Commission can motivate how advisers pick

Columnist prefers noncommissioned reps because they're less likely to encounter conflicts of interest

HUMBERTO
CRUZ

Q: *I want your opinion on sales charges for IRAs. I hear that one should not pay a high sales charge, but that's like telling someone not to drink too much water. How much is too much? I recently took out a Roth IRA for my wife and the sales charge was 5.75 percent. Seemed kind of steep, but is that the going rate?*

A: First off, the 5.75 percent sales charge was not for setting up an IRA but for investing in a particular mutual fund. You would have been charged the same for a non-IRA account with the same fund, which is considered a "load fund" because it charges a commission or "load."

With a 5.75 percent sales charge, assuming that the investment is for $4,000, you pay a load of $230 (5.75 percent of $4,000) and only $3,770 goes into your account. The mathematically inclined will notice that a 5.75 sales charge is the equivalent of a 6.1 percent commission on the amount invested ($230 is 6.1 percent of $3,770). Your investment must now go up 6.1 percent, not 5.75 percent, for you to be back even.

Is this charge excessive? It depends on a number of factors.

Did you, for example, receive personalized advice and guidance from the broker or financial adviser who recommended this fund to you? Is this fund appropriate for your goals? Does it have a solid long-term record? And now that you've paid the load, will the fund charge reasonable management fees and other annual expenses going forward? Over the long haul, a fund with high annual expenses, even one that charges no upfront commission or load, can be more expensive than a load fund.

On the other hand, the 5.75 percent sales charge you paid does nothing to enhance the fund's return. It does not go to the firm that manages the fund to help with securities analysis and research, but rather to the fund distributor, which is a separate company that underwrites, markets and distributes the fund shares. The distributor typically keeps a small portion of the load money and passes on the rest to the brokerage or selling firm that actually sells the fund shares.

Translation of all this jargon: Even if a load fund is terrific, the person selling it has a financial incentive to do so, and therefore a built-in conflict of interest. That's why I much prefer advisers who are paid the same regardless of which fund they recommend. These advisers are free to recommend any investment, including no-load funds that don't charge commissions and perform as well or better than load funds.

Also, a 5.75 percent sales charge, while not unusual, is definitely on the high end. Although load funds may legally charge as much as 8.5 percent, I don't know any that does, and many charge 5 percent or less. A 2003 study by the mutual fund trade group Investment Company Institute, the most recent I found on the subject, put the average front-end load at 5.2 percent for stock funds and 4.2 percent for bond funds in 2001.

These figures represent the maximum load these funds may charge, according to their prospectus. Typically, the sales charge is reduced as you invest higher amounts. (For example, the load may go down to 5.5 percent if you invest more than $25,000, to 4.5 percent if you invest more than $50,000, and so on.) Your fund most likely offers such "breakpoints," so keep that in mind if you intend to keep investing. The study I cited found that, because of these breakpoints, load fund investors on average were actually paying only about 1.1 percent in sales charges in 2001.

A couple more things. Loads are particularly bothersome in IRAs because they effectively reduce the amount you can legally contribute to your retirement account. According to an Internal Revenue Service ruling, the load you pay is considered part of the maximum allowable contribution. That maximum is $4,000 in 2005, or $4,500 for people 50 and older. With a fund that charges a 5.75 percent load, those maximums are effectively reduced to $3,770 and $4,241.25 – the rest of the money goes for the load, not your retirement.

Finally, I am confused by your statement that "I recently took out a Roth IRA for my wife." IRA means individual retirement account, and your wife must open her IRA in her own name. I trust you just had a slip of the tongue and did not set up an illegal account.

Humberto Cruz welcomes questions and comments from readers. He will answer those of general interest in his column. Write to him c/o Tribune Media Services, 435 N. Michigan Ave., Suite 1500, Chicago, Ill. 60611; Or e-mail him at AskHumberto@aol.com.