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Mutual Fund Distribution Channels and Distribution Costs

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SUMMARY

In the past 25 years, there have been dramatic changes in how mutual funds are sold to the investing public. Before 1980, all funds had a single share class, and shares of a given fund were offered to all investors. Most funds were sold through a broker, who provided advice, assistance, and ongoing service to the fund buyer. The shareholder paid for these distribution services through a front-end sales charge when he or she bought the fund. Other funds sold shares directly to investors without a sales charge. Investors in these funds either did not receive advice and assistance or obtained and paid for these services separately.

Funds sold through financial professionals such as brokers have since adopted alternatives to the front-end sales charge. The alternative payment methods typically include a fee based on assets that may also be in combination with a front-end or back-end sales charge. In many cases, funds offer several different share classes—all of which invest in the same underlying portfolio of assets, but each share class may offer shareholders different methods of paying for broker services.

In addition, the range of venues (or distribution channels) through which an investor can purchase fund shares has expanded since 1980, and each distribution channel may offer different services. As a consequence, companies sponsoring mutual funds have created new funds and share classes that have costs reflecting the different distribution services. With the expansion in distribution channels, many fund sponsors have abandoned earlier, single-channel distribution strategies in favor of multi-channel distribution. As a result, mutual fund sponsors that once marketed exclusively through a single, traditional distribution channel—a sales force or directly to investors—often now compete head-to-head in the same distribution channels.

The changes in fund distribution have been accompanied by a significant decrease in the average cost of distribution services incurred by mutual fund buyers. The decline in distribution costs reflects a variety of developments, including competition between mutual funds, expansion of the 401(k) plan market and other markets with low distribution costs, and increased availability of lower-cost advice to investors.

The purpose of this paper is to describe the current structure of the distribution system for mutual funds and to analyze trends and developments in distribution cost incurred by mutual fund investors since 1980. The principal findings of the paper include the following:

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Distribution of Mutual Funds

- ▶ Mutual funds are sold through five principal distribution channels: (1) the direct channel, (2) the advice channel, (3) the retirement plan channel, (4) the supermarket channel, and (5) the institutional channel.
- ▶ The first four channels primarily serve individual investors. In the direct channel, investors carry out transactions directly with mutual funds. In the advice, retirement plan, and supermarket channels, individual investors use third parties or intermediaries that conduct transactions with mutual funds on their behalf. Third parties also provide services to fund investors on behalf of mutual funds.
- ▶ The most important feature of the advice channel is the provision of investment advice and ongoing assistance to fund investors by financial advisers at full-service securities firms, banks, insurance agencies, and financial planning firms. Advisers are compensated through sales loads or from asset-based fees.
- ▶ The retirement plan channel primarily consists of employer-sponsored defined contribution plans in which employers provide mutual funds and other investments for purchase by plan participants through payroll deductions.
- ▶ The supermarket channel is made up of discount brokers that offer mutual funds from a large number of fund sponsors. Many of the fund offerings are subject to no transaction charges or sales loads.
- ▶ Businesses, financial institutions, endowments, foundations, and other institutional investors use the institutional channel to conduct transactions either directly with mutual funds or through third parties.

Capital Structure

- ▶ The capital structure of mutual funds has changed over the past two decades from solely single-class funds to a mixture of single- and multi-class funds. The majority of funds are now multi-class.
- ▶ The change in capital structure partly reflects the broadening of the distribution system. In particular, the multi-class structure enables funds to offer different distribution and service arrangements to investors with differing needs. As a consequence, investors benefit by obtaining preferred distribution arrangements typically at a lower cost.
- ▶ Because each share class is part of the same portfolio, investors benefit from the economies associated with the management of a single portfolio. Each share class is charged the same base fee for the management of the fund. Differences in fees, expenses, and sales charges reflect differences in the distribution and service arrangements available to investors in a particular share class.
- ▶ The vast majority of funds sold through full-service brokers in the advice channel have multi-class structures. The most common use

involves a group of three classes—A, B, and C shares—that are sold to individuals through stock brokerages. Each share class offers a different method for compensating brokers for advice and assistance. Class A shares rely primarily on front-end loads, whereas class C shares predominantly use asset-based, 12b-1 fees. Class B shares combine 12b-1 fees with declining contingent deferred sales loads that are triggered by redemptions. Each mutual fund investor chooses a share class based on individual circumstances, particularly his or her investment horizon.

- ▶ Other important share classes include an institutional share class for defined contribution plans and institutional investors, and an adviser share class that is sold through financial advisers who charge their clients directly for advice and services.
- ▶ Fund companies that sell funds directly to shareholders typically offer a distinct share class or fund for these direct sales. Fund sponsors that sell directly to retail clients might also offer separate share classes to institutional clients and financial advisers.

Distribution Cost

- ▶ Distribution cost—the combination of sales loads and 12b-1 fees incurred by buyers of mutual funds—decreased 60 percent for equity fund share classes with loads and 43 percent for bond fund share classes with loads between 1980 and 2001.
- ▶ Distribution cost fell as load share classes were sold with greater frequency in retirement plans and other accounts that reduce or waive the load. The decline in cost of purchasing load share classes was also partly in response to competition from no-load fund companies. To meet the competition, load funds reduced front-end sales loads in the 1980s and offered lower-cost alternatives to front-end loads.
- ▶ For the mutual fund industry as a whole, distribution costs fell as sales of no-load share classes increased through the direct, supermarket, and retirement plan channels. The

combination of lower distribution costs among load share classes and increased sales of no-load share classes caused overall distribution costs to fall by 73 percent for equity funds and 60 percent for bond funds between 1980 and 2001.

- ▶ Since the adoption of Rule 12b-1 in 1980, asset-based distribution fees have become a significant element of distribution cost. In 2001, 12b-1 fees represented an estimated 48 percent of all distribution costs for equity fund load share classes and 49 percent for bond fund load share classes. The use of 12b-1 fees has not offset reductions in sales loads, however.

The remainder of the paper is organized as follows. The first section describes the distribution channels through which investors purchase mutual funds. The next section discusses the current capital structure of mutual funds and explains how share classes are tailored for particular types of investors, distribution channels, and alternatives for paying for distribution services. The final section examines trends in distribution charges paid by fund investors.

MUTUAL FUND DISTRIBUTION CHANNELS

Mutual funds are offered for sale in five distribution channels (Figure 1). In the direct channel, investors carry out transactions directly with mutual funds themselves by mail, phone, the Internet, or at customer service centers. In the advice channel, investors purchase and redeem shares through financial advisers at securities firms, banks, insurance agencies, and financial planning firms. In the supermarket channel, discount brokers offer a large number of mutual funds to investors from a broad array of fund companies. In the retirement plan channel, employers sponsoring defined contribution plans select a limited number of mutual funds for retirement plan participants to purchase. Finally, the institutional channel consists of nonpersonal

accounts held by trusts, corporations, financial institutions, endowments, nonprofit businesses, and other organizations.

In contrast to the institutional channel, investors in the other four channels are principally individuals. Among these four channels, it is only in the direct channel that investors interact with mutual funds themselves. In the other three channels—advice, supermarket, and retirement plan—a third party or intermediary, whether a discount broker, financial adviser, or a retirement plan administrator selected by the 401(k) plan sponsor, places transaction orders with mutual funds on behalf of investors and provides services to investors on behalf of mutual funds. In many instances, the funds themselves may not know the identity of the investors but only that of the intermediaries.

During the 1990s, it became increasingly common to offer mutual funds through more than one distribution channel. The development of multi-channel distribution has brought a larger number of funds into direct competition within the same distribution channel.

As a share of mutual fund assets, the advice channel is the largest, accounting for an estimated 55 percent of all mutual fund assets at the end of 2002 (Figure 2). The retirement plan channel is second in size with an asset share of 16 percent. The institutional channel has an estimated 13 percent, the direct channel 12 percent, and the supermarket channel 5 percent of all fund assets.

A distribution channel's asset share, however, does not necessarily reflect individual investors' use of that channel. In a household survey of mutual fund owners conducted in 2001, 48 percent indicated that the retirement plan channel was their primary source of mutual fund purchases, while 37 percent pointed to the adviser channel as the primary purchase channel (Figure 3).² This reversal partly reflects the relative newness of the retirement plan channel, which did not grow rapidly until the 1990s. Hence, average account sizes are much smaller in the retirement plan channel than in the adviser channel. In addition, the presence of assets in other channels often resulted from the rollover of assets from defined contribution plans, usually triggered by job changes and retirement. Ten percent of the respondents to the survey primarily used the direct channel, and 5 percent used the supermarket channel.

The remainder of this section describes more fully the features of the five distribution channels.

² 2001 *Profile of Mutual Fund Shareholders*, Investment Company Institute: Washington, DC, October 2001, p. 68 (www.ici.org/pdf/rpt_profile01.pdf).

FIGURE 1

Principal Features of Mutual Fund Distribution Channels

Channel	Principal Investors Using the Channel	Companies or Organizations Providing Transaction Services	Method of Conducting Share Transactions	Mutual Funds Offered in the Channel	Investor Services
Direct	Individual investors	Mutual fund companies	Transaction orders placed directly with mutual fund companies by mail, telephone, or Internet, or at customer-service centers	Mutual funds of the fund company offering direct transactions	Investment information
Advice	Individual investors	Full-service securities firms, registered investment adviser firms, and insurance agencies	Transaction orders placed with representatives of firms providing transaction services who transmit orders to fund companies	Mutual funds from a large number of fund companies	Investment information, advice, and ongoing assistance; access to funds from different companies within one account
Retirement Plan	Participants in defined contribution plans	Plan sponsor or employer	Transaction orders placed with plan administrators who transmit orders to fund companies	Limited number of mutual funds selected by plan sponsor	Investment information
Supermarket	Individual investors and registered investment advisers acting on behalf of individual investors	Discount brokers	Transaction orders placed with discount brokers who transmit orders to fund companies	Mutual funds from a large number of fund companies	Investment information; access to funds from different fund companies within one account
Institutional	Trusts, businesses, financial institutions, endowments, and other institutional investors	Mutual fund companies	Direct contact with mutual fund companies or with agents of the fund companies	Mutual funds of the fund companies offering direct transactions	Investment information

Direct Channel

In the direct channel, investors buy and redeem shares directly from the fund or, more precisely, through the fund’s transfer agent. The fund company sponsoring the fund does not provide investment advice, so investors must undertake their own research to choose funds. Fund companies selling directly to investors provide a variety of products and tools to assist in decisionmaking.

When investors purchase fund shares directly, the fund company provides ongoing services to the fund shareholder such as quarterly statements, recordkeeping, and transaction processing. These firms typically maintain websites and telephone servicing centers that their direct customers may use. Because of the relatively fixed cost of providing these services, funds selling directly to investors often require higher minimum balances than funds offering shares through third parties, and they frequently assess fees to those investors who do not maintain the minimum balance levels in their accounts.

Advice Channel

The principal feature of the advice channel is the provision of investment guidance, assistance, and advice by financial professionals. These include full-service brokers at national wirehouses, independent financial planners and advisers, registered sales representatives at banks and savings institutions, and insurance agents. Such advisers help fund shareholders identify financial goals such as retirement, tax management, education savings, and estate planning. They assess the risk tolerance of their clients and select mutual funds and other investments to meet these goals.

As an intermediary between investors and funds, financial professionals conduct transactions for the shareholder, maintain the financial records for the investments under their management, send periodic financial statements to shareholders, and

coordinate the distribution of prospectuses, financial reports, and proxy statements to shareholders on behalf of the funds. Shareholders' questions about their funds and accounts often are handled by the financial professionals rather than by the fund companies themselves.

Fund shareholders must compensate financial professionals for their services with payments over and above the fees and expenses that their fund is charged for the fund's management. This compensation can be in the form of one-time sales charges or annual 12b-1 and service fees. These annual fees are also used to compensate financial professionals and, along with the fund's management fees, are part of the expense ratio of share classes sold through financial professionals.

Alternatively, some financial professionals charge their clients directly for their services.³ These advisers typically assess a fee amounting to a percentage of an investor's assets managed by the financial professional. This fee might range from 1 to 2 percent of assets per year, depending on the size of the account.⁴

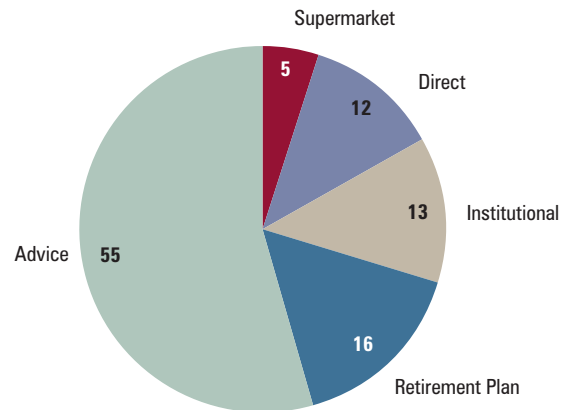
Retirement Plan Channel

In the 1990s, defined contribution retirement plans, such as 401(k) plans, became one of the primary sources through which investors buy mutual funds. In 2002, \$1 trillion was invested in mutual funds through defined contribution plans, up from \$67 billion in 1990. Furthermore, 62 percent of all household owners of mutual funds held shares in defined contribution plans.⁵

Employers sponsoring defined contribution plans rely upon third parties to administer the plans and provide plan investments to employees. The third-party administrator (TPA) typically handles the recordkeeping and other administrative

FIGURE 2

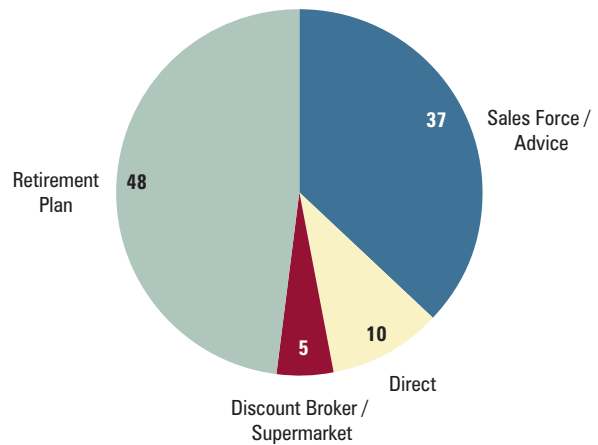
Share of Mutual Fund Assets by Distribution Channel, 2002
(percent of mutual fund assets)



Note: Components do not add to 100 percent because of rounding.
Sources: Investment Company Institute and Cerulli Associates, Inc.

FIGURE 3

Primary Mutual Fund Purchase Channel Used by Households, 2001
(percent of households)



Source: Investment Company Institute.

³ See "RIAs: The State of the Fee-based Financial Adviser Market," *The Cerulli Report*, Cerulli Associates, Inc: Boston, MA, 1999 for a detailed discussion of the fee-based adviser channel.

⁴ Some advisers charge for their services on a fee-for-service basis with an hourly fee.

⁵ 2001 *Profile of Mutual Fund Shareholders*, p. 68.

services and assists the employer in the selection of the investment options offered to employees. Investment options typically include mutual funds, guaranteed investment contracts, stable value funds, and company stock.⁶

Among the services provided by these third parties are educational materials and seminars for employees that explain the retirement plan, investment options, and investment principles. TPAs are involved in the provision of other services to employees participating in defined contribution retirement plans, including staffing telephone call centers to answer questions, developing and maintaining automated telephone voice-response systems, building and maintaining websites with information specific to the employees' particular retirement plan, and producing participant account statements, daily transaction recordkeeping, and annual tax reporting.

Some employers assume the cost of TPA services. In these cases, employees receive all of the education and service associated with the retirement plan as an employee benefit. Other employers do not subsidize the full cost of the plan. In these cases, third-party services are paid by employer subsidies, direct charges to employees, or fees included in mutual fund expenses. These expenses that pay for third-party services, such as 12b-1 fees and service fees, are included in the expense ratio of the share class along with the annual fees and expenses that shareholders pay for the management of the fund.

Supermarket Channel

The introduction of the first mutual fund supermarket by a discount broker in 1992 represented a significant innovation in the distribution of mutual funds. Many other discount brokers, some affiliated with mutual fund companies, have since organized fund supermarkets.

The most important feature of a fund supermarket is its non-transaction-fee (NTF) program, whereby an investor may purchase mutual funds with no transaction fees from a large number of fund companies. The NTF offerings at a discount broker often number in the thousands, providing an investor the convenience of purchasing "no-load" funds from different families at a single location.

Supermarkets generally do not provide investment advice, and investors must undertake their own research when choosing funds.⁷ However, supermarkets provide a variety of products and tools to assist

shareholders' decisionmaking. In addition, the supermarkets provide a convenient platform through which investors can research funds, obtain fund literature, and purchase fund shares. The supermarket platform not only provides fund sponsors with access to a national retail distribution channel, but it also promotes competition among funds because investors can readily compare fund fees, expenses, and returns.

The fund supermarket holds a single account with each fund and maintains shareholder transaction records for the mutual fund. The supermarket also provides consolidated reports to fund shareholders, distributes mutual fund proxy statements, financial reports, prospectuses, and tax reports. In addition, because the supermarket maintains the relationship with the investor rather than the fund itself, fund shareholders rely on the supermarket's telephone representatives and website for account information, reducing the fund's direct cost for providing these services.

Some funds pay for services provided by supermarkets through a 12b-1 fee. In addition, funds can pay for non-distribution services, such as shareholder recordkeeping, using fund assets rather than a 12b-1 fee. Alternatively, some fund advisers use their own revenues to pay the supermarket for servicing their shareholders.⁸ The total amount of fees that a supermarket charges the fund is typically based on the fund's level of assets with the supermarket.

Investors can also purchase funds that do not participate in the NTF program through the supermarket. The supermarket recoups the costs of providing services to shareholders in these funds by charging commissions on fund transactions, including reinvestment of dividends and capital

⁶ In 2000, the average employer in the database of 401(k) plans tracked jointly by ICI and the Employee Benefit Research Institute offered their employees about 10 investment options.

⁷ A few mutual fund supermarkets now offer advice as an additional service. The investor pays the supermarket directly for the advice.

⁸ See letter to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission, dated October 30, 1998.

gain distributions. In addition, some supermarkets have a special program whereby financial advisers can purchase funds without transaction fees for their clients.

Institutional Channel

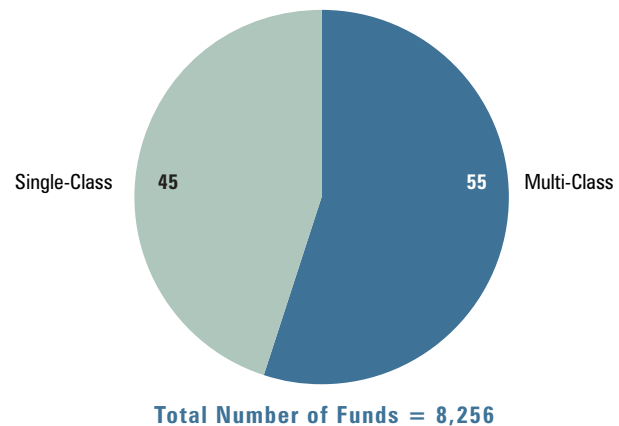
The institutional channel comprises a variety of institutions purchasing fund shares for their own accounts. These institutions include businesses, financial institutions, endowments, foundations, and state and local governments. Fund sponsors often create special share classes or funds for institutional investors.

Because these investors have large average account balances, the cost of managing a fund or share class with institutional accounts is lower than that for funds with a large number of small accounts. Consequently, the expense ratios for institutional funds and share classes tend to be lower than for comparable funds sold to individual investors.

Institutional investors can purchase shares directly from fund companies, but they also rely on third parties to purchase their fund shares. For example, banks and other third parties that help institutions manage their cash holdings have created platforms that offer a variety of money market funds. These platforms permit institutional investors to place money in multiple money market funds and to move money between the funds on this platform. These arrangements allow institutional investors, which are often restricted as to the portion of their cash holdings that can be held in any particular mutual fund, to easily diversify their holdings across funds.⁹

FIGURE 4

Single-Class and Multi-Class Mutual Funds, 2002
(percent of total)



Source: Investment Company Institute.

CAPITAL STRUCTURE OF MUTUAL FUNDS

The capital structure of mutual funds has changed significantly since 1980. In 2002, over half of all mutual funds had two or more share classes, a marked contrast to the early 1980s when all funds had only one share class (Figure 4).

The movement to a multi-class capital structure reflects two developments. The first is the use of multi-channel distribution strategies, which has led many funds to establish share classes with different distribution, service, and expense arrangements. The use of multi-class funds permits investors in each share class to benefit from economies of scale associated with a single portfolio of securities while obtaining distribution and service arrangements suited to their specific needs.¹⁰ The second development involves the use of multi-class funds in the advice channel to give investors several ways to pay for the services provided by financial advisers. Most funds sold through this channel offer investors three payment plans through three share classes, each having different mixes of sales loads and asset-based fees.

Single-class funds are primarily found among funds sold in the direct and institutional channels or sold as variable annuities. For example, of the 3,694 single-class funds in 2002, 29 percent were direct market funds, 33 percent were variable annuities, and 16 percent were

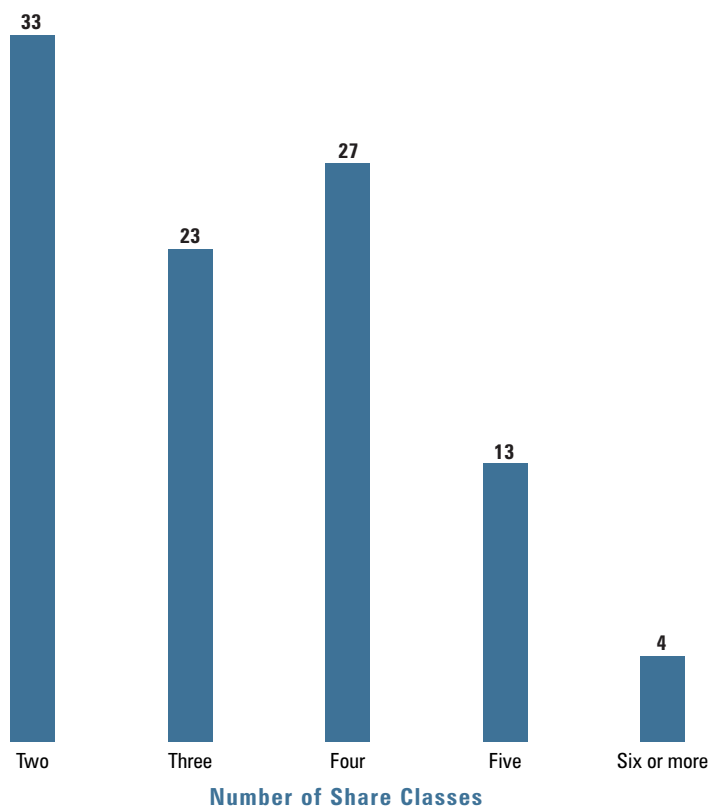
⁹ See *Money Fund Report*, iMoneyNet: Westborough, MA, May 23, 2003, for a discussion of these platforms.

¹⁰ Robert C. Pozen, *The Mutual Fund Business*, Houghton Mifflin Company: Boston, MA, 2002, pp. 437–438.

FIGURE 5

Percentage of Long-Term, Multi-Class Mutual Funds by Number of Share Classes, 2002

(percent of total)



Source: Investment Company Institute.

institutional funds. Among the multi-class funds, half of the funds had three or four share classes (Figure 5). Seventeen percent had five or more classes.

This section discusses the capital structure of multi-class mutual funds, starting first with the class A, B, and C shares offered through the advice channel. It then considers other share classes available to institutional investors, retirement plans, registered investment advisers, and educational savings plans. Finally, this section presents assets and sales data for single- and multi-class funds.

Class A, B, and C Shares

One use of the multi-class structure is to provide investors in the advice channel with alternative ways to pay for advice and service provided by financial professionals. The share classes offered in these channels are typically labeled class A, B, and C shares.

A Shares. The A share class represents the traditional means for paying for investment advice. Class A shares carry a front-end sales load that is charged at the time of purchase as a percentage of the sales price or offering price. For example, if the offering price were \$10.00 per share, an investor buying A shares with a 5.5 percent load would pay a load of \$0.55 per share, leaving \$9.45 to be invested.¹¹ On a \$10,000 investment, the investor would pay a \$550 load and invest \$9,450.

The investor, not the fund, pays the load, and the load itself is collected by the fund’s distributor, which is a separate company that underwrites, markets, and distributes the fund’s shares.¹² The distributor serves as the interface between the fund and third parties selling shares to the investor. Most of the load is paid to the selling firm and its brokers to compensate them for advice and service provided to fund shareholders. The distributor, however, typically retains a small portion of the load to cover its expenses.

The front-end load on A shares is charged on new sales and is not generally incurred when A shares are exchanged to another fund within the same fund family.¹³ The primary exception involves A shares of money market funds, of which only a handful carry front-end loads. As a consequence, transfers of initial sales in money

¹¹ The difference between the offering price and load, \$9.45, is the net asset value. Measured relative to net asset value, the effective front-end load is 5.82 percent. More generally, if the front-end load is f , the effective load is $f/(1-f)$.

¹² The distributor is a separate legal entity from the fund but is often affiliated with the fund’s adviser. The distributor underwrites or buys shares from the fund and redistributes those shares to investors either directly or indirectly through brokers and other third parties.

¹³ Some fund companies sponsor several fund families. Exchanges between funds within a fund family do not generally trigger a new sales charge. However, exchanges between funds of different fund families sponsored by a fund company are considered new sales and typically are charged a sales charge.

market funds to long-term funds trigger a front-end sales charge. Although funds are permitted to impose a sales load on reinvested dividends and capital gain distributions, few actually do, and funds must disclose to shareholders when they do.

A fund with A shares establishes a maximum front-end load and a schedule of load reductions for large purchases. In 2001, the average maximum front-end load was 5.2 percent on equity funds and 4.2 percent on bond funds.¹⁴ Scheduled load reductions for quantity purchases typically occur in steps or breakpoints. The first breakpoint usually occurs at \$25,000 or \$50,000, and additional breakpoints are introduced generally up to \$1,000,000 for which the load is often eliminated altogether (Figure 6).^{15,16} Employer-sponsored, defined contribution plans typically waive or reduce the load on A shares based upon the cumulative size of the plan's assets. In addition, A shares often are available with the load waived in mutual fund wrap accounts.¹⁷

As a result of load reductions, the average actual load paid by buyers of A shares is lower than the maximum load of the share class. For example, the average front-end load collected on sales of A shares of long-term funds in 2001 was an estimated 1.1 percent, about one-fifth of the average maximum load (Figure 7). In contrast, the average actual load was 3.6 percent in 1991, about three-fourths of the average maximum load.

FIGURE 6

Schedule of Breakpoints and Front-End Sales Loads for Front-End Equity, Bond, and Hybrid Funds, 2001

(percent)

Amount of Purchase	Equity Funds	Hybrid Funds	Bond Funds
\$25,000	5.50	5.28	4.50
\$50,000	4.50	4.50	4.00
\$100,000	3.50	3.50	3.50
\$250,000	2.50	2.50	2.50
\$500,000	2.00	2.00	2.00
\$1,000,000	0.00	0.00	0.00

Note: The median of the front-end sales load is used for each purchase amount level.

Sources: Investment Company Institute and Morningstar, Inc.

FIGURE 7

Average Actual and Maximum Front-End Sales Load for Long-Term Funds, 1960 – 2001, Selected Years

(percent)

Year	Average Actual Load	Average Maximum Load †	Ratio: Actual to Maximum
1960	7.0	N/A	
1970	5.7	N/A	
1982	4.9	7.0	0.70
1989	4.4	5.5	0.80
1991	3.6	4.9	0.73
1997	2.1	5.1	0.41
1998	1.8	5.1	0.35
1999	1.8	5.2	0.35
2000	1.5	5.3	0.28
2001	1.1	5.2	0.21

**Sales-weighted average of maximum loads for a sample of stock and bond funds with maximum front-end sales loads greater than 3 percent. The maximum front-end load is the highest load the fund is allowed to charge as set forth in its prospectus.*

Sources: Investment Company Institute and Strategic Insight Mutual Fund Research and Consulting LLC.

¹⁴ The regulatory maximum is set under Rule 2830 of the National Association of Securities Dealers (NASD). The distributor is a registered broker-dealer with the U.S. Securities and Exchange Commission and thus required to be a member of the NASD, the self-regulatory organization overseeing registered broker-dealers. NASD regulates sales practices of broker-dealers and, under this authority, has adopted Rule 2830, which sets limits and conditions on mutual fund sales loads and asset-based distribution fees. The 8.5 percent maximum applies to share classes without a 12b-1 fee. Lower maximums govern share classes with 12b-1 fees.

¹⁵ An investor may qualify for the quantity reductions not only by his or her individual purchases but also, in most cases, by aggregating purchases of immediate family members and purchases of shares in different funds within the same fund family. In addition, most funds offer rights of accumulation that permit an investor to qualify for load reductions by combining the purchase of A shares with the current value of shares held in the complex's funds. Moreover, the investor may qualify for quantity discounts by agreeing to purchase a large quantity over a specified period of time. In some fund families, holdings of certain funds may be excluded. In addition, some funds permit the value of previous purchases less redemptions to be used in place of the current value of holdings if it is greater.

¹⁶ Earlier this year, the SEC asked the NASD, with the support of ICI and the Securities Industry Association, to spearhead the formation of a task force after routine NASD examinations found that investors did not always receive the correct sales charge discounts. The task force is charged with recommending ways in which the mutual fund and brokerage industries can assure that investors are not overcharged when they purchase mutual funds with front-end loads. The task force is expected to issue its recommendations in the near future.

¹⁷ A mutual fund wrap account is a program in which a number of funds from different fund families are available for purchase. An investor working with an adviser at the brokerage or sponsoring firm selects funds from the program. The investor pays a single fee to the adviser that is based upon the value of all the investor's assets held in the wrap program. The funds in the wrap program typically are A shares with the front-end loads waived.

In addition to the front-end load, A shares usually have an annual 12b-1 fee that is used to compensate brokers and sales professionals for ongoing assistance and service provided to fund shareholders. The 12b-1 fee is asset-based and allowed under SEC Rule 12b-1, which permits a fund or share class to use its assets to pay for distribution-related services, subject to various conditions. The 12b-1 fee for A shares is typically between 25 and 35 basis points of share-class assets. The allowable maximum is 100 basis points.¹⁸ The share class as a whole pays the fee, with each fund shareholder indirectly bearing the cost. The fee initially is paid to the fund's distributor, who compensates brokers for shareholder services on a quarterly basis.

B Shares. Unlike A shares, B shares are offered for sale at net asset value without a front-end sales load. B share investors pay for advice and assistance from brokers through a combination of an annual 12b-1 fee, usually 100 basis points, and a contingent deferred sales load (CDSL). The deferred sales load is triggered when shares are redeemed and is typically based upon the lesser of the original cost of the shares or the current market value of the shares.

The CDSL typically is set at 5 percent for the first year in which the B shares are held. Thereafter, it decreases in units of 1 percentage point, reaching 0 percent in the sixth or seventh year in which the shares are held. After six to eight years, B shares typically convert to A shares, lowering the level of the annual 12b-1 fee from 100 basis points to that of A shares.

Shares that are transferred or exchanged to class B shares of another fund within the fund family are not subject to the CDSL. Nor does the exchange generally affect the calculation of the holding period for determining the applicable CDSL, which is based on the purchase date of the original shares.¹⁹ In a partial redemption, the actual shares redeemed are those subject to the lowest sales charges. The first shares redeemed are those purchased through dividend reinvestments and capital gain distributions, since they are not subject to the sales loads. Thereafter, shares are redeemed based upon the length of time they have been held, starting with the longest holding period.

When B shares are purchased, the fund distributor pays the brokerage firm an upfront fee similar to the upfront payment of the sales load on A shares.²⁰ In addition, the selling broker receives an annual payment of 25 basis points from the 12b-1 fee for providing ongoing assistance and service to holders of B shares. The distributor retains the remaining 75 basis points of the 12b-1 fee to service borrowings used to finance the upfront payments. The borrowing often occurs through the securitization of the 12b-1 fees, with the fees providing the stream of payments necessary to service asset-backed commercial paper or securities.

From the investor's perspective, the purchase of B shares spreads the payment for the broker's services over the period of time the shares are held, rather than requiring a single upfront payment as with A shares. Consequently, the difference in the annual expense ratio between an A share and B share simply equals the portion of the 12b-1 fee included in the B share to repay the single upfront payment to the broker. In 2001, the average equity fund's B share had an annual expense ratio that was 72 basis points greater than its A share.

B share investors also avoid the front-end load charged by A shares, which reduces the amount of the original investment. In theory, the investor could achieve the same result by buying A shares and borrowing the amount of the front-end load. In practice, however, it would not be economical to do so because the interest rate on the loan would generally be higher than that incorporated into the cost of B shares. That is, B shares offer

¹⁸ The maximum 12b-1 fee is covered under NASD Rule 2830. Under the rule, a distinction is made between a service fee and an asset-based sales charge. A service fee refers to payments from a 12b-1 fee for personal service or maintenance of shareholder accounts. An asset-based sales charge includes payments from a 12b-1 fee used to finance sales or sales promotion expenses. The service fee may not exceed 25 basis points and the asset-based sales charge may not exceed 75 basis points. Consequently, in total, the 12b-1 fee may not exceed 100 basis points. The NASD also limits the aggregate dollar amount of sales loads and asset-based sales charges that a share class may collect. The maximum is based upon the cumulative volume of new sales of the share class plus interest less any 12b-1 fees and sales loads collected on the share class. The interest rate applied is the prime rate plus 1 percentage point per annum.

¹⁹ An exception can occur with exchanges into the B class of a money fund, if the money fund has a lower 12b-1 fee than the B shares of long-term funds. In this case, the calculation of the holding period is suspended until the shares are moved back into a long-term fund.

²⁰ The amount paid to the broker-dealer is generally fixed for B shares but declines for A shares with the reduction in the front-end load for quantity purchases. The payout to the dealer from sales of A shares typically is higher than that for sales of B shares on small to moderate purchases and lower on large purchases. However, as discussed below, funds typically limit investor purchases of B shares to no more than \$250,000.

more favorable financing terms by substituting the better credit rating and lower borrowing rate of the distributor for those of the investor.

Equating the purchase of B shares to an investor borrowing to make the upfront payment to the broker demonstrates that the function of the CDSL is to ensure that the full amount of the loan is repaid should the investor redeem shares ahead of the implicit schedule of loan payments. The ability to redeem shares, in essence, gives the shareholder an option to prepay the loan in the form of the CDSL. On a more practical level, the CDSL serves to ensure that the distributor is reimbursed for the sales charge paid to the broker at the time of the sale. Moreover, the decline in the CDSL as the length of the holding period increases reflects the paydown of the load used to finance the upfront payment to the broker.²¹

C Shares. Class C shares offer a third option for paying for advice and assistance. C shares are offered at net asset value with no front-end load, and they typically recover distribution costs through a combination of an annual 12b-1 fee of 100 basis points and a CDSL set at 1 percent in the first year of purchase. After the first year, no CDSL is charged on redemptions. The distributor makes an upfront payment of 1 percent of the purchase price to the selling broker and, starting in the second year, pays the full amount of the 12b-1 fee to the broker. The C shares usually do not convert to A shares, and thus the annual 100-basis-point payment to the broker continues throughout the period of time that the shares are held. Because of this feature, C shares are often referred to as “level-load” shares.

The level load makes the C share class similar to standard advisory fee agreements found throughout the asset management industry. In these agreements, the adviser charges the client an annual fee—computed as a percent of assets—that the client pays directly out of assets. Although the C share investor does not directly pay his or her broker for advice, the end result is the same in that the C class shareholder indirectly uses the assets in his or her account to compensate the broker. C shares are not just used by brokers but also by certain fee-based advisers outside brokerages who receive their compensation indirectly through the payment of the 12b-1 fee instead of a direct charge paid by the client.²²

Choice Between A, B, and C Shares. Several factors can influence an investor’s choice of share classes. One factor is the amount invested by the shareholder because investors in A shares typically receive load reductions for large purchases, whereas investors in B and C shares do not. Another factor is the investor’s preference for paying an upfront sales load as opposed to spreading the payments over time through 12b-1 fees. Some investors would prefer to invest the full amount, as in the case of B and C shares, rather than reduce the amount to be invested by paying the front-end load. A choice of C shares also could reflect the business practice of the adviser, who may charge clients an annual fee. Finally, C shares may appeal to investors who want flexibility in moving between funds offered by different fund sponsors.

Another consideration when choosing between share classes is the expected investment return for each share class over the period in which they are held. The three share classes participate in the same portfolio of securities and generally have the same non-distribution expense ratio. By design, however, each share class has a different distribution arrangement and cost, and thus returns from investing in the share classes can and do differ. The relative returns of the share classes depend upon several factors, including the level and timing of sales loads, the level of 12b-1 fees, and the length of time that the investment is held.

The effect of these factors on decisionmaking can be illustrated by calculating the returns from investments in class A, B, and C shares. For this purpose, initially assume that the gross return for each share class before distribution costs and non-distribution expenses is 10.00 percent and that the non-distribution expense ratio for each share class is 0.75

²¹ The distributor assumes a risk in financing the upfront payment to the broker in B shares because if the share class’ assets decline, the 12b-1 fees could drop below the level necessary to service the loan.

²² The adviser receives the 12b-1 fee through the NASD member broker-dealer that the adviser uses to purchase the fund shares.

percent. To compute the return for each share class, additional assumptions must be made about the structure of distribution charges. In particular, suppose that:

- ▶ A shares have 5.75 percent front-end load and 12b-1 fee of 0.25 percent;
- ▶ B shares have a 12b-1 fee of 1.00 percent, convert to A shares after the end of the eighth year, have an initial CDSL of 5.00 percent followed by successive levels of 4.00 percent, 3.00 percent, 3.00 percent, 2.00 percent, and 1.00 percent over the next five years, and have no CDSL starting in the seventh year;
- ▶ C shares have a 12b-1 fee of 1.00 percent, a CDSL of 1.00 percent in the first year, and no CDSL thereafter.

Based upon these assumptions, total annual returns for A, B, and C shares can be computed for a given holding period. For example, for an investor holding shares for five years, the annual rate of return over the five-year period would be 7.62 percent for A shares, 7.78 percent for B shares, and 8.08 percent for C shares (Figure 8).²³ If return were all that mattered and the investor knew with certainty that the shares would be held for five years, C shares would be the appropriate choice.

The effects of distribution arrangements on rates of return can be demonstrated by calculating returns over holding periods ranging from one to 15 years. Returns on both A and B shares increase as the holding period increases, whereas the return on C shares is constant beyond the first year. The return on A shares rises with the holding period because the initial upfront payment of the front-end load is spread over longer intervals of time.²⁴ The increase in the return on B shares partly reflects a similar effect of spreading the CDSL over longer holding periods. In addition, successive decreases in the CDSL boost the annual return. Moreover, the conversion of B shares to A shares after the eighth year increases the return further, as the 12b-1 fee drops to the lower level of A shares.²⁵ The constancy of the return on C shares after the first holding period results from the absence of any sales loads and any conversion that would alter the level of the 12b-1 fee.²⁶

FIGURE 8

Hypothetical Total Annual Return on A, B, and C Shares¹

(percent)

Holding Period	A Shares ²	B Shares ³	C Shares ⁴
1	2.64	3.08	7.08
2	5.72	6.21	8.08
3	6.77	7.21	8.08
4	7.30	7.48	8.08
5	7.62	7.78	8.08
6	7.83	7.96	8.08
7	7.98	8.08	8.08
8	8.10	8.08	8.08
9	8.19	8.17	8.08
10	8.26	8.24	8.08
11	8.32	8.30	8.08
12	8.36	8.35	8.08
13	8.40	8.39	8.08
14	8.44	8.43	8.08
15	8.47	8.46	8.08

¹ Assumptions for all share classes: Before-expense return, 10.00 percent; non-distribution expense ratio, 0.75 percent; redemptions occur at end of holding period.

² Assumptions: Front-end sales load, 5.75 percent; 12b-1 fee, 0.25 percent.

³ Assumptions: CDSL, 5.00 percent in year 1, 4.00 percent in year 2, 3.00 percent in year 3, 3.00 percent in year 4, 2.00 percent in years 5, 1.00 percent in year 6, 0.00 percent thereafter; 12b-1 fee, 1 percent in years 1 to 8, 0.25 percent thereafter.

⁴ Assumptions: CDSL, 1.00 percent in year 1, 0.00 percent thereafter; 12b-1 fee, 1.00 percent.

Sources: The SEC Mutual Fund Cost Calculator (www.sec.gov/investor/tools/mfcc/mfcc-int.htm) and Investment Company Institute.

For holding periods from one to six years, C shares are the highest yielding investment in the example. The return advantage is especially large in the first several years when A and B shares are most affected by sales loads. For holding periods of seven and eight years, B and C shares produce

²³ The computations for the rate of return for each of the share classes used the SEC mutual fund cost calculator available at www.sec.gov/investor/tools/mfcc/mfcc-int.htm. In calculating the annual return for a given holding period, shares are assumed to be redeemed at the end of the holding period. For a similar analysis of rates of return on the three share classes, see Edward S. O'Neal, "Mutual Fund Share Classes and Broker Incentives," *Financial Analysts Journal*, Vol. 55, No. 5 (September/October 1999), pp. 79–81.

²⁴ In the SEC cost calculator, the annual return on A shares equals $[(1-e)(1+R)(1-f)^{1/n}]^n - 1$, where e is the expense ratio including the 12b-1 fee, R is the gross return before expenses, f is the front-end load, and n is the holding period. The expression approximately equals $R - e - (f/n)$. As the holding period increases, the value of f/n decreases.

²⁵ In the SEC cost calculator, the annual return on B shares for holding periods between one and six years is $\{[(1-e)(1+R)]^n - d\}^{1/n} - 1$, where the holding period n ranges between 1 and 6 years and d is the CDSL for the holding period. The magnitudes of the variables are such that this expression approximately equals $R - e - (d/n)$. For the seventh and eighth holding periods, the annual return is $(1-e)(1+R) - 1$, which approximately equals $R - e$. For holding periods beyond the eighth, the annual return is $\{[(1-e)(1+R)]^8 [(1-e^*)(1+R)]^{(n-8)}\}^{1/n} - 1$, where e* is the lower expense ratio resulting from the conversion to A shares in the ninth year. This expression approximately equals $R - [8e + (n-8)e^*]/n$.

²⁶ In the SEC cost calculator, the return for a one-year holding period is $[(1-e)(1+R)] - d - 1$ and the return for the remaining holding periods is $(1-e)(1+R) - 1$.

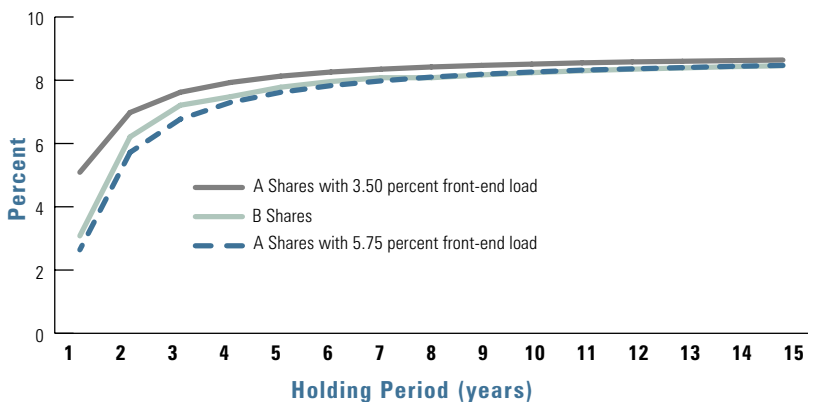
identical returns, as both have the same 12b-1 fee and no CDSL. For holding periods in excess of eight years, A shares have the highest returns, although only slightly larger than the return on B shares. C shares have the lowest return for long holding periods.

In the example, B shares have higher returns than A shares for all holding periods of eight years or less. This relationship, however, is dependent upon the level of the front-end sales load on A shares. If the front-end load were 3.50 percent rather than 5.75 percent, A shares would outperform B shares for all holding periods (Figure 9), not just holding periods of eight years or more. Investors buying in quantity are eligible for lower front-end loads; as a result, funds limit investor purchases of B shares typically to no more than \$250,000. Reductions in front-end loads also significantly lower the return advantage of C shares over A shares at short investment horizons. In fact, in the example of A shares with a 3.50 percent front-end load, the return on C shares exceeds that on A shares only for holding periods up to four years.

The example leads to several generalizations with respect to the selection of share classes based on total return. First, investors subject to the maximum front-end sales load would prefer C shares for short and intermediate holding periods. Investors with a long investment horizon would choose A shares. Second, investors who are eligible for significant reductions in front-end loads would choose A shares for all but short holding periods. Third, investors who are uncertain about the length of the holding period and with relatively moderate amounts to invest may choose B shares even though they generally do not outperform other share classes.²⁷ Returns on B shares over long holding periods are only slightly below

FIGURE 9

Hypothetical Total Annual Return on B Shares and on A Shares with Front-End Sales Load of 5.75 Percent and 3.50 Percent



Note: See Figure 8 for assumptions underlying the calculations.

Source: Investment Company Institute.

returns on A shares and, at other holding periods, are above returns on A shares. In addition, for short holding periods, B share returns are relatively close to those of C shares except at the very shortest holding periods.

Assets and New Sales of Load Share Classes of Long-Term Funds

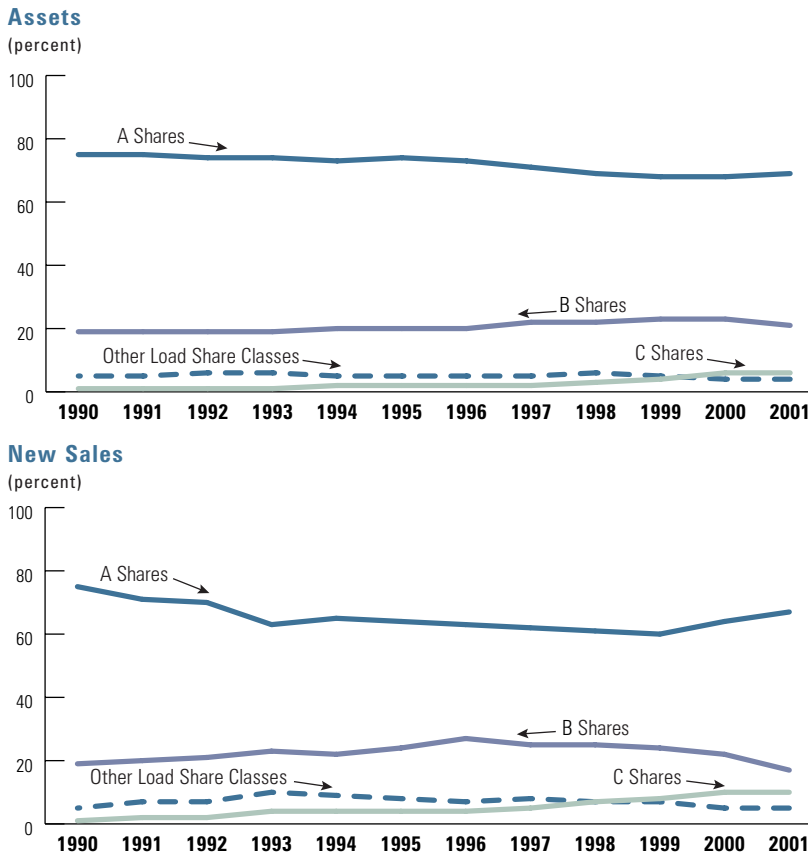
Even with the expansion of new share classes, A shares have maintained the largest share of assets and new sales among load share classes of long-term funds. In 1990, 75 percent of the assets of load share classes of long-term funds were held in A shares (Figure 10). The market share of this class declined during the 1990s but still stood at 69 percent in 2001, the most recent year for which data were available. Other classes have garnered marginally higher asset shares since 1990. The B share class is the second largest, with 21 percent of assets in 2001 compared to 19 percent in 1990, while assets of the C share class have risen from 1 percent in 1990 to 6 percent in 2001.

New sales by share class reveal a similar picture. A shares have accounted for the majority of new investments in load share classes of long-term funds since 1990, although the percentage of the total has moved downward from 75 percent in 1990 to 67 percent in 2001. B shares similarly account for a smaller percent of new sales in 2001 than in 1990, while C shares have increased.

²⁷ If the B shares in the hypothetical example had converted to A shares after the end of six or seven years, they would have outperformed the A shares with a 5.75 percent front-end load in all years and would have outperformed C Shares beginning in the year of the conversion. In 2002, about 13 percent of all B shares reporting to Morningstar, Inc. converted to A shares before the end of the eighth year.

FIGURE 10

Assets and Sales of Load Share Classes of Long-Term Funds, 1990–2001



Sources: Investment Company Institute; Lipper, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; Wiesenberger Investment Companies Service; ©CRSP University of Chicago, Used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary datasource & ©Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC.

The dominance of A shares is due, in part, to their use in 401(k) plans and mutual fund wrap accounts. Data are not available to separate assets and sales by source, but it is widely acknowledged that rapid growth in 401(k) plan assets and wrap accounts in the 1990s has contributed significantly to A shares maintaining a majority of sales over the past decade.

Other Share Classes

Mutual funds have established other share classes in recent years that have their own distribution and cost arrangements. These share classes are generally targeted to specific investor groups or specific distribution channels.

Institutional Share Class. The institutional share class has no load and low or no 12b-1 fees. Given the structure of distribution fees, this share class is designed to be sold in distribution channels that do not involve the provision of third-party advice or for which the fund provides little or no service to the investor. The institutional share class is most often found in employer-sponsored retirement plans, such as 401(k) plans, and is used as an alternative to A shares in such plans. It is also sold to large institutional investors and high net-worth individuals that can satisfy the high required initial investment.

Adviser Share Class. A more recent development is the adviser share class, which is made available for sales in advice channels served by fee-based, registered investment advisers and not by brokers in securities firms. This share class has no front-end load or CDSL but does carry a small 12b-1 fee that compensates the adviser for service provided to fund shareholders. The adviser, however, typically charges investors an additional asset-based fee, determined by the adviser, for advice and assistance. It is not incorporated into the distribution fee of the adviser share class and thus is not collected by the fund. As noted above, the C share class can serve registered investment advisers in some instances.

Retirement and 529 Plan Classes. Mutual funds also have recently introduced two other types of share classes: the retirement share class and the 529 plan share class. The retirement share class is structured to be sold in 401(k) plans marketed and sold by broker-dealers. This share class serves as an alternative to the use of A shares in these broker-dealer plans. The 529 plan share class is only available to investors who have 529 plans, which are state-sponsored savings accounts that are used to fund future post-secondary education.

TRENDS IN DISTRIBUTION COSTS

Distribution cost represents those charges, if any, incurred by mutual fund buyers either directly through the payment of sales loads or indirectly through 12b-1 fees. Since 1980, these costs have declined significantly for long-term mutual funds. In particular, buyers of equity funds in 1980, on average, incurred a distribution cost amounting to 1.49 percent or 149 basis points of their initial investment (Figure 11).²⁸ By 2001, the distribution cost for equity funds stood at 40 basis points, down 73 percent since 1980. Distribution costs of bond funds likewise moved lower, falling 60 percent from 82 basis points in 1980 to 33 basis points in 2001.

This section describes the technique used to measure distribution cost and then considers reasons for the downward trend. It also discusses the shift that has occurred over the past 20 years in the composition of distribution fees from sales loads to 12b-1 fees.

Measurement of Distribution Cost

In order to measure distribution cost, distribution charges incurred by buyers of funds during a given year must be expressed as a percent of those purchases. The computation is complicated by the different methods an investor can use to pay for distribution and advice services. The 12b-1 fee spreads the payment over the entire holding period, whereas a sales load concentrates payment at a single time in the holding period. The two forms of distribution charges can be made comparable, however, by converting or annuitizing the sales load into an equal series of annual payments.²⁹ This process spreads the load over the entire holding period, allowing the annuitized load to be added to the 12b-1 fee to form an estimate of distribution cost.³⁰

²⁸ Throughout this discussion, equity funds include hybrid funds.

²⁹ This technique is described in John D. Rea and Brian K. Reid, "Trends in the Ownership Cost of Equity Mutual Funds," *Perspective*, Vol. 4, No. 3, November 1998, Investment Company Institute, pp. 5–9 (www.ici.org/pdf/per04-03.pdf).

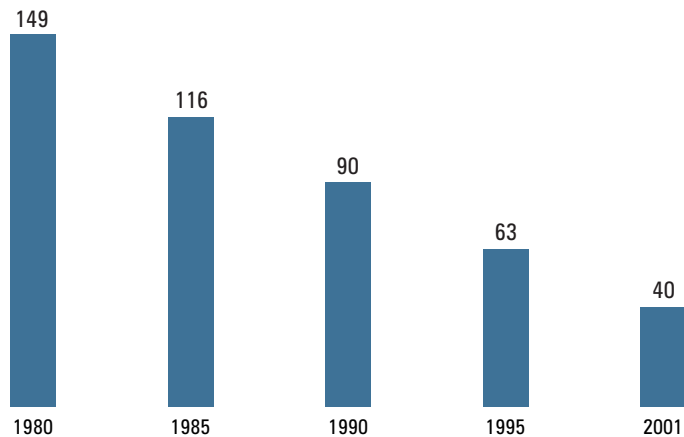
³⁰ A similar technique was first developed and applied by Erik R. Sirri and Peter Tufano in "Competition and Change in the Mutual Fund Industry," *Financial Services: Perspectives and Challenges*, edited by Samuel L. Hayes, III, Harvard Business School Press: Boston, MA, 1993, pp. 199–202.

FIGURE 11

Average Distribution Cost for Equity and Bond Funds,* 1980–2001, Selected Years

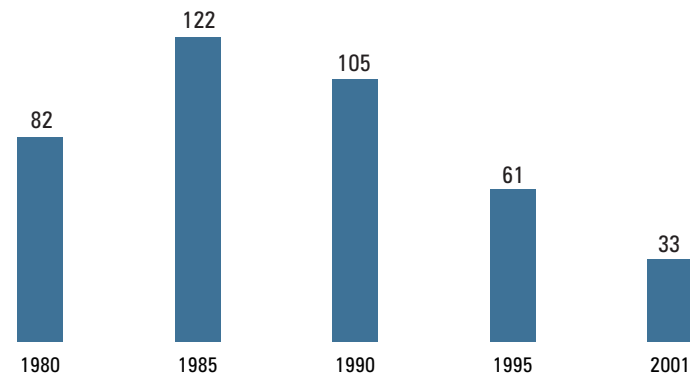
Equity Funds

(basis points)



Bond Funds

(basis points)



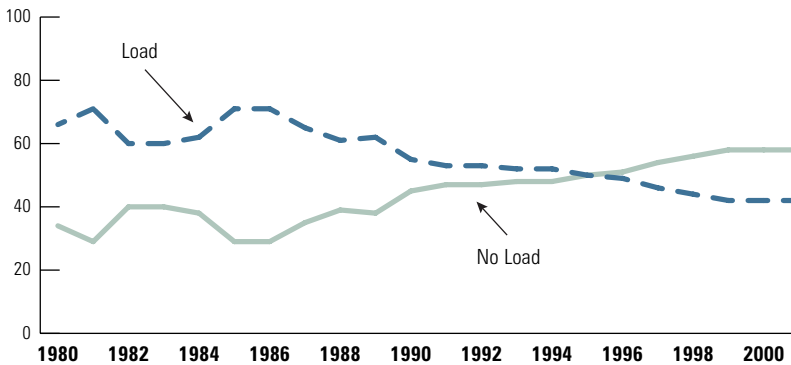
*Sales-weighted average of 12b-1 fee and annuitized load for all fund share classes. Equity funds include hybrid funds.

Sources: Investment Company Institute; Lipper, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberg Investment Companies Service; Wiesenberg Investment Companies Service; ©CRSP University of Chicago, Used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary data source ©Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC.

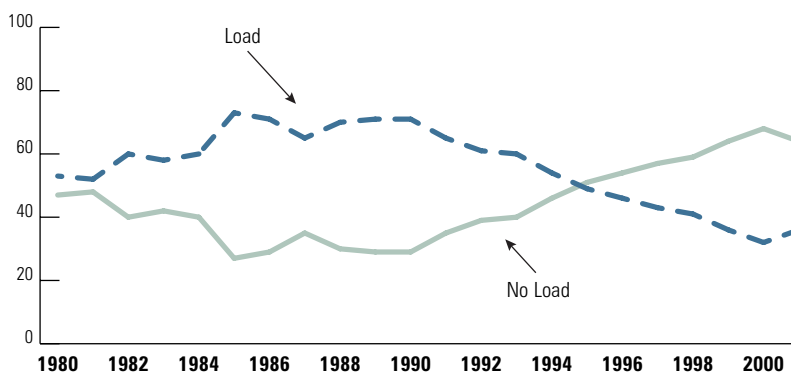
FIGURE 12

Sales of Load and No-Load Share Classes as a Share of Total Equity* and Bond Fund Sales, 1980–2001
(percent)

Equity Funds



Bond Funds



*Equity funds include hybrid funds.
Source: Investment Company Institute.

For a given year, distribution cost is calculated for each share class in the universe of funds. Share classes that have no sales load and no 12b-1 fee have a distribution cost of zero. Share classes with a sales load or a 12b-1 fee have a positive distribution cost. By construction, distribution cost for such a share class is the average cost incurred by those investors who actually bought shares in that class in that year.

For an industry wide cost measure, the distribution cost can be averaged across share classes in each year.³¹ In the analysis that follows, aggregates are formed for equity and bond funds and for certain subgroups of each of these categories. Because distribution cost, by

design, measures the actual cost incurred by buyers of mutual funds in a given year, a sales-weighted average is the appropriate averaging technique. With a sales-weighted average, the distribution costs of those share classes with large sales receive more weight than those classes with small sales. Using equal weights would distort the aggregate measure of distribution cost because share classes with small or possibly no sales would be treated as being the equal of those classes for which distribution costs are actually being incurred.

Source of the Decline in Distribution Cost

The substantial decline in the distribution cost of equity and bond funds between 1980 and 2001 is the result of several developments. For both bond and equity funds, about one-third of the decrease resulted from a relative shift in new sales from share classes with loads to those with no load.³² A no-load share class, including single-share class funds, is one that has no sales load and a 12b-1 fee of no more than 25 basis points; all other share classes have a load.³³ Between 1980 and 2001, the percent of equity fund sales due to no-load share classes rose from 34 to 58 percent, while the share of no-load sales of bond funds increased from 47 percent to 64 percent (Figure 12). Because no-load share classes have lower distribution costs than load share classes, a rising percent of sales in no-load share classes causes the sales-weighted average cost to decline. The decline in distribution cost partly reflects investor behavior, as investors sought lower cost funds. Growth in sales of no-load share classes through 401(k) plans and independent financial advisers also helped to push distribution costs lower.

³¹ See Rea and Reid (November 1998, pp. 8–9) for a description of the data.

³²The change in industry average distribution charge was calculated for each year and parsed out between changes attributable to the change in load fund distribution costs, change in no-load distribution costs, and the change attributable to fluctuations in the no-load share of sales. The changes were summed across the 1980–2001 period.

³³These definitions correspond to those that NASD Rule 2830 currently requires funds to use.

The remaining two-thirds of the decrease in overall distribution costs for equity and bond funds between 1980 and 2001 can be attributed to a decline in distribution costs for load share classes. The distribution cost in equity fund share classes with loads fell from 227 basis points in 1980 to 90 basis points in 2001, a 60 percent decline (Figure 13). The average distribution charge for bond fund share classes with loads declined from 155 basis points in 1980 to 88 basis points in 2001, a 43 percent decline.

The decline in the average distribution charges of funds with load share classes reflects several factors. First, sponsors of funds with load share classes responded to competition from no-load funds through reductions in maximum front-end loads, and most of the reductions occurred in the 1980s. The average maximum front-end load was 7.4 percent in 1980, and 60 percent of funds carried a maximum of 8.0 percent or more (Figure 14). By 2001, the average maximum front-end load had declined to 4.9 percent, with about half of the share classes with a front-end load charging less than 5 percent.

The reduction in maximum front-end loads also shifted downward the schedule of quantity discounts. As the schedule of discounts moved lower, funds generally did not change the break-points at which lower sales loads were effective. As inflation pushed incomes higher and rising stock prices raised asset values, small investors and middle-income households were increasingly able to qualify for load reductions.³⁴ In addition, most fund companies reduced their minimum front-end loads to zero for large purchases, compared with 1 percent before 1980.

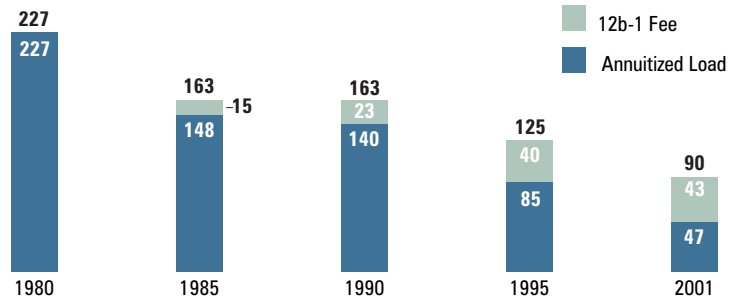
Finally, the growing share of purchases made through employer-sponsored retirement plans in which front-end loads were reduced or waived contributed to the decline in the distribution cost of load share classes. A larger percentage of

FIGURE 13

Average Distribution Cost for Equity and Bond Fund Load Share Classes,* 1980–2001, Selected Years

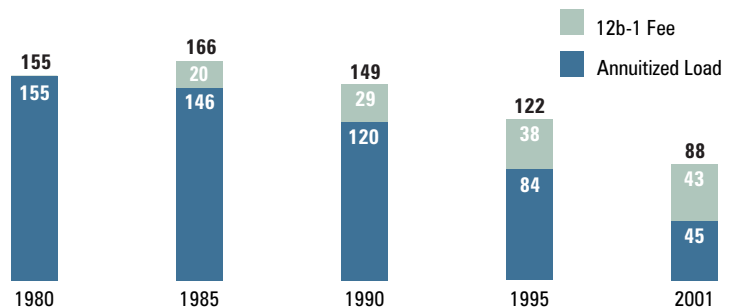
Equity Fund Load Share Classes

(basis points)



Bond Fund Load Share Classes

(basis points)

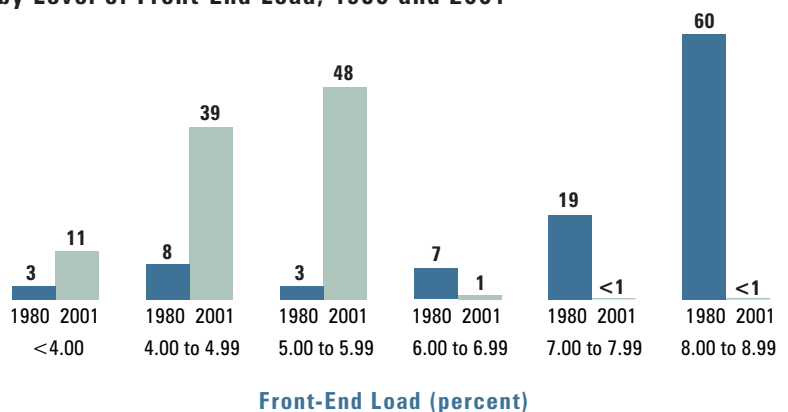


*Sales-weighted average of 12b-1 fee and annuitized load for all load share classes. Equity funds include hybrid funds.

Sources: Investment Company Institute; Lipper, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberg Investment Companies Service; Wiesenberg Investment Companies Service; ©CRSP University of Chicago, Used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary data-source © Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC.

FIGURE 14

Percentage of Long-Term Front-End Load Share Classes by Level of Front-End Load, 1980 and 2001



Source: Investment Company Institute.

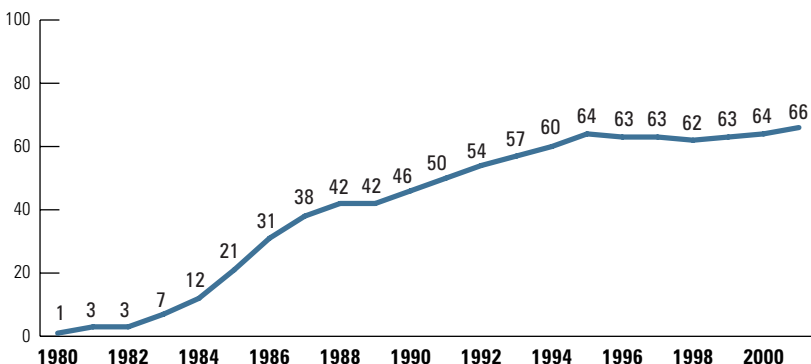
³⁴ For example, the distribution cost for a \$10,000 purchase that was held for five years would have been 221 basis points given the typical schedule of loads in 1980. In 2001, inflation would have placed the equivalent purchase at \$21,500 and the investor would have paid an annualized cost of 150 basis points on the purchase.

FIGURE 15

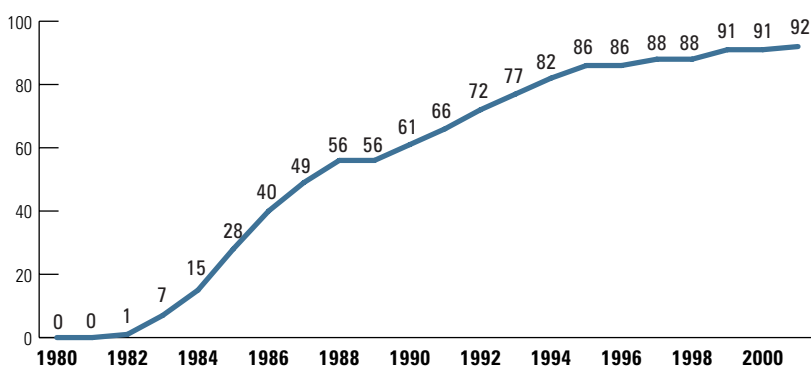
Long-Term Share Classes with a 12b-1 Fee, 1980–2001

(percent of total)

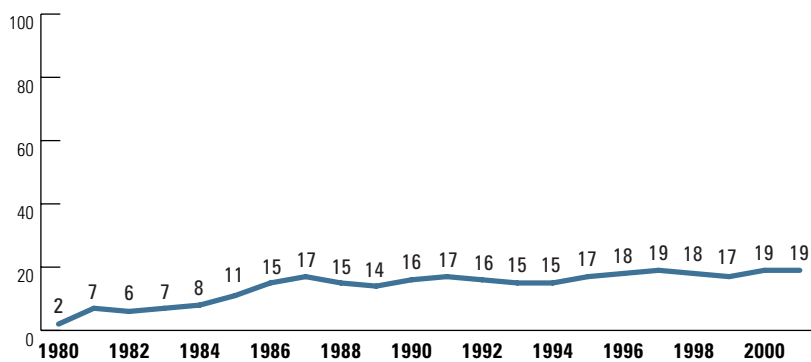
All Share Classes



Load Share Classes*



No-Load Share Classes*



*No-load share classes have no front-end load or CDSL and a 12b-1 fee of 25 basis points or less in the year plotted. Load share classes are all others.

Sources: Investment Company Institute; Lipper, Inc.; Value Line Publishing, Inc.; CDA/Wiesenberg Investment Companies Service; Wiesenberg Investment Companies Service; ©CRSP University of Chicago, Used with permission, all rights reserved (773.702.7467/www.crsp.com); Primary data-source © Standard & Poor's Micropal, Inc. 1998 (617.451.1585/www.micropal.com); and Strategic Insight Mutual Fund Research and Consulting, LLC.

front-end load share class purchases also occurred with the load waived through fee-based advisers, which are paid directly by investors rather than through the fund.

Substitution of 12b-1 Fees for Sales Loads

Not only did the level of distribution cost in load share classes decline between 1980 and 2001, but also the composition of the cost changed over this period. Before Rule 12b-1 was adopted in 1980, all distribution costs were front-end sales loads. After the rule was approved, funds initially were slow to set up 12b-1 plans and by 1984 only 12 percent of long-term funds had a 12b-1 fee (Figure 15).³⁵ Most of the early adopters were no-load funds. But in the mid-1980s, load funds began to use asset-based distribution fees along with sales loads. Thereafter, use of 12b-1 fees among load share classes spread rapidly, reaching 61 percent in 1990 and 92 percent in 2001. In contrast, the percentage of no-load share classes with 12b-1 plans has remained relatively steady since the mid-1980s, ranging between 14 and 19 percent.

Funds with front-end loads that adopted 12b-1 fees in the mid-1980s often reduced front-end sales charges so that by 1986 the average maximum load for funds charging a 12b-1 fee was 6.2 percent, compared with 7.5 percent for funds without a 12b-1 fee (Figure 16). Front-end loads continued to decline in the 1980s for funds with and without 12b-1 fees, reaching their present-day levels by the end of the 1980s.

As funds adopted 12b-1 plans, however, asset-based distribution fees gained in significance and accounted for 48 percent of the distribution cost of equity fund load share classes and 49 percent of that for bond fund load share classes by 2001. In effect, load share classes have used asset-based fees as a substitute for sales loads over the past two decades.

³⁵ Reference is to funds with plans for which 12b-1 fees were paid. Some funds adopted defensive plans that did not pay fees. Rule 12b-1 contains a provision that some funds interpreted as meaning that payment by the fund adviser out of its own revenues for distribution might indirectly be in violation of the rule unless a 12b-1 plan were in place. The so-called defensive plans thus were to avoid any unintentional rule violation.

Use of 12b-1 Fees

Although 12b-1 fees can be used to pay for any distribution expense, in practice they are largely used to compensate sales professionals for investment advice and ongoing service to fund shareholders. A survey of fund companies in 1999 found that 63 percent of the revenue from 12b-1 fees was used to compensate broker-dealers and other sales professionals (Figure 17).³⁶ This compensation includes payments made to broker-dealers for the sale of fund shares, reimbursements to the fund distributor for financing charges arising from advances to broker-dealers for the sale of fund shares, and compensation of in-house personnel. An additional 32 percent of the 12b-1 fees was paid for administrative services, including compensation to third parties for recordkeeping and other services provided to fund shareholders. Only about 5 percent of 12b-1 fees was used for advertising and other sales-promotion activities, including expenses for printing and mailing prospectuses and sales materials to prospective investors.

CONCLUSION

The changes in the distribution of mutual funds during the past two decades have allowed investors to choose from a wider range of services and has provided greater access to mutual funds than was available in 1980. Companies sponsoring mutual funds are able to tailor funds and share classes to provide packages of services and means of paying for those services that better meet investor needs. The wider availability of mutual funds through new distribution channels, investors' increased reliance on no-load mutual fund share classes, and competition between load and no-load fund sponsors has sharply reduced the distribution costs paid by mutual fund shareholders.

FIGURE 16

Average Maximum Load for Equity Front-End Load Share Classes With and Without 12b-1 Fees, 1980–2001

(percent)

Year	Share Classes Not Charging 12b-1 Fee	Share Classes Charging 12b-1 Fee	Number of Share Classes with 12b-1 Fee
1980	8.0	N/A	0
1981	8.0	N/A	0
1982	7.9	8.5	2
1983	7.9	6.8	12
1984	7.8	6.7	21
1985	7.8	6.5	40
1986	7.5	6.2	85
1987	7.2	5.7	130
1988	6.8	5.3	190
1989	6.2	5.0	228
1990	5.8	5.1	312
1991	5.7	5.1	376
1992	5.2	5.1	490
1993	5.1	5.0	602
1994	5.1	5.0	749
1995	5.0	4.9	911
1996	5.0	4.9	940
1997	5.2	5.0	986
1998	5.1	5.0	1,181
1999	5.2	5.1	1,386
2000	5.3	5.2	1,534
2001	5.4	5.2	1,687

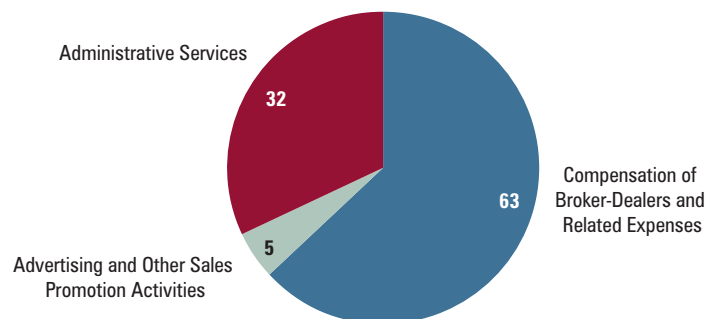
Note: Front-end load share classes are defined as having a front-end load greater than 3 percent.

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FIGURE 17

Use of 12b-1 Fees, 1999

(percent of total 12b-1 fees)



Source: ICI survey of 95 mutual fund complexes having at least one fund with a 12b-1 plan.

³⁶“Use of Rule 12b-1 Fees by Mutual Funds in 1999,” *Fundamentals*, Vol. 9, No. 1, April 2000, Investment Company Institute (www.ici.org/pdf/fm-v9n1.pdf). The survey included 95 mutual fund organizations having at least one fund with a 12b-1 plan. Survey respondents accounted for 52 percent of the share classes and 69 percent of the assets of all share classes with 12b-1 plans.

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