

## Mutual Fund Scandals Will Make Fund Industry Better in the Long Run

Last year, it seemed that every morning the newspaper reported some scandalous behavior associated with corporate accounting. Remember Enron and the other related headlines? This year, the bad news allegations have been about a handful of mutual fund families.

As an independent, professional financial advisor, I'd like to add my voice to what will obviously be an ongoing conversation in the weeks and months ahead. Hopefully, this commentary will provide some insights and help you give you a better perspective regarding what the press is calling "the Mutual Fund Scandal."

Let's start by defining the related terms and by putting a framework around the problems that have been unearthed. More importantly, my commentary will also address the most pressing question you most likely have: What does all this mean to me as an individual investor?

### Two Key Problem Areas

The current mutual fund problems fall into two broad categories:

1. Excessive trading ("market timing")
2. Late trading ("stale price arbitrage")

While late trading is actually illegal, excessive trading is not illegal. Excessive trading is, however, of dubious ethical standing. You may also hear "excessive trading" referred to as "market-timing" and "late trading" referred to as "stale price arbitrage."

First, let's make some distinctions about the term "market timing:"

- Calling excessive trading "market timing" may be confusing to many investors. "Market timing" as it pertains to a particular mutual fund company's wrongdoing means something entirely different than what your current understanding of the term may be.
- Normally, when financial planners talk about "market timing" we are referring to the fact that no one can predict with any degree of certainty the short-term ups and downs of the securities markets. Many financial planners, myself included, emphasize that *time in the market* – not market timing – is an investor's friend. Studies show that even the most astute investors have difficulty timing their investment purchases and sales to meet the lofty goal "buy low and sell high." Instead, most investors hurt themselves by being out of the market during market rallies.
- What's involved in the mutual fund company problems is the rapid buying & selling of fund shares in anticipation of short-term price movements in the securities contained in fund portfolios. This is not illegal, but such trading may increase expenses for long-term fund shareholders, and can violate fund company policies.

Late trading or "stale price arbitrage" involves taking advantage of price movements after the exchange on which the mutual fund shares are traded is officially closed. This is (at least mostly) illegal.

## Impacts to Mutual Fund Shareholders

A study by a respected industry publication, Investment News, suggests that neither late trading nor “marketing timing” have overtly hurt mutual fund shareholders. While it is difficult to draw a definitive link between such questionable trading activities and fund performance, if we look at the performance of the fund groups implicated we see that they compare nicely (as measured by Morningstar ratings) to other well-respected fund companies that have not been implicated. Theoretically, marketing timing and late trading can lead to poor performance, but in reality it is the underlying stocks and expense ratio of the fund that makes the biggest difference in performance.

Let’s dig a little deeper. Most Americans invest through mutual funds. Are they still safe? How should we respond to these scandals?

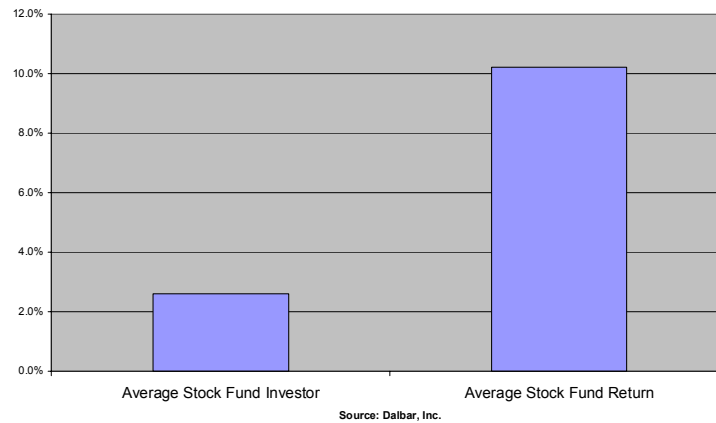
**Minimal Impact.** Without at all excusing this unethical behavior, let’s acknowledge that unlike the accounting and management irregularities at companies like Enron and Worldcom, which caused their investors substantial losses, the mutual fund company improprieties have caused minimal loss to fund shareholders like you or me on an individual basis. It’s a little like the old movie about a scheme to direct all the “rounding” in a certain bank’s accounts to a single account; while fractions of a cent can really add up if you have enough volume, for any given account the effect is really not material. According to the Investment Company Institute, even if restitution funds add up to one billion dollars, that would equate to about a \$20 restitution per U.S. household owning mutual funds.

**Another Argument for Index Funds.** It is important to note that most of the objectionable activities would be pointless if investors held broadly diversified index funds. Actively managed mutual funds are just extensions of the “hot money” philosophy and counterintuitive to a sensible investment approach. Active management is almost exclusively employed in highly volatile, growth-oriented, sector-betting funds. This highlights the need for investors to understand not only investments, but the investment business, and associated potential conflicts of interest. When you invest in broadly diversified index funds, there is virtually no possibility of trading impropriety. In addition, passive management reduces the overall expense ratios, which gives the underlying securities in the index fund a better chance to provide a good return.

**The enemy is us.** Unfortunately, the biggest threat by far to most investors’ overall rate-of-return is bad investing habits (mostly linked to fear or greed). “Market timing” in its traditionally-used sense (see my commentary above) is almost always linked to emotionally-based investing. Rationally-based investing that follows a thoughtful investment policy is always the best course. Asset allocation and “dollar cost averaging” are long-term investing strategies that have stood the test of time.

As mentioned above, even if you are invested in one of the implicated mutual funds, the impact on you is likely very minimal. On the other hand, studies constantly show that investors’ own trading practices typically drive their returns far below those of the funds in which they invest, let alone reasonable market benchmarks. For example, a recent study by the financial research firm, Dalbar, showed that from 1984 – 2002 the average stock **fund** delivered an average annual return of 10.2% while the average stock **fund investor** earned only 2.6% annually per year:

### Average Annual Returns, 1984 - 2002



This equates to a **cumulative return of 536% for the average stock fund** versus a **cumulative return of only 63% for the average stock fund investor**. Why the big difference? In a nutshell, fund investors exhibited signs of emotionally-driven investment, with fear and/or greed the primary motivations.

So, while we are right to be indignant about the (at least) immoral and (at worst) illegal activities among some in the mutual fund industry, I believe investors should focus on fundamental investing principles. In other words: we should refrain from shooting ourselves in our respective feet!

### The Bottom Line on Mutual Funds

Now is not the time to lose confidence or bail out of mutual funds altogether. Mutual funds remain, in our opinion, the investing vehicle of choice for most investors. The good ones offer professional management of a basket of individual securities at a reasonable cost. We continue to champion broad diversification, partially through index funds such as those from Vanguard, and disciplined investing practices such as “dollar cost averaging” (regular and systematic contributions into an investment account) and annual rebalancing among asset classes.

### Things to Do Now

- Year-end is an especially good time to examine how your mutual funds have performed for you (don't just look at the published return). You should do your best to determine how much you are paying for the funds and contact the company directly (or your financial advisor) if you are unable to figure out your costs.
- Make sure that the funds you hold are part of a long-term investment policy that includes your personal preferences on risk and long-term goals. Consider your rate of return *after taxes, transaction costs and inflation*.
- Consider the mutual fund company's user-friendliness. Are the materials clear and easy to understand? Are the company representatives helpful? Does the company put investors first? Look for reputable firms with transparent costs (low-cost index funds as well as managed funds). There are companies that operate ethically, put the investor first, and charge

fair and transparent fees. If you are in your accumulation phase of life, you have the responsibility of preparing for your own retirement; no generation before has ever had to do as much to get ready for retirement. Not only will you need to accumulate a sizeable amount of money in accounts earmarked for your retirement, but you will need a strategy to make that money grow (you will probably need to outpace taxes and inflation at the bare minimum).

- If you are in your distribution phase (retired and taking withdrawals from your life-long savings), you will want to include mutual funds on some level throughout retirement (assuming you need some continuing growth).
- All investors need take a more active role in understanding what they are purchasing. Fraud is not something the mutual fund investor can control. You can, however, do more to demand accountability from the funds themselves and the employers who position these funds as *the* retirement vehicle for accumulating enough savings.
- Be aware that unscrupulous brokers (sometimes cloaked as “financial advisors” or “investment advisors” who are actually sales representatives for an investment or insurance company) may try to take advantage of the current Mutual Fund Scandal situation. While there are many ethical and competent advisors who work on a commission basis, the surest way to secure independent, objective advice is to work with “a fee-only advisor.” Fee-only advisors do not receive third-party compensation in any form, thus there are no sales-driven incentives tied to their recommendations.

### **The Good News Going Forward**

The turbulence going on in the Mutual Fund Industry right now is actually a good thing. Poor fund governance, which many industry experts say is at the root of the allegations of market timing and late trading, was previously hidden to investors. Watch for new regulations from the governing bodies. These new checks and balances will help to better protect investors against unethical practices. Also look for additional policing within the financial services industry. Despite the uncovered abuses, and the ones that are sure to surface, the fact is that mutual funds are an important part of the financial structure of the country. Americans need and want mutual funds to work for them. Industry leaders, and state and federal regulators, will be working hard to bolster investors’ confidence and put the additional safeguards in place.

Thanks for reading. As always, we welcome your comments or questions.