level load classes. However, an advisor's compensation is a function of commission percentage and sales volume. An advisor may earn greater dollar compensation if they can sell more of a different class, even if the compensation per sale is lower. One advantage to CDSC classes is that investors pay no initial commission at the time of purchase. As a result, advisors may find it easier to sell the CDSC class, thereby increasing volume above what could be achieved selling front-end load shares, and possibly increasing the total dollar commission for the advisor and assets under management for fund sponsors (Clements, 2003; Lauricella, 2003c). In fact, a leading mutual fund company lists in its distribution materials that one advantage of selling CDSC shares is that "Because there is no up-front sales charge, brokers who offer B (*CDSC*) shares may compete effectively with no-load funds."[7] Therefore, one goal of this study is to determine the commission levels for each share class as reported by advisors, and any relation between commission levels and the frequency of sales of each share class. Some evidence of the impact of commissions on sales practices is found in Benson, Rystrom, and Smersh (1995), which finds that sales volume at one firm increases during the last five days of the production month, presumably to increase the monthly commissions received by the broker.

The discussion thus far implicitly assumes advisors are paid fixed commissions. In fact, advisors can be categorized as being commission-based, fee-based, or a combination of the two. We expect the compensation structure advisors receive to impact the fund classes they recommend. Advisors receiving at least some of their compensation via fees are expected to use fewer funds having fixed commissions. These advisors have a choice between no-load and level load funds to achieve their objectives. When traditional no-load funds are used, advisor compensation is not remitted to advisors by fund companies; instead, advisors deduct fees from investor accounts. In contrast, if advisors make use of level load funds, fund companies pay advisors from ongoing 12b-1 fees and the advisor does not take additional fees from investor accounts. Therefore, we seek to determine if the frequency of selling each share class differs according to advisor compensation method (i.e., fee only, commission only, or a combination).

Commission structures within a firm are not constant. Just as mutual fund fees change, so do the commissions paid to advisors for various classes. Thus, the third topic we explore with respect to advisor compensation is whether there have been changes in commission percentages that advisors receive for the various share classes.

2.2.2. Advisors and proprietary funds

Advisors who work for companies that market their own mutual funds are faced with possibly conflicting incentives. NASD requires advisors to recommend financial products that are in the best interests of investors. However, advisors, as employees of firms that market their own mutual funds, may feel implicit or explicit pressure to market the firm's products. For example Lauricella (2003c) points out that Morgan Stanley provided incentives to brokers selling the most proprietary funds during a year. Additionally, Morgan Stanley reportedly paid extra commissions to brokers selling shares in certain funds that make their "preferred" list. This list contains in-house funds as well as outside funds that generally have some relation to Morgan Stanley. More importantly, certain fee structures within MS funds may be more advantageous for the company, leading to pressure to sell specific classes. Lauricella (2003c) points out that Morgan Stanley pays higher commissions on its Class B (CDSC) shares, which they believe to be the most profitable. One reason that CDSC shares are more profitable is because of their higher annual 12b-1 fees. In addition, profits are enhanced if investors choose to sell before the point when the deferred load declines to zero because the sponsor receives the redemption fee in addition to the higher 12b-1 fees earned to that point. Given the higher profitability of CDSC share classes, we investigate whether the frequency of selling particular share classes varies according to whether or not a fund markets its own funds.

2.2.3. Customer characteristics

Finally, we also examine MS sales and customer investment characteristics. We focus on two areas: investment time horizon and size of the purchase. O'Neal (1999) and Livingston and O'Neal (1998) demonstrate that the optimal economic choice of commission structure in MS funds differs based on investment time horizon. Specifically, investors are better off in front-end load or possibly CDSC classes if their investment horizon is greater than seven years. However, advisors have financial incentives to recommend the level load class to these investors since advisors receive ongoing revenues as long as investors remain in the fund, thus creating a potential agency issue between advisor and investor. The opposite scenario arises when investors have short-term horizons of seven years or less. An example provided in the Appendix and O'Neal (1999) help demonstrate this point. Generally speaking, level load shares are best for investment horizons of seven years or less and certainly for very short holding periods, while either FEL or CDSC shares dominate for longer holding periods. However, for mutual fund purchasers that qualify for commission discounts by exceeding specific "break points," front-end load shares dominate CDSC shares over long investment horizons, as demonstrated in Panels A and B of Table A-1 found in the Appendix.

Overall, our analysis and that provided by O'Neal (1999) and Lauricella (2003b) suggest that there should be differences in sales volumes of MS classes based on investment size and investment time horizon. Thus, we seek to explore advisor's recommendations of share classes for various time horizons and the size of purchases. This examination will provide us with an understanding of which share classes advisors recommend for various time periods and allow us to compare these recommendations with the share class that maximizes investor wealth for given time periods.

Table 1
Sample characteristics

Characteristic	Percent
Sex	
Female	14.2
Male	85.8
Age	
25 or younger	2.1
26–35	24.7
36–45	22
46–55	29.3
56–65	17.4
Over 65	4.4
Income	
$49,999 or less	13.1
$50,000–$99,999	32.4
$100,000–$149,999	23.2
$150,000 or more	31.4
Education	
High school	7.3
Associates	4.4
Bachelors	62.4
Masters	24.6
Doctorate	1.1
Years Advising	
0–5	32.5
6–10	20.9
11–15	14.8
16–20	14.1
Over 20	17.7
Professional Designation (Percent Possessing)	
CFP	14.6
CPA	4.2
CLU	3.2
CFC	4.0

3. Method and sample statistics

We investigate our research questions by surveying financial advisors. A mailing list of 3,000 randomly selected financial advisors located in a 10-state area of the southeastern United States was purchased from a widely circulated periodical targeted exclusively to financial advisors. Respondents were mailed a letter of introduction, a survey, and a postage-paid return envelope. A total of 530 surveys was returned for an 18% response rate (after accounting for undeliverables). Non-response bias were assessed by comparing early and late respondents on all questions (Armstrong & Overton, 1977). There was no evidence of non-response bias as no significant differences emerged.

As shown in Table 1, respondents represent a broad cross-section of financial advisors. A large proportion of respondents are male (85.8%), while respondents' age varied greatly with 24.7% of respondents reporting an age of 26–35, 22% an age of 36 to 45, 29.3% an age of 46 to 55 and 17.4% an age of 56 to 65. The reported income of respondents varied somewhat

Table 2
Reported frequency of selling each share class

Share class	Average reported frequency
Front-end load	36.3
Contingent deferred sales charge	26.9
Level load	28.4
No load	8.3

Question: "Please allocate 100 percentage points to the four types of share classes reflecting the frequency with which you sell each particular share class."

with 13.1% of respondents making $49,999 or less, while 32.4% of respondents reported an income of $50,000 to $99,999. 23.2% of respondents reported an income of $100,000 to $149,999, and 31.4% reported an income of $150,000 or greater. In terms of education, a majority of respondents (62.4%) reported having a Bachelors degree and 24.6% reported having a Masters degree. The experience of the respondents varied greatly with almost one-third of respondents advising for 5 years or less, 20.9% of respondents reported advising between 6 and 10 years, 14.8% between 11 and 15 years, 14.1% between 16 and 20 years, and 17.7% have over 20 years of advising experience. The most widely held professional designation was the CFP (approximately 15% of respondents). Less than 5% of respondents reported having a CPA, CLU, or CFC designation.

4. Results

One of the most basic issues our research addresses is the frequency with which financial advisors recommend various share classes. Respondents were asked to report the frequency with which they currently sell front-end load (FEL), CDSC, level load (LL), and no load (NL) funds. The average reported frequency of selling each share class is presented in Table 2. The most commonly sold share class is FEL funds, which respondents indicate selling 36.3% of the time. Respondents report similar selling frequencies for CDSC and LL funds (26.9% for CDSC funds and 28.4% for LL funds). NL funds are sold only 8.3% of the time.

4.1. Advisor compensation

Findings relating to MS funds and advisor compensation are presented in Tables 3–5. Table 3 presents the reported commission for FEL, CDSC, and LL funds when advisors were asked to indicate the percentage commission received for selling various share classes. More than one-half of respondents report a commission of 4.0% or more for both FEL funds (58.8%) and CDSC funds (58.3%). The most common (77.0% of respondents) commission reported for LL funds is 1.0–1.9%. Overall, the rather large variability in the commission reported within each share class suggests that either there are substantial differences in the commissions paid to advisors across companies and funds, or there is some confusion among advisors as to the commission they receive for selling each share class.

Table 3
Reported commission by share class

Reported commission	Share Class		
	Front-end load	Contingent deferred sales charge	Level load
0–0.9%	2.9	3.6	13.0
1.0–1.9%	7.4	12.2	77.0
2.0–2.9%	11.7	8.9	5.8
3.0–3.9%	19.3	16.9	1.5
4.0% or more	58.8	58.3	2.8

Question: "On average, what is your commission percentage on mutual fund purchases for each of the following types of mutual funds?"

To determine if commission percentages are directly related to the frequency of selling a particular share class, advisor's responses regarding the frequency of sales of each share class are considered with their reported commission for each class. ANOVA is used to determine if the differences in selling frequencies for each share class across commissions are statistically significant. Table 4 presents the frequency of selling share classes by reported commission. The frequency of selling LL funds does not vary significantly ($p > .10$) across reported commissions. However, selling frequency of FEL and CDSC funds does vary significantly ($p < .01$) across reported commissions, with larger commissions generally reflecting a greater frequency of selling a particular share class. These results suggest that higher commissions are related to a higher frequency of selling particular share classes, which is consistent with wealth-maximizing advisors.

The frequency of selling each share class is also examined across compensation methods. Advisors reported whether their compensation was commission, fee-based, or a combination of the two. Again, ANOVA is used to determine if the differences across compensation methods are statistically significant. As indicated in Table 5, the frequency of selling each share class varies significantly ($p < .01$) across compensation methods. The results indicate

Table 4
Frequency of selling share classes by reported commission

Share class	Reported commission					F value
	0–0.9%	1.0–1.9%	2.0–2.9%	3.0–3.9%	4% or more	
Front-end load	24.0	45.0	52.0	50.7	39.6	3.49*
Contingent deferred sales charge	5.9	23.3	22.5	32.8	42.1	11.32*
Level load	29.9	37.7	30.2	9.5	34.0	1.69

This table presents the frequency of selling each share class by the reported commission for each share class. In other words, advisors receiving a commission between 0 and 0.9% for front-end load shares reported selling front-end load funds 24.0% of the time. However, advisors receiving a commission of 4% or more reported selling front-end load funds 39.6% of the time. The F value reveals, for example, that the frequency of selling front-end load funds and contingent deferred sales charge funds varies significantly according to the reported commission.

* $p < .01$.

Table 5
Frequency of selling share classes by method of compensation

Share class	Method of Compensation			F value
	Fee	Commission	Both	
Front-end load	10.8	51.7	25.7	56.02*
Contingent deferred sales charge	8.7	29.9	28.0	11.12*
Level load	56.1	15.9	35.6	44.64*
No load	24.4	2.4	10.7	25.21*

This table presents the frequency of selling each share class by the reported method of advisor compensation. Advisors were asked the following question: "For advising associated with mutual fund purchases, how are you most often compensated?" The F value generated by ANOVA indicates that the frequency of selling each share classes varies significantly by the method of compensation that the advisor receives.
* $p < .01$.

that fee-only advisors predominately sell LL (56.1%) and NL (24.4%) funds, while commission-only advisors sell predominately FEL (51.7%) and CDSC (29.9%) funds, as expected. Advisors who are compensated by both fees and commissions display a more consistent frequency of selling each share class across FEL funds (25.7%), CDSC funds (28%), and LL funds (35.6%).

One question that may arise when examining Table 5 is why fee-only advisors would sell any form of load fund. One explanation for this finding is that while level load classes are a type of "load" fund, the form of compensation to the advisor is in the form of an ongoing fee paid from the 12b-1 fee. As explained earlier, fee based advisors typically use a combination of no-load and level load classes in their recommendation mix. So, the approximately 80% of funds sold via these classes is consistent with a fee-only response. In addition, some fund companies waive front-end loads for advisors, or advisors pool fund sales for multiple clients in such a way that the dollar amount leads to an elimination of the front-end load. Finally, while the majority of an advisor's business is fee only, they may still use commission-based products on some occasions.

4.2. Proprietary funds

Because some firms market proprietary funds, as well as selling other companies' funds, we investigate whether the frequency of selling each share class varies based on whether an advisor's company markets its own funds. A t test is used to determine if the difference in selling each share class is statistically significant. Table 6 shows that the frequency of selling three of the four share classes varies significantly depending on whether the company markets its own funds. Advisors who work for companies that market their own funds sell significantly ($p < .01$) fewer FEL funds (25%) and significantly ($p < .01$) more CDSC funds (29.9%) and LL funds (35.8%) than advisors who work for companies that do not market their own funds (FEL funds 51.2%, CDSC funds 23%, and LL funds 18.7%). There is no significant difference ($p > .05$) in the selling of no load funds across companies that market their own funds (9.3%) and companies that do not (7.2%).

This finding raises some concern regarding the selling of MS funds by financial advisors.

Table 6
Frequency of selling share classes by whether or not their company markets their own funds

Share class	Market own funds		t-statistic
	No	Yes	
Front-end load	51.2	25.0	8.81*
Contingent deferred sales charge	23.0	29.9	−2.73*
Level load	18.7	35.8	−6.09*
No load	7.2	9.3	−1.06

This table presents the frequency of selling each share class by whether or not the advisor's company markets its own funds. Advisors were asked the following question: "Does the company you work for market its own mutual funds?" The t-statistic revealed, that the frequency of selling front end load funds, contingent deferred sales charge funds, and level load funds differed significantly depending on whether or not the advisor's company markets their own funds.

* $p < .01$.

Traditionally, CDSC and LL classes are the most profitable fund classes for fund sponsors because of the ongoing fee revenue generated. Thus, this finding that they are sold more often by advisors selling their own firm's funds begs the question of whether they are given extra incentive to sell these classes (cf. Lauricella, 2003c). We are not able to address this issue in our study, but the issue may be of interest to investors and regulators, and a topic for future research.

4.3. Customer characteristics

Results relating to MS funds and customer characteristics are presented in Tables 7 and 8. The first issue examined concerning customer characteristics is whether or not the frequency of selling each share class varies according to average purchase size. Respondents were asked the average size of a client's single mutual fund purchase and classified it as either less than $25,000 or $25,000 or greater. Although some firms are moving to a $50,000 minimum break point, we use $25,000 as the break point for FEL shares because it is the

Table 7
Frequency of selling share classes by average size of single mutual fund purchase

Share class	Average size of purchase		t-statistic
	<$25,000	$25,000 or more	
Front-end load	37.9	33.1	1.41
Contingent deferred sales charge	28.4	22.9	1.97*
Level load	27.6	30.1	−0.77
No load	6.2	13.8	−2.96**

This table presents the frequency of selling each share class by the average size of a single mutual fund purchase. Advisors were asked, "Approximately what is the average size of a single mutual fund purchase of your clients?" The t-statistic revealed that the frequency of selling contingent deferred sales charge funds and no load funds differed significantly depending on the average purchase size.

* $p < .05$; ** $p < .01$.

Table 8
Percent of advisors recommending a share class for various time periods

Share class	Time frame		
	1–3 years	4–7 years	8 years or more
Front-end load	16.4	34.7	62.6
Contingent deferred sales charge	8.6	42.2	32.8
Level load	73.3	37.8	20.4

Advisors were asked to indicate which class or classes they would recommend to an investor with each of the following time horizons: 1–3 years, 4–7 years, and 8 years or more. Advisors were instructed that they could select more than one class if they thought multiple classes were appropriate given the time horizon.

smallest applied in the industry (Clements, 2003; Lauricella, 2003d). Table 7 presents the frequency of selling each share class by the average size of single mutual fund purchases. A t test is used to determine if the difference in selling each share class is statistically significant. The frequency of selling FEL funds and LL funds is not significantly ($p > .05$) different across the average size of a single mutual fund purchase. The result for FEL funds is surprising since the wealth of larger investors is enhanced as they often receive commission reductions because of break points, thus we expect to see greater use of FEL classes for larger purchases. Advisors reported selling CDSC funds significantly ($p < .05$) more often when the average purchase was below $25,000 (28.4%) when compared to when the average was $25,000 or more (22.9%). Conversely, the frequency of selling NL funds was significantly greater for advisors who reported the average purchase size was $25,000 or more (13.8%) when compared to purchases less than $25,000 (6.2%). This result is likely a function of higher net worth individuals using fee only planners that make use of no-load funds.

Our second issue with respect to customer characteristics focuses on O'Neal's (1999) discussion of the optimal fund classes for various holding periods. Respondents were asked to indicate which share class (either FEL, CDSC, or LL) they would recommend for investors with the following time horizons: one to three years, four to seven years, and eight or more years. The results of their responses are shown in Table 8. Respondents were allowed to recommend more than one share class for each horizon (thus the columns of Table 8 can add up to more than 100%). For the one to three year horizon, the overwhelming majority of advisors (73.3%) indicate they would recommend LL funds, while 16.4% and 8.6% of advisors recommend FEL and CDSC funds, respectively. These findings are consistent with our example and that of previous research indicating that LL funds are optimal for shorter holding periods. However, one quarter of respondents actually recommend classes that are clearly not optimal for investors with a one to three year horizon, a finding consistent with the theoretical explanation in O'Neal (1999) concerning the agency issue that exists between advisors and investors.

The results are more uniform across the three share classes for the four to seven year time horizon as 42.2% of advisors recommend CDSC funds, 37.8% recommend LL funds, and 34.7% recommend FEL funds. There appears to be confusion among advisors as to which class is optimal for this holding period. As demonstrated in the Appendix and O'Neal (1999),

Table 9
Regression results for prediction of frequency of selling each share class

Variable	Dependent variable			
	Front-end load	Contingent deferred sales charge	Level load	No load
Education	−0.040 (−0.817)	−0.034 (−0.609)	0.046 (0.901)	0.053 (0.940)
Experience	−0.019 (−0.326)	−0.092 (−1.356)	0.095 (1.540)	0.017 (0.248)
Company	0.006 (0.115)	0.108 (1.940)	−0.137 (−2.724)**	0.069 (1.239)
Gender	0.055 (1.125)	0.071 (1.279)	−0.108 (−2.149)**	−0.028 (−0.506)
Age	−0.054 (−0.996)	0.188 (3.032)**	−0.097 (−1.716)	−0.032 (−0.516)
Income	0.051 (0.904)	−0.065 (−1.015)	0.010 (0.179)	−0.014 (−0.220)
CFP	−0.002 (−0.045)	0.067 (1.156)	−0.111 (−2.118)*	0.103 (1.782)
Compensation	0.332 (6.430)**	0.063 (1.069)	−0.320 (−6.012)**	−0.179 (−3.054)**
Market Own Funds	−0.304 (−6.046)**	0.154 (2.685)**	0.201 (3.874)**	−0.035 (−0.610)
Purchase Size	−0.084 (−1.686)	0.087 (1.536)	−0.019 (−0.366)	0.061 (1.068)

This table shows the results of predicting the frequency of selling each share class using various predictor variables. The dependent variable is the frequency of selling each share class as indicated by the column heading. All predictor variables are dichotomous variables as follows: Education—0 for Bachelor's degree or less, 1 for Masters degree or above; Experience—0 for 0–10 years of experience, 1 for 11 or more years; Company—0 for brokerage firms, 1 for all others; Gender—0 for women, 1 for men; Age—0 for 45 years or younger, 1 for 46 years or older; Income—0 for under $100,000, 1 for $100,000 or more; CFP—0 for no CFP designation, 1 for holding a CFP designation; Compensation—0 for fee only or fee and commission, 1 for commission only; Market Own Funds—0 for working for a company that does not market its own funds, 1 for working for a company that markets its own funds; Purchase Size—0 for having an average purchase size less than $25,000, 1 for having an average purchase size of $25,000 or more. The first number is the beta coefficient and the second number in parentheses is the t-statistic.

* $p < .05$; ** $p < .01$.

LL shares are optimal during this period. More importantly, 77% of advisors recommended a share class other than LL funds for this time horizon.

For the time horizon of eight or more years, 62.6% of advisors recommend FEL funds, while a substantially smaller percentage recommend CDSC funds (32.8%) and LL funds (20.4%). The findings for this horizon are more consistent with optimal fund class recommendations. Our example shows that investor wealth is maximized in the LL class for short periods, but FEL or CDSC classes are optimal for long-term horizons.[8] Once again, however, 20% recommend the level load, which is never optimal for longer holding periods (O'Brian, 2001; Lauricella, 2003b). The results in Tables 8 provide some indication that advisors may not fully understand MS class economics or may be selling other share classes as a result of company policy or compensation structure.

5. Multivariate analysis

In addition to our univariate results we perform a multivariate analysis to further examine the relationship between advisor characteristics and MS class selection.[9] Table 9 presents the results from estimating a model where the frequency of selling a particular fund class is

regressed against variables indicating specific advisor characteristics. The model takes the following form:

$$\begin{aligned}\text{Class Frequency} = {} & \beta_0 + \beta_1 \text{ Education} + \beta_2 \text{ Experience} + \beta_3 \text{ Company} \\ & + \beta_4 \text{ Gender} + \beta_5 \text{ Age} + \beta_6 \text{ Income} + \beta_7 \text{ CFP} + \beta_8 \text{ Compensation} \\ & + \beta_9 \text{ Mkt own Funds} + \beta_{10} \text{ Purchase Size} + \varepsilon. \end{aligned} \quad (1)$$

Class Frequency represents the reported frequency of selling front-end load, contingent deferred sales charge, level-load, and no-load fund classes by an individual advisor. Each of the independent variables is dichotomous and takes a value of either one or zero depending on the characteristics of the specific advisor. Education takes a value of one if the advisor has a master's degree or higher and zero if the advisor has a bachelor's degree or less. Experience takes a value of one if the advisor reports 11 or more years of advising experience and zero otherwise. Company takes a value of zero if the advisor works for a brokerage firm and one otherwise. Gender takes a value of one if the advisor is male and zero if the advisor is female. Age takes a value of one if the advisor is 46 years or older and zero otherwise. Income takes a value of one if the advisor reports annual compensation of $100,000 or greater and zero otherwise. CFP takes a value of one if the advisor holds a CFP designation and zero if not. Compensation takes a value of one if the advisor is compensated by a commission only and zero if at least some of the advisor's compensation is fee based. Market Own Funds takes a value of one if the firm for which the advisor works sells proprietary funds and zero otherwise. Finally, Purchase Size takes a value of one if advisors report individual mutual fund sales averaging $25,000 or more and zero otherwise.

The results shown in Table 9 can be viewed in two dimensions. First, by fund class, the first column of the table illustrates that commission-based advisors are significantly more likely to sell front-end load classes, while advisors whose firms sell their own funds are significantly less likely to sell the front-end load class. In the second column, older (over 45 years) advisors and those that have in-house funds are significantly more likely to offer CDSC shares. Level-load shares are more likely to be sold by advisors with their own funds, but not by advisors who work for brokerage firms, by female advisors, by advisors with a CFP, or by advisors compensated by commission only. Finally, no-load funds are sold less by commission-based advisors.

A second way to view the results is by advisor characteristics. From this perspective it is apparent that compensation structure and whether the advisor's firm offers its own funds are the most important characteristics with respect to class choice. Specifically, advisors compensated solely through commission are significantly more likely to sell FEL and significantly less likely to sell LL and no-load shares, which is comparable to our earlier result. Advisors working for firms that sell proprietary funds are significantly less likely to sell FEL classes, but more likely to sell CDSC and LL classes, which, again, are traditionally more profitable for fund sponsors.

Next we perform a logistic regression to try to identify advisor characteristics that help identify those advisors better able to maximize fund returns for investors by matching fund classes to investor time horizon. Table 10 displays the results of the model where the "correct" class choice for various holding periods is regressed against the independent variables from Eq. (1). The "correct" decision depends on the planned holding period. For

Table 10
Logistic regression results for choice of multiple share class for various time horizons

Variable	Dependent Variable			
	MS choice for 1–3 years	MS choice for 4–7 years	A: MS choice for 8 years or more	B: MS choice for 8 years or more
Education	0.603	0.119	−0.032	−0.168
	(4.013)*	(0.155)	(0.015)	(0.117)
Experience	0.291	0.423	0.506	−0.857
	(0.887)	(1.488)	(2.986)	(2.597)
Company	−0.251	−0.602	−0.115	0.561
	(0.714)	(2.952)	(0.17)	(1.588)
Gender	−0.036	−0.484	0.622	−0.478
	(0.010)	(1.756)	(3.465)	(0.914)
Age	−0.775	−0.486	−0.267	−0.117
	(7.409)**	(2.442)	(1.028)	(0.068)
Income	0.158	0.253	−0.178	0.076
	(0.295)	(0.642)	(0.426)	(0.026)
CFP	−0.36	−0.7	−0.182	1.052
	(0.840)	(2.659)	(0.242)	(3.631)
Compensation	−0.635	−1.282	0.547	0.650
	(5.771)*	(18.844)**	(5.009)*	(2.020)
Market own funds	0.708	0.295	−0.559	−0.448
	(7.633)**	(1.084)	(5.492)*	(1.082)
Purchase size	0.332	0.369	−0.175	−0.031
	(1.081)	(1.381)	(0.379)	(0.003)

The dependent variable is a dichotomous variable reflecting either an incorrect (0) or correct choice (1) of a share class given the time horizon indicated. The correct choice (1) for each of the time horizons is as follows: 1–3 years—level load, 4–7 years—level load; A—8 or more years-front-end load, B—8 or more years-front end load or contingent deferred sales charge. All predictor variables are dichotomous variables as follows: Education—0 for Bachelor's degree or less, 1 for Masters degree or above; Experience—0 for 0–10 years of experience, 1 for 11 or more years; Company—0 for brokerage firms, 1 for all others; Gender—0 for women, 1 for men; Age—0 for 45 years or under, 1 for 46 years or older; Income—0 for under $100,000, 1 for $100,000 or more; CFP—0 for no CFP designation, 1 for holding a CFP designation; Compensation—0 for fee only or fee and commission, 1 for commission only; Market own funds—0 for working for a company that does not market its own funds, 1 for working for a company that markets its own funds; Purchase Size—0 for having an average purchase size less than $25,000, 1 for having an average purchase size of $25,000 or more. The first number is the beta coefficient and the second number in parentheses is the Wald statistic.

* $p < .05$; ** $p < .01$.

the first two columns of Table 10 (one to three years and four to seven years) the optimal class as identified in O'Neal (1999) is the level load. For the third column (eight years or more) the correct choice is defined as the FEL class. For completeness, the correct choice in Column 4 is defined as either FEL or CDSC because there are circumstances where CDSC can be preferable. Observations where the correct choice is made by an individual advisor receive a value of one for the dependent variable, while incorrect choices have a value of zero.

We find that for the one to three year horizon, brokers with higher levels of education are more likely to make the correct choice of level load funds, as were those advisors that work for funds that sell their own funds. Older advisors (older than 45 years) and those compen-

sated by commission only were significantly less likely to choose level load funds for this time horizon.

For the intermediate horizon (four to seven years) we find that commission-only advisors are still less likely to recommend the level load class, even though it is the optimal choice among the three load structures. Only for the long horizon, do commission-only advisors appear better at recommending the correct fund class, which happens to be the FEL class they are most likely to sell overall. Advisors with firms that market their own funds are less likely to recommend FEL for periods beyond eight years, but they are also less likely to recommend this class in the aggregate. When CDSC is included as a correct fund choice for long holding periods, none of the variables have coefficient estimates significantly different than zero. Overall, the findings from this logistic regression reinforce the selling practices described in Table 9 and indicate that advisor compensation is a significant determinant of class recommendation.

6. Conclusions

Individual investors have made mutual funds their investment of choice in recent years. The mutual fund industry has responded by offering a dizzying array of investment opportunities. However, many of the new investment options are the result of multiple share class funds with various fee structures that greatly complicate the investment decision. The goal of this study is to determine how well the person investors turn to first, financial advisors, can successfully steer investors through the decision process. Although we generally find no glaring problems with advisor practices, there are several areas of concern that deserve further investigation.

Specifically, advisors appear to recommend share classes related to the commission level for individual classes, and advisors employed by firms with proprietary funds tend to sell a higher proportion of their most profitable fund classes. Additionally, the impact of load structure on investor wealth is not completely understood by advisors in our sample. Although advisors generally choose correct fund classes for short and long horizons, there does not appear to be a good understanding of the optimal class choice for an intermediate horizon, and even with the high propensity to recommend the correct class for short and long horizons, there are still high frequencies of recommending inappropriate classes to investors over those horizons. Especially disconcerting is the fact that fund class choices by advisors often appear associated more with commission and profit than a knowledge of which class is best for investors. While these results are not conclusive for or against any agency problems between advisors and their clients, it does open the door to future analysis. Finally, our study uses self-reported data from financial advisors, which we suspect would be the most conservative. The only true test of these important issues would require proprietary data, which at best would be difficult to obtain.

Our findings are informative for investors, regulators, and advisor firms. The results should give investors some comfort in knowing that in most cases, the advisor recommends the fund class best suited to the investor. However, knowing how the advisor is compensated, commission or not, and whether the advisor's company has proprietary funds is an important

question to have answered because these two characteristics are related to sub-optimal recommendations by advisors. Individual investors should be aware of the impact of different commission structures on their returns and communicate their investment horizon to their advisor. By communicating clearly with their advisor, investors can increase the likelihood that they will be placed in the optimal share class. Our findings provide regulators with empirical evidence of the complex nature of the MS structure as highlighted in the popular press and NASD publications. Finally, firms employing advisors can use the findings to evaluate current sales practices and to develop training for advisors.

Notes

1. See the Investment Company Institute, 2001 Profile of Mutual Fund Shareholders, Fig. 6, p. 16.
2. See Figs. 2, 4, and 6 in *Equity Ownership in America*, September 2002, on ICI's Web site.
3. Morningstar reports each share class separately because the fee structures impact performance for each class.
4. Two of the most common MS structures are (1) funds with front-end load, CDSC, level load, and institutional classes and (2) funds with the three retail classes without the institutional class. However, a wide variety of structures can be found, such as funds with only an institutional and no-load class.
5. Front-end loads have risen steadily since 1995, when the average was approximately 4.8%. As of 2001, the average is approximately 5.1%. Additionally, approximately 65% of all front-end load funds or classes in 2001 had a front-end load greater than or equal to 5.25%. In general, the advisor usually receives anywhere from 0.5–0.75% less than the stated front-end load. This information was obtained from three independent sources of fund company information provided to financial advisors.
6. This information was obtained from three independent industry sources.
7. The identity of the fund company making this statement will remain anonymous to protect privacy.
8. The choice of FEL or CDSC is dependent on the level of the load.
9. We wish to thank the editor and an anonymous reviewer for suggesting this analysis.
10. It should be noted that we have used the most commonly used front-end load for the example in Panel A of Table A-1. However, the level of front-end loads varies considerably and as we show below, the lower the front-end load, the greater the likelihood that CDSC shares are never optimal for the investor.

Acknowledgments

This research was partially funded by a research grant to the first two authors from the U.C. Foundation at the University of Tennessee at Chattanooga. The authors would like to

thank David Dameron, an anonymous reviewer, and Conrad Ciccotello, the editor, for helpful comments.

Appendix

In Panel A of Table A-1, we examine the growth of $10,000 using each share class of a hypothetical portfolio. For simplicity, we assume fund administrative and management fees (Expense) total 75 basis points and each class has the standard 12b-1 fee for its class. We first assume a front-end load of 5.75% and use a 5, 4, 4, 3, 2, 1 declination schedule for CDSC shares. Finally, we assume an expected annual gross fund return of 11%. The values under columns Class A, B, and C represent investor wealth at the end of the corresponding time horizons, assuming any front-end load (Class A) or redemption fees (Class B) are assessed. Additionally, the CDSC shares (Class B) convert to front-end load shares at the end of eight years. It is evident that level load shares are economically optimal out to seven years, at which point CDSC shares become optimal. In fact, front-end load shares are never preferred under these assumptions. This latter statement holds for most reasonable assumptions for expected returns.

While it appears front-end load shares are never in the investor's economic best interest, a unique feature of these classes makes them a viable alternative to CDSC shares.[10] In addition to paying advisors different commission percentages for front-end load and CDSC shares, the classes differ in another unique way as well. The industry practice is to reduce front-end load commission levels based on investment size. The first break point often occurs at $25,000. The break points can be achieved with single purchases or by combining the account values of all funds for an investor with a particular advisor. As the example below demonstrates, this can lead to alternative choices of MS classes based strictly on economics.

In Panel B of Table A-1, we demonstrate the wealth effects of break points for front-end load shares. Using the commission examples given in Clements (2003) and Lauricella (2003d), the front-end load drops to 5.00% with an investment of $25,000. Even with the lower commission on FEL shares, level load shares continue to dominate out to seven years. However, the supremacy of CDSC shares for longer periods no longer holds. For holding periods greater than seven years, front-end load shares are now superior to CDSC shares.

While not shown in Table A-1, larger commission breaks are achieved with larger investments. In fact, the commissions on FEL classes can generally be eliminated for investments exceeding $1 million. Using the returns in our example, when the front-end load falls to 4% the front-end load class proves superior to level load shares beginning in Year 6. Additionally, front-end load shares always dominate CDSC shares at this commission level.

Table A-1

Optimal Share Class and the Effect of Commission Breaks

Panel A:					
Investment:		$10,000	$10,000	$10,000	
FEL		5.75%	0%	0%	
Amt. Invest.		$9,425	$10,000	$10,000	
Gross Ret:		*11.00%*	*11.00%*	*11.00%*	
Expense		*0.75%*	*0.75%*	*0.75%*	
12b-1 Fee		0.25%	1.00%	1.00%	
Net Return		10.00%	9.25%	9.25%	
		Class A	**Class B**	**Class C**	**Red. Sch.**
1	**Year 1**	10,368	10,425	10,925	5%
2	**Year 2**	11,404	11,536	11,936	4%
3	**Year 3**	12,545	12,640	13,040	4%
4	**Year 4**	13,799	13,946	14,246	3%
5	**Year 5**	15,179	15,363	15,563	2%
6	**Year 6**	16,697	16,903	17,003	1%
7	**Year 7**	18,367	18,576	18,576	
8	**Year 8**	20,203	20,294	20,294	
9	**Year 9**	22,224	22,324	22,171	
10	**Year 10**	24,446	24,556	24,222	
Panel B:					
Investment:		$25,000	$25,000	$25,000	
FEL		5.00%	0%	0%	
Amt. Invest.		$23,750	$25,000	$25,000	
Gross Ret:		*11.00%*	*11.00%*	*11.00%*	
Expense		*0.75%*	*0.75%*	*0.75%*	
12b-1 Fee		0.25%	1.00%	1.00%	
Net Return		10.00%	9.25%	9.25%	
		Class A	**Class B**	**Class C**	**Red. Sch.**
1	**Year 1**	26,125	26,063	27,313	5%
2	**Year 2**	28,738	28,839	29,839	4%
3	**Year 3**	31,611	31,599	32,599	4%
4	**Year 4**	34,772	34,864	35,614	3%
5	**Year 5**	38,250	38,409	38,909	2%
6	**Year 6**	42,075	42,258	42,508	1%
7	**Year 7**	46,282	46,440	46,440	
8	**Year 8**	50,910	50,735	50,735	
9	**Year 9**	56,001	55,809	55,428	
10	**Year 10**	61,601	61,390	60,556	

References

Allen, F. (2001). Do financial institutions matter? *Journal of Finance, 56,* 1165–1175.

Armstrong, J. S., & Overton, T. S. (1977). Estimating non-response bias in mail surveys. *Journal of Marketing Research, 14,* 396–402.

Benson, E. D., Rystrom, D. S., & Smersh, G. T.(1995). Commission-motivated trading patterns of brokers across the production month. *Financial Services Review, 4,* 81–95.

Bigel, K. S. (1998). The correlations of professionalization and compensation sources, with the ethical development of personal investment planners. *Financial Services Review, 7,* 223–236.

Brennan, M. J. (1995). The individual investor. *Journal of Financial Research, 18,* 59–74.

Brown, K. C., Harlow, W. V., & Starks, L. T. (1996). Of tournaments and temptations: an analysis of managerial incentives in the mutual fund industry. *Journal of Finance, 51,* 85–110.

Carhart, M. M. (1997). On persistence in mutual fund performance. *Journal of Finance, 52,* 56–82.

Chevalier, J., & Ellison, G. (1997). Risk taking by mutual funds as a response to incentives. *Journal of Political Economy, 105,* 1167–2000.

Chordia, T. (1996). The structure of mutual fund charges. *Journal of Financial Economics, 41,* 3–39.

Clements, J. (2003). Why B shares deserve to get an 'F': these broker-sold funds are a bad deal. *Wall Street Journal,* July 2, p. D 1.

Dellva, W. L., & Olson, G. T. (1998). The relationship between mutual fund fees and expenses and their effect on performance. *Financial Review, 33,* 85–104.

Jain, P. C., & Wu, J. S. (2000). Truth in mutual fund advertising: evidence of future performance and fund flows. *Journal of Finance, 55,* 937–958.

Lauricella, T. (2003). Morgan Stanley is sued on 'break points.' *Wall Street Journal,* March 5, p. C1.

Lauricella, T. (2003b). Mutual-fund investors take quiz: A, B, or C? *Wall Street Journal,* March 7, p. C1.

Lauricella, T. (2003c). Morgan Stanley's fund machine. *Wall Street Journal,* May 22, p. C1.

Lauricella, T. (2003). NASD orders refunds by brokers on mutual-fund commissions. *Wall Street Journal,* August, 27, p. A1.

Livingston, M., & O'Neal, E. S. (1998). The cost of mutual fund distribution fees. *Journal of Financial Research, 21,* 205–218.

Morey, M. R. (2004). Multiple-share classes and mutual fund composition. *Financial Services Review, 13,* 33–56.

National Association of Securities Dealers, *Notice to Members 95-80.*

O'Brian, B. (2001). Fund fees make investors 'class' conscious. *Wall Street Journal,* July 20.

O'Neal, E. S. (1999). Mutual fund share classes and broker incentives. *Financial Analysts Journal,* September-October, 76–87.

Smythe, T. I. (1999). Multiple share class funds: efficiency or exploitation. Unpublished dissertation; University of South Carolina.