Discrimination, Or Keeping It Simple?
By Thomas M. Kostigen

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Schwab boots funds that have cheaper share classes elsewhere.

Pick a fund, any fund, at Charles Schwab and you won't find a cheaper share class anywhere else. If you do, Schwab won't match the price, like a car dealer or a mattress store would with their competitors. Instead, it will boot the fund out of the Schwab system, making it unavailable for new purchases.

This acknowledged Schwab practice is aimed at keeping things simple for investors, the company says. "We have an ongoing practice to offer one class of shares to all investors at Schwab," says Doug Hanson, vice president of asset management and strategic alliances for the firm. "We want it to be simple, and we don't want to compromise."

Morningstar, for one, isn't buying the KISS (keep it simple stupid) defense. "I think it is arguably a mechanism that keeps fund fees higher than they should be," says Christine Benz, director of mutual fund analysis at Morningstar.

Hanson acknowledges that he sees how the policy could be misconstrued, but insists that Morningstar and others who take issue with it aren't seeing the bigger picture of serving all Schwab clients, whether investor or advisor, the same.

When asked about it, however, advisors step right up and complain. "For the last four years I have noticed more of my favorite funds disappearing from Schwab, or having exorbitant charges assessed to buy a fund through Schwab. I have had to pull more and more funds out of Schwab and send it direct to the fund company to get the best pricing. I feel Schwab is trying to manipulate clients to buy in-house funds," says Don Martin, a certified financial planner at Mayflower Capital in Los Altos, Calif.

Hanson denies that charge too, and says he couldn't point to or think of any fund that has been dropped from its offering menu because of share class controversy. The use of multiple share classes has been the subject of an ongoing investigation by the National Association of Securities Dealers, because of concerns that investors may have purchased Class B mutual fund shares when it would have been more cost-effective for them to purchase shares of a different class.

"Before purchasing Class B mutual fund shares, you should determine whether this investment is in your interest, and not just in the interest of your broker or advisor who may receive higher commissions from the sale of Class B shares than other classes of fund shares," says an NASD alert. "Class B shares do not impose a front-end sales charge, but they may charge higher expenses that investors are assessed over the lifetime of their investment in a fund, as compared to Class A shares. Class B shares also normally impose a contingent deferred sales charge (CDSC), which you pay if you sell your shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares."

It was this last point that tripped up Merrill Lynch, Wells Fargo and Linsco/Private Ledger, to name just a few brokerages. Last December the NASD announced fines against them totaling $19.4 million for "improper sales of Class B and C mutual fund shares."

Hanson says this isn't the case with Schwab at all. He says the firm, which in June said it was cutting prices for equity, option, mutual fund and bond transactions and eliminating service fees, such as charges for ATM withdrawals, various checking services and electronic bill payments, effective July 1, is merely trying to do the right thing for clients, whether advisors or individuals, by creating a level playing field for fees. "We don't want to disadvantage our customers," he says.

But Benz says this is exactly what Schwab's policy does. She says smaller mutual funds are afraid they will get shut out of the Schwab program and lose assets, so they keep a higher-priced share class on the books even though they could offer direct investors a lower price. Moreover, some fund companies complain that the cost of participating in Schwab OneSource, typically 40 basis points per year, can consume more than 50% of a bond fund's revenues.

Small fund groups also are convinced their largest competitors can wield their clout with Schwab and negotiate deals well below the annual 40 basis points charge. "You know Pimco isn't paying Schwab 40 basis points on its bond funds," says the marketing chief at one small fund boutique.

Davis Selected Funds, the highly regarded Tucson, Ariz.-based fund family, is the only firm she knows of that is allowed to offer two share classes in the Schwab system. Hanson explained that Davis is allowed two share-class offerings because its Selected or "S" class has been in the Schwab program for a long time and it "has a fantastic record." Still, he says, the new "D" class, offered as a no-load with no 12b-1 fees, is the only share class available to new investors. Existing "S" class investors can accumulate more shares through Schwab, however.

Davis is a big, widely respected firm, Benz notes. A smaller firm may not garner the attention or the accommodation that big "product" firms get. Indeed, in other circumstances, large mutual fund complexes pay big dollars to get wider exposure, gain more assets and rake in fees.

"I don't think this is just a Schwab issue but is a problem with many B-Ds. One of the reasons I left my former firm was due to this issue. My former B-D would not allow certain share classes in their selling agreements because they said they felt there were potential regulatory problems. Speaking with some of my friends on the inside, I found out anonymously that there was no 'sponsorship' provided by these distributors and therefore selling the cheaper share class cut their profits," says Allen Bronton, at Wealth Preservers LLC in Crystal Lake, Ill.

Meanwhile, Schwab execs hold a steady line. "We work with funds to determine if the share class available is right for our investors," Hanson says. Another Schwab spokesman says there is no discrimination among its vendors.

Schwab says this is how the fund universe is winnowed: 6,000 are made available through Schwab, but only 2,500 are available through OneSource, its "no transaction fee" program. Another 1,500 or so are available for $49.95 per trade.

"Schwab's Mutual Fund OneSource service gives you access to a wide selection of funds from America's most prominent fund companies, all available without transaction fees," firm literature says. "Transaction fees may apply to certain no-load and low-load funds which do not participate in our Mutual Fund OneSource service. Such funds are subject to Schwab's standard transaction fees in addition to any redemption fees imposed by the fund."

In certain circumstances, Schwab notes, transaction fees are waived for certain high-load funds. It doesn't explain why. However, it goes on to say, "Schwab receives remuneration from participating fund companies."

Advisors access Schwab's menu of mutual funds through its institutional division. The division has grown, over almost two decades, to service more than 5,000 registered investment advisors representing almost a half trillion dollars in assets. Many, if not most, of those assets under management are in mutual funds.

The Investment Company Institute, the mutual fund trade association in Washington, D.C., reports in its 2006 ICI Fact Book that "more than half of all mutual funds offer two or more share classes." That puts a big dent in Schwab's offering capability, given its "one share class" mandate.

Some advisors aren't bothered by this. "We utilize Schwab Institutional and we seldom come across funds we would like to access but that are not available," says Shannon A. King at SilverOak Wealth Management LLC in Minneapolis.

Others are. "I discovered years ago, in my year on Schwab's inaugural advisory board, that the company is a one-way, heavy-handed bully and not to be trusted. I subsequently transferred every dime of AUM to Fidelity and Waterhouse," says Gene Balliett at Balliett Financial Services Inc. in Winter Park, Fla.

Fidelity, Schwab's biggest competitor, offers multiple share classes for mutual funds, and it has its own famous brand of mutual funds.

TD Ameritrade, yet another Schwab competitor, also offers multiple share classes for the same funds.

To be sure, offering multiple share classes poses its own problems. As the NASD found in its investigation of the issue, some mutual fund investors weren't aware that shares could be purchased more cheaply via other distribution routes, such as buying directly from the company, while others were left in the dark about breakpoints afforded to certain institutional share classes if they made larger investments.

Mutual fund expenses have been on the decline, according to the ICI, falling in 2005 to their lowest levels in more than 25 years. The decline is being driven primarily by continued investor migration to lower-cost funds and by cuts in expense ratios by funds, ICI research shows. It says wider availability of lower-cost funds is "slightly more important" in driving this trend. What the ICI fails to mention is that much of the reduction in expenses was driven by the mutual fund scandal after which many fund complexes agreed to lower fees as part of their settlements with regulators.

Other factor come into play as well. "As a rule, asset growth tends to reduce the advisory fees of a given mutual fund, whether that fund is a stock, bond or money market fund. Some mutual funds have 'breakpoints' in their advisory contracts that automatically lower their advisory fees as fund assets grow. Even if a fund's advisory contract does not have breakpoints, the fund's advisor (in conjunction with the fund's board) may cut a fund's advisory fee as its assets grow. Moreover, regardless of asset growth, advisors may cut their fees for competitive reasons or may institute fee waivers, both of which lower a fund's expense ratio. All of these factors helped to lower the expense ratios of stock funds in 2005," ICI reports

The Schwab philosophy helps keep things clean and avoids investor/advisor ignorance and/or ineptitude with regard to purchasing the proper share class. But at the same time, Schwab may be keeping mutual funds from lowering their shareholder fees to attract more assets: Why give up a sure thing and a gorilla distributor to—maybe—find assets somewhere else?

The ICI notes funds "that sell through financial advisors offer more than one share class to provide investors with several ways to pay for the services of financial advisors." In Schwab's world there is only one way; it's their way.

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