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Beat Deferred Sales Charges

The decision of whether a mutual fund is the most suitable investment vehicle for an investor is a matter of investment needs and objectives, personal preferences, availability of alternatives and practical considerations. For those who have decided, for whatever reason, to scale back their mutual fund holdings, this will outline the cost structures.

There are three basic commission structures under which mutual funds are sold: no-load, front-load and deferred sales charge. Under a no-load scheme, investors pay no commissions when they buy or sell the fund. There may, however, be a redemption fee if the fund is sold shortly after purchase and there may be a transaction charge if bought through a broker rather than directly from the fund company. On a front-end load fund, the investor pays a commission (typically up to 5%) when the fund is bought, but may sell it at any time with no penalty. In either of these first two cases the investor can sell their mutual funds without significant costs.

Most mutual funds, however, are bought on a deferred sales charge (DSC) basis. This means that an investor does not pay their advisor a commission when they purchase the fund. Instead the fund company pays the broker a commission, typically between 0% and 5%, for selling the fund to their client. Because the fund company has essentially paid the commission on behalf of the investor, the investor is charged a fee, the deferred sales charge, if they sell the mutual fund within a certain time period, typically six years. The amount of deferred sales charge usually decreases each year the investor holds the fund. For example, one fund company's deferred sales charge schedule is 6.0% (year one), 5.5% (year two), 5.0% (year three), 4.5% (year four), 3.0% (year five), 1.5% (year six) and zero after six years.

Many investors are shocked to learn when they want to sell their units that they have entered into a contract with this sort of pricing scheme. Here are some tips and strategies that can help to reduce the impact of a deferred sales charge.

TIP 1:
Know the anniversary date of each fund purchased. With this information it is easy to look up the rate on the deferred sales charge schedule and calculate the cost of selling the fund or the benefits of holding on until after the next anniversary date.

TIP 2:
Most fund companies allow redemption of some units, typically 10%, each calendar year at no cost. The way in which the 10% is calculated varies so it's best to ask the fund company for this information.

As an aside, some unscrupulous financial advisors take advantage of the free unit redemption feature. These advisors sell the free units on behalf of their clients and then reinvest the proceeds in another deferred sales charge fund, generating an upfront sales commission for themselves in the process. The motivation for the switch is not to rebalance funds in the interests of the investor, but to increase the advisor's income.

TIP 3:
If an investor wants to sell all units of a fund and take advantage of any free units (Tip 2), it is usually necessary to first place an order to sell the free units and then place a second order for the balance of the units. Most fund companies will apply the deferred sales charge on redemption without giving credit for any free units that may be available.

TIP 4:
Swap mutual fund units that are held in a registered plan with cash held in a non-registered plan and then sell the units in the non-registered account. Assuming there is no change in market value between the transfer price and the actual selling price, the deferred sales charge will reduce the proceeds thus generating a capital loss that can be used to offset capital gains. As there may be a nominal administrative cost for doing an asset swap, the potential tax savings must be greater than any costs incurred to implement the strategy.

This strategy makes the most sense for large fund holdings where the deferred sales charge is high. For example, assume a $100,000 fund holding in an RRSP that is at 5% on the DSC schedule. Using this swap strategy, the net proceeds in the non-registered account is $95,000 but the cost for tax purposes is $100,000. The sale would trigger a capital loss of $5,000 that could be applied against capital gains from other investments. Assuming a 40% tax rate and with 50% of capital gains taxed, the $5,000 capital loss could result in tax savings of $1,000.

TIP 5:
Most mutual fund companies will allow an investor to switch, at no penalty, to other funds managed by the company. The deferred sales charge schedule does not get reset. This strategy can be useful for changing the asset allocation of a portfolio, such as for moving funds that are in equities into bonds.

Keep in mind when implementing any strategy that there can be income tax consequences, such as triggering capital gains. Talk to your accountant and advisor or mutual fund company to make an informed decision.