An Important Message to Investors About Frequent Trading or Exchanging of Mutual Funds

January 1, 2006

Mutual fund companies have begun charging short term redemption fees in an effort to discourage frequent trading of mutual fund shares. Frequent trading drives up a fund's expenses and thereby drives down the fund's net earnings. By imposing short term redemption fees, fund managers aim to reimburse the fund -- and its long term shareholders -- the costs of short term trading.

The fees assess from two factors defined by the fund manager: First, the holding period considered "short term" -- if you trade your shares within that period, you have traded them in the short term and will be assessed the fee -- and second, the fee itself, as expressed as a percentage of the value of the transaction. An example of a short term redemption fee is a 1% fee charged on redemption of shares held fewer than 30 days; another is a 2% fee on shares held fewer than 90 days.

Some fund families charge a short term redemption fee on all transactions; other fund families exempt certain transactions. The distinction rarely comes into play for 401(k) investors except in the case of a total distribution because shares are typically liquidated on a first-in-first-out basis, meaning oldest shares get liquidated first. Say you request a 401(k) loan that amounts to liquidating one-third of your account balance and you have been participating in the 401(k) for many years. Chances are that none of the shares liquidated will have been purchased in the "short run" and thus no short term redemption fees will apply. If any of the shares were purchased in the short run, only those shares, not the entire loan cash-out, will be subject to the relevant short term redemption fee(s).

If you are a long-term investor, three cheers for short term redemption fees for helping protect the value of your shares. If you are a short-term investor, however, beware the impact on your account. The fees can eat into your balance, and predicting their exact amount can prove difficult because short term redemption fees vary, often significantly, in scope and basis from fund company to fund company, even fund to fund within a single company, and they can be changed without notice. Though it would seem illogical for a fund manager to change the fee daily -- doing so would invite heightened administration costs when the purpose of the fee is to recoup administrative expenditures -- there is no regulation barring such an action.

Read mutual fund prospectuses carefully before investing; thereafter, pay attention to updates that you, as a shareholder, will receive -- and be aware that if you liquidate recently purchased shares, you will likely pay a price called a short term redemption fee.