Are Direct-Sold Funds a Better Value?

By Editor Test *Wed, Jan 12, 2011*

New research argues that broker-sold mutual funds—both active and passive—tend to generate lower returns at higher costs than direct-sold mutual funds.

In a provocative new research paper, three writers, including one from the Federal Reserve Bank of Atlanta, suggest that broker-sold mutual funds tend to generate returns that are about one percentage point lower *before fees* than returns generated by less expensive direct-marketed mutual funds.

Jonathan Reuter of Boston College, Diane Del Guercio of the University of Oregon and Paula Tkac of the Atlanta Fed argue that "mutual funds in broker-sold channels charge higher total fees because they need to compensate brokers for servicing investors, and earn lower before-fee returns, because they invest less in portfolio management."

In short, they claim there's a "tradeoff between investments in brokers and investments in portfolio management." The study, published by the National Bureau of Economic Research and entitled "Broker Incentives and Mutual Fund Market Segmentation," is based on mutual fund distribution data from 1996 through 2002.

The result, they say, is that direct-sold funds not only tend to be cheaper but also better-performing than broker-sold funds, leading to a significant difference in after-fee returns for investors. "This is an unintended consequence for people seeking advice," Reuter said.

On an after-fee, risk-adjusted basis, broker-sold funds "underperform by about 2.5 percentage points," Reuter told *RIJ*, citing a newer, unpublished working paper. "You're underperforming by more than the fees. That's the distressing thing."

The paper also claims that some fund companies may appear to invest more in portfolio management than they actually do. "Consistent with the concern that management fees overstate investments in portfolio management, we find that the median management fee is 80 basis points, while the median subadvisory fee is only 40 basis points," the authors said.

From a fund marketing standpoint, this makes sense, Reuter explained. Direct-sold companies cater to the informed, performance-driven, do-it-yourself investor, so they hire the best money managers. Broker-sold companies, in contrast, invest in the intermediary services that less self-reliant investors need or demand.

"Vanguard and Fidelity invest in better managers, they're more likely to hire managers that went to more selective schools, and they get higher risk-adjusted returns," Reuter said in an interview.

The study also found that very few mutual funds are sold both direct and through intermediaries—for the logical reason that people might not buy through a broker if they could get the exact same fund for less by buying direct. "Only 3.3% of [fund] families serve both market segments," the paper said. Because of this, brokers have no incentive to recommend index funds, since those funds can easily be purchased direct for less.

Direct-sold companies seem to be as good at active management as they are at indexing. “In the direct channel, the active funds and the index funds have about the same risk-adjusted performance after fees. When you compare across channels, in the broker channel, both the index and the active performance is really bad. That surprised the heck out of me,” Reuter said.

“Because actively managed funds in the *direct* channel have the strongest incentive to invest in portfolio management, a more powerful test of the puzzle of active management is whether index funds in the *direct* channel outperform actively managed funds, also in the *direct* channel,” the paper said.

“Within the distribution channel with the strongest incentive to invest in portfolio management, we find no evidence that index funds out- perform actively managed funds during our sample period. In contrast, when we focus on the sample of actively managed and index funds outside the *direct* channel, we find that index funds outperform actively managed funds by as much as 8.9 basis points” per month, the researchers wrote.

Even though their costs are high, brokers might be performing a social good by guiding certain investors into mutual funds and away from keeping their money in unproductive cash accounts, Reuter said. “Maybe it’s cheaper from a societal perspective,” he said.