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The ABC's of Investing and Why You Should Avoid Them

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If you're not educated on the ABC's, you could end up with a "D" or an "F" in portfolio management. The ABC's I'm referring to are the share classes of commission mutual funds.

"A" shares are where you pay a commission upfront for a mutual fund. The typical commission is from 4% - 6% of the amount invested. If you invested $20,000, you would probably pay a commission of around $1,000 for the transaction, therefore leaving you with a balance of $19,000. For larger amounts, companies usually offer breakpoints (commission discounts). Still, if you invested $100,000, it would probably cost you $3,500. That's a lot of money. After the payday, your broker then earns about 0.25%/year to "service" the account. If you were a broker, where would you spend your time - servicing your existing accounts for 0.25% or prospecting for another big payday? And you wonder why they never call you…

"B" shares of mutual funds still pay the broker their commission upfront, however, you do not see it taken out of your account. A $10,000 investment yields a $10,000 balance. The catch is that you would incur a deferred sales charge if you were to sell within the first four to six years. These charges usually start out around 4.5% and go down every year. Larger contributions are often not rewarded though, as many companies do not offer breakpoints on B shares. They come with higher expense ratios too, usually in the neighborhood of 2.25%. If you look at the prospectus of any commission fund, you will usually find that over a holding period of 5-10 years, B shares are your most expensive option. Like annuities, B shares are often sold, they are not bought. People just don't ask to buy the most expensive, under-performing funds; they are coaxed. Similar to A shares, brokers only receive a small "trail" fee to service your account. Expect a phone call when your deferred sales charge goes away though. Also, expect a recommendation to a different fund as your "trusted advisor" is looking for another payday.

With "C" shares you do not have an upfront sales charge, and your deferred sales charge is usually limited to 1% for one year. You still have the higher expense ratios though similar to B shares. Instead of the 4% - 6% commission, your broker only earns around 1% upfront. However, they also earn that 1% for subsequent years meaning that they are more likely to pay attention to your account. The problem with this arrangement is that the 1% per year is not transparent. It's built into the price of the fund so you never see it come out. After awhile, you may forget that you are paying it.

Commission funds are an expensive option. Let's also not forget that the majority of them fail to beat their benchmark in any given year. Basically, you could be paying higher fees for sub-par results. If Donald Trump were around, I'm sure we'd quickly hear the words "you're fired!".

Avoiding the ABC's is not too difficult though. There are many funds available for which you do not have to pay a commission. There are also professional advisors who, for a fee, will recommend a portfolio of no-load (commission-free) mutual funds. Invest some time in investor education and get your "A" in decision-making.

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