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Sharp Investing

The Mutual Fund Scandals: Who's Looking Out for You?

By Daniel R. Sharp, Ph.D

In over thirty years of investing in stocks I have never owned a mutual fund. Neither has my father who has over fifty years investing experience. Neither has Warren Buffett. Unfortunately, we are the rare exception - the bulk of American investors own mutual funds rather than individual stocks.

Mutual funds began as a way for the small investor to be able to participate in the stock market and instantly diversify small amounts of money without paying the full service commissions of a broker. In 2003 the seven *trillion* dollar industry has grown to the point where there are more funds trading than the number of stocks in which they invest, with almost 100 million American investors owning mutual funds. There are obscene amounts of money made from mutual funds legally: sales charges, brokers' commissions, management fees, marketing fees, advertising fees, trading commissions, soft dollar rebates, spreads between bid and asked prices, and financial advisors fees. All these add up to an incredible gravy train for the financial services industry. As a result, the original intent of funds (for small investors to get instantly diversified) was shoved aside. Everyone from insurance agents to CPAs began pushing funds to Americans as the "cure-all investment" for every situation. It was legal, although perhaps not ethical, to sell funds to someone with hundreds of thousands or millions of dollars that instead could be cheaply and easily diversified into individual stocks. With all the deep discount brokers out there you can buy a stock for $10 instead of the $100 it used to cost with a full service broker. Again, it is completely

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Market Update November 2003

This quarter saw a resurgent economy that powered the stock market right through the historically weakest months of the year. We had expected the market to take a breather this quarter after two previous strong quarters, but the continuing evidence of a strengthening economy kept the market strong during what is usually the worst quarter of the year. There was a small pullback in late October that allowed us to put cash to work,

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legal for that million-dollar portfolio to be charged a 5% sales charge ($50,000) and annual costs averaging 1.6% (another $16,000 annually), even though a direct money manager would provide them with personalized portfolio management and tax strategies for far less. Legal beyond reproach is the additional 1% annual fee (another $10,000) that a financial planner might charge to "manage" the portfolio of mutual funds. A millionaire could pay over $75,000 for the privilege of owning a portfolio of funds.

Ah, but it was all worth it for the security and fidelity of mutual funds, right? Mutual funds were watching out for the little guy and allowing them access to deals they couldn't otherwise obtain. Portfolio managers spent their days worrying about how to make money for the little guys in the heartland - unlike those greedy corporate CEOs that abused their positions of power.

Guess what? The exact same conditions that lead to CEOs abusing power have existed for a long, long time in the mutual fund industry:

1. **Ridiculous amounts of money**
2. **Decentralized, powerless shareholders**
3. **Low visibility and disclosure**

Starting with Putnam funds only a month ago, and now cascading to over twenty fund companies and brokerages (including Charles Schwab), illegal fund trading activities are being unearthed. In the end, improper practices will be found at almost all funds - far more prevalent than CEO corruption, which was still a small percentage in spite of the spectacular examples. CEO corruption was a case of a few renegades or teams of renegades that broke rules to enrich themselves. Mutual fund corruption is systemic and ubiquitous - almost all of them are doing it. And often with the blessing of the fund company itself.

With all of the legal ways to extract money from customers' wallets, why would funds dare to kill the goose that laid the golden egg? Why would billionaire Martha Stewart risk jail by selling $400,000 worth of stock on inside trading information? Because they figured they could get away with it and greed knows no bounds.

Does that sound like an industry that is looking out for you and your portfolio?

The illegalities popping up are falling into two categories. The first is late trading, which is when funds allow their biggest customers to trade their funds after the 4:00 pm EST cutoff for the rest of us "small people". This is like letting someone bet on a horserace after the race has completed. The second is short-term timing trades by actual fund employees, who end up using your money to gamble based on their inside knowledge of how the fund works. Neither of these actions amount to huge losses by fund owners on a separate basis, but show the disregard that fund employees hold at the highest level for the average American's money. In one case, the owner and CEO of a large fund family, Richard Strong, stands accused of making short-term timing trades of his own funds that netted him over $600,000 (this from a guy worth probably one hundred times that amount).

So the question remains: Who's looking out for you? The answer: NO ONE! The fund industry needs huge reform and much more disclosure. Why aren't funds required to show you what you are paying to them in total fees each year instead of burying a percentage figure in a fifty-page prospectus? Do you think the millionaire in my earlier example would have

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bought a load of mutual funds if he had to sit down and write out a check for $76,000 right off the bat? Why do funds only mark to market (see sidebar) once per day? It has been possible for funds to price continuously like other securities for about twenty years now - why don't they do it? Why are portfolio managers allowed to buy and sell their own fund multiple times per day for personal gain when they charge you a penalty fee if you try to "short-term trade" your funds?

The reason for all the illegal abuses lie in the thinly spread 350 SEC inspectors that monitor over 13,000 mutual funds and over 10,000 publicly-traded companies. Most of these inspectors have been concentrating on corporate enforcement rather than fiduciary enforcement. The focus needs to change.

The reason that investors tolerate the legal abuses, high fees, and low level of disclosure is that that don't have any other choice in their 401k. The mutual fund industry has co-opted corporate America and in most cases investors are limited to a choice of lesser evils within the same fund family. Such 401k plans put the investment liability on the participant. The flaw in the system that must be addressed is this: *Don't give the employee the responsibility without also giving them the freedom of choice to invest in something other than mutual funds.*

New safeguards may address some of the pennies per share being siphoned illegally from funds, but the bigger issue is making investors aware of the dollars per share being siphoned legally from their portfolios by funds. Once investors are aware of what they are really paying, they will demand alternatives that, in many cases, will provide them with better returns at a lower cost.

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pullbacks as short-term investors digest gains. There will likely be one more buying opportunity this year and then another in February (based on history). However, the general direction of the market should be up right through 2004 elections as the economy roars and interest rates remain historically low.

The Federal Reserve continues to keep interest rates very low in spite of ample evidence of economic expansion. The last GDP figures that came in reported a torrid 7.2% growth rate - consumers are spending money, real estate is still relatively strong, corporations are starting to spend money again, and the retail industry is gearing up for the best holiday season in years. The current administration is doing everything in their power to make sure that the economic environment is as friendly as possible, stacking the deck for a strong stock market for at least the next year. However, tax cuts and low interest rates won't fuel the economy and markets forever – we need economic fuel for a long expansion, which is not policy related.

Where the economy and the market goes after 2004 elections largely depends on the one missing piece of the economic puzzle – job creation. Ross Perot's "giant sucking sound" is coming true in a big way, many skilled jobs have

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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relocated overseas as corporations save 70% of the cost of a domestic employee, and a lot of jobs have been lost permanently to foreign competition. In order for a long period of economic growth to occur, the U.S. needs to create around 150,000 new jobs per month to lower the 6.1% unemployment rate, which is about twice the rate of current job creation. If corporate America can get the Great American Job Machine going again and we see that skilled people are going back to work that will be the last piece for the "goldilocks" economy and should result in a long period of economic prosperity.

The biggest change that we have seen this quarter is that, as the economy moves from rebound to strong growth, investor preferences shift from smaller growth stocks to largecap value stocks. Economically sensitive cyclical stocks are going to do the best if the economy expands over the next year, and is where we've been concentrating our buying. There are still a number of economically sensitive stocks that pay big dividends and are closer to multi-year lows than to peak valuations that look quite attractive if the economy continues to hum. As the mutual fund scandals and favorable tax treatments drive more and more investors to individual, dividend paying, cyclical largecap companies this sector should do very well for the next several years if job creation fuels a long expansion.

Between now and elections both the economy and markets should be strong. If job creation becomes a part of this recovery, the good times could last for several years. If prices stay strong, there will be some harvesting of fully valued positions and then a period of waiting for a pullback to reinvest the cash. Until conditions dictate otherwise, we will be focusing on economically sensitive companies, as they offer both the most attractive buying prices and the greatest chance for price appreciation.