

Avoiding Redemption Fees in 401(k) Plans

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Watch out: More funds are introducing them

To combat the mutual fund timing problem, the Securities and Exchange Commission (SEC) has proposed that mutual fund companies assess shareholders a short term redemption fee. In other words, if a shareholder buys and then sells shares within a fund in a short period of time, the SEC is strongly encouraging the fund company to assess the shareholder a "redemption fee." At this time, the fee is voluntary and varies by fund company.

The redemption fee does not go back to the fund company, but rather goes to the fund itself. Short-term redemption fees are designed to reimburse the fund for the direct and indirect costs that the fund pays to redeem short-term investors' shares, as well as discourage market timing practices. In the past the cost of accommodating frequent traders was borne by the fund's long-term investors.

"Fund companies love charging redemption fees because it helps fund returns. This is especially true when redemption fees exceed the actual cost of short-term investing in the fund."¹ Since performance figures drive the marketability of a fund, redemption fees can only add to those quoted returns.

Clearly, the SEC's intent is to protect the interests of each investor in the mutual fund. However, by not standardizing the process with its own formula, the SEC is further complicating the matter by directing each mutual fund company to determine how the fee is calculated and what is considered "short term."



The Root Cause of the Problem

The root cause of the mutual fund timing problem is two-fold: (i) mutual fund prices (NAVs) are predictable and (ii) in the absence of transaction costs that predictability is exploitable.²

Fund price predictability is well documented, dating back to Cowles and Jones (1937)³ statistical ratio. The Cowles-Jones Ratio proposed a statistic for testing market efficiency based on the frequencies of up movements relative to down movements. Other researchers have also identified several patterns of predictability: a weekend effect, a January effect, and a post-earnings announcement drift.

Mutual fund prices are predictable because (i) the prices of the underlying securities in the fund's portfolio are predictable and (ii) mutual funds often use "stale prices" of securities that have not recently traded to compute the NAV. This situation is ripe for the arbitrageurs who exploit this predictability.

Mutual Fund Pricing (NAV)

Mutual fund shares are a compilation of a portfolio of assets which in turn makes trades in the mutual fund shares indirect trades in the underlying assets. To arrive at a fund's net asset value (NAV), fund companies base the value of the shares in the fund on the closing price (last trading price) of the underlying securities in the fund.

However, the value of the fund shares may not reflect an accurate price for the underlying securities. For example, fund investors can feasibly make their trading decision as late as

3:55 PM. By this time, many of the underlying assets held by the fund have long-since experienced their last transaction of the day making the mutual fund's price stale since the underlying securities' closing prices may not fully reflect the day's market news.⁴

The Exploitation of Mutual Funds

You may wonder why mutual funds can be exploited and individual securities generally are not exploited. The answer is simple.

The profit opportunities that arise from predictable NAVs are often greater than mutual funds' transaction fees. By comparison, transaction costs for individual securities more than offset the potential profits from trading strategies devised to capture the predictability. In an attempt to engineer a level playing field, the SEC is encouraging fund companies to impose redemption fees on short-term trades, which are sufficiently large enough to offset potential gains from market timing the funds.

Undermining the Benefits of Mutual Funds

Redemption fees add costs and restrict liquidity. Within retirement plans, these disadvantages greatly undermine the benefits of investing in mutual funds.

Given the fact that plan participants are constantly making contributions to their retirement accounts through payroll contributions, which in turn are used to purchase additional fund shares, redemption fees represent a harsh assessment for these participants. As plan participants adopt investment strategies practiced by institutional investors; that is, investing their contributions by allocating their money among the asset classes according to an asset allocation model (often referred to as a managed account), redemption fees impose a harsh penalty on the participants when it is necessary for them to rebalance their portfolios.

Quarterly Rebalancing

A managed account necessitates that the account be rebalanced at least quarterly in order to maintain the portfolio in-alignment with its target composition; i.e., asset allocation model. In other words, a participant may need to sell enough of an overweighed asset and

reinvest the money in the remaining assets to return the portfolio to its target composition.

Since plan participants are constantly investing money in their retirement accounts, no matter when a participant initiates a rebalancing the participant will evidently be hit with some redemption fees. Furthermore, since rebalancing is fundamental to the entire process of managed accounts, most service providers who offer asset allocation models are rebalancing participants' accounts automatically on a quarterly basis.

Fair Value Pricing

Of course, other options have been considered and debated at length regarding the appropriate solution to the mutual fund timing problem. Some proponents argue that fair value pricing would fix the problem while others advocate next-day fund pricing.

The objective of fair value pricing, as defined by the SEC, is to adjust the prices of the fund's underlying securities for staleness. In a letter from the SEC to the Investment Counsel Institute (ICI), the SEC states, "Ascertaining fair value requires a determination of the amount that an arms-length buyer, under the circumstances, would currently pay for the security. Fair value cannot be based on what a buyer might pay at some later time."

In principle, fair value pricing would eliminate fund timers' profits without imposing substantial costs on fund investors. Despite its attractiveness, fair value pricing involves numerous complexities, which most researches agree will introduce its own artificial source of predictability in NAV.

Without a perfect methodology for fair value pricing, there will be times when pricing vendors will be forced to adjust too little and times when the vendors will adjust too much. "To the extent that some arbitrageurs know more about the true relation between available information and fair value than the pricing vendor, they will exploit it."⁵

Next-day Fund Pricing

Another option is to apply next-day pricing to mutual funds. Proponents of next-day pricing explain that this option effectively removes the predictability in mutual fund NAV by placing a

one-day gap between the time an investor decides to make a transaction and the time at which the transaction is “priced.” Next-day pricing completely eliminates the usefulness of an individual’s ability to predict next-day prices.

The virtues of this approach are its simplicity and explicit low cost to investors. However, the magnitude of the cost to implement this strategy have not been explored and it clearly undermines the promise of liquidity which investors have come to expect from mutual funds.

Given all the solutions, the SEC obviously seeks to correct the imbalance by its encouragement of redemption fees. However, participants in 401(k) plans may feel that this solution is wholly unfair.

Redemption Fees and 401(k) Plans

Redemption fees can only discourage plan participants who adopt a managed account approach to investing. As mentioned previously, this strategy of investing involves a periodic rebalancing of the portfolio when the allocation model becomes unbalanced.

A portfolio can become “unbalanced” when assets in the portfolio perform extraordinarily well, or conversely, perform poorly. This throws the portfolio out-of-balance since the weighting in the various asset classes is not in alignment with the allocation model. To return the portfolio to its target composition, the participant must sell enough of the over-weighted assets and buy enough of the under-weighted assets to bring the portfolio back in alignment with the criteria for division among the asset classes for the model.

Prudently, a participant should rebalance his or her portfolio at least quarterly. For participants invested in mutual funds, the impact of redemption fees during this rebalancing process has not been given any obvious consideration.

Exchange-traded Funds

Since it’s indisputably that redemption fees are becoming entrenched within mutual funds at an accelerated pace, an obvious solution to avoiding redemption fees altogether is to invest in exchange-traded funds (ETFs) which trade like stocks and are completely free of redemption fees.

Maybe its time for plan sponsors to give more consideration to changing the investment options in their retirement plans to ETFs. As an instrument that could change the scope of investing in 401(k) plans, it is inevitable that more and more money will pour into ETFs.⁶ ©

¹ *Mutual Funds Hike Short-Term Redemption Fees*, by Jonas Max Ferris, February 16, 2004

² *On Solutions to the Mutual Fund Timing Problems*, by Gregory Bryant Kadlec, Pamplin College of Business, Professor of Finance Virginia Polytechnic Institute, August 30, 2004

³ *A Quantile Approach to Evaluating Directional Predictability*, O. Linton, Department of Economics, London School of Economics, U.K. and Yoon-Jae Whang, Department of Economics, Korea University, Seoul, Korea, November 2004.

⁴ *Predictable changes in NAV: The wildcard option in transacting mutual-fund shares*, John M.R. Chalmers, Lundquist College of Business, Roger M. Edelen, The Wharton School University of Pennsylvania, and Gregory B. Kadlec, Pamplin College of Business Virginia Tech, February 2000

⁵ *On Solutions to the Mutual Fund Timing Problems*, by Gregory Bryant Kadlec, Pamplin College of Business, Professor of Finance Virginia Polytechnic Institute, August 30, 2004

⁶ *ETFs Advance in Banks' Thinking as 401(k) Option*, by Jenna Gottlieb, American Banker, January 2005

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