"A Good Deal of Sense"

What Investors Need From Mutual Funds….
And From Policymakers

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At a hearing titled

"Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Understanding the Fund Industry From the Investor's Perspective"

Committee on Banking, Housing, and Urban Affairs
Of the United States Senate
Sen. Richard Shelby, chairman

February 25, 2004

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Mister Chairman, Members of the Committee:

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute, where my focus is economic and financial issues. I am also host of the website TechCentralStation.com, which concentrates on matters of technology, finance and public policy.

In addition, for the past 10 years, I have written a weekly syndicated column for the Washington Post on investing. I have also written two books geared to small investors and have published numerous articles on investing topics in publications ranging from The Reader's Digest to The Wall Street Journal. Thank you for inviting me to testify at this important hearing on mutual funds from the point of view of the investor, especially the small investor, who is my main concern. I testify as an individual. The views are mine, not those of any institution with which I am connected.

The Mutual Fund Scandals

In early September of last year, the attorney general of New York, Eliot Spitzer, announced that several mutual fund firms had allowed large investors to profit from practices that were either illegal or actively discouraged by their own published policies. One of those investors, Canary Capital Partners, LLC, a hedge fund, agreed to pay a fine of $40 million to settle civil charges. Since then, two dozen mutual-fund houses, including several of the largest, have been implicated in the scandal, which, by the end of January, had led to civil or criminal complaints against at least 10 companies by attorneys general, the U.S. Securities and Exchange Commission and the Justice Department; the dismissal or resignation of 60 executives, including the president of Alliance Capital and the CEOs of Pilgrim, Baxter & Associates, Putnam Investments and Strong Capital; and the imposition of more than $640 million in penalties.[1]

Specifically, the charges concern two practices:

Late trading, by which an investor purchases shares in a mutual fund after the 4 p.m. deadline but pays the price at that day's close, rather than the next day's. This practice, which typically requires the collusion of a broker or mutual fund employee, is illegal.

Market timing, by which an investor makes quick trades in a mutual fund's shares. Most mutual funds discourage market timing – and so officially state to investors – because it can add costs for other shareholders in the fund.

Both practices attempt to capitalize on "stale prices" – usually in international stocks. Trading in Europe and Japan, for example, ends many hours before the 4 p.m.

[1] "Putnam Led Industry With $28.9 Billon of Withdrawals," Bloomberg, Jan. 28, 2004

deadline and, in the interim, events may occur that could lift prices the next day. Through stale price arbitrage, an investor can, to paraphrase Spitzer, bet on a horse after the outcome of the race is known.

These practices dilute the holdings of the other shareholders in the fund. According to research by Eric W. Zitzewitz, "In 2001, a shareholder in the average international fund in my sample lost 1.1 percent of assets to stale-price arbitrage trading and 0.05 percent of assets to late trading. Losses are smaller, but still economically significant, in funds holding small-cap equities or illiquid bonds."[2] Large-cap U.S. stock funds are generally unaffected.

The scandal is by far the most extensive to afflict the mutual fund industry, which, since its founding 80 years ago,[3] has been relatively free of impropriety and broadly respected by investors. Even before Spitzer filed his initial charges, however, Congress and the SEC had been examining major changes in the structure and regulation of mutual funds, and, after the scandals, a flood of legislation was introduced, including three major bills in the Senate in the space of 20 days in November.[4]

But is the rush to regulate the proper response to the scandals? Judging from the perspective of the investor, as this hearing requests, I have serious doubts.

While steps need to be taken to ensure that some investors do not exploit stale pricing at the expense of others, the mutual fund industry is basically sound. It is highly decentralized and competitive, and, despite the scandals and the three-year bear market in stocks, it continues to attract savings at a remarkable rate. The largest firms -- including Fidelity Investments, which offers more than 300 funds; Vanguard Group, whose Index 500 Fund is the largest mutual fund with $77 billion in assets; and American Funds, which runs four of the top biggest funds, with assets totaling $200 billion – have not been tainted by the scandal.

A greater worry is that, by rushing to increase regulations in areas such as fees, board composition, and disclosure, policymakers run the risk of limiting choices and raising costs for small investors. The mutual fund industry is a great American success story. It has democratized finance. It has both provided capital for businesses and increased the net worth of families. But, weighed down by dozens of new counterproductive rules, it could lose its robust character.

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[2] Eric W. Zitzewitz, assistant professor of economics, Stanford University, testimony before Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, Nov. 6, 2003.

[3] Massachusetts Financial Services (MFS) is generally credited with launching the first mutual fund in the spring of 1924. MFS, the 11th-largest mutual fund firm, reached an agreement on Feb. 5 to pay $225 million and reduce fees in a settlement with regulatory authorities after charges of permitting market timing. In addition, the CEO and president of MFS have stepped down. (Letter to clients from Robert Manning of MFS, Feb. 17, 2004, at http://www.mfs.com/about/index.jhtml;$sessionid$5MJVUBMKDMDCBTXTQYUBFD4O4ODCSESS.)

[4] S. 1822, S. 1958 and S. 1971. These three, along with H.R. 2420, passed by the House on Nov. 19, 2003, are examined at length in a CRS Report (RL32157), "Mutual Fund Reform Bills: A Side-by-Side Comparison," updated Dec. 9, 2003.

Popularity of Mutual Funds

The most striking characteristic of mutual funds is how popular they have become in such a short time. In a free economy with abundant selections, people buy what they want, and their investment of choice in the past three decades has been mutual funds. In 1970, for example, there were 361 funds with a total of $48 billion in assets. At the end of 2003, there were 8,124 funds with $7.2 trillion in assets. Mutual funds are owned by 91 million investors in 53 million U.S. households – roughly half the nation.[5]

Even in the wake of the scandals, Americans have continued to invest in mutual funds. In 2003, a total of $152 billion in net new money (after redemptions) flowed into stock mutual funds, including $30 billion in November and December, at the height of the revelations by Spitzer and the SEC.

In his history of popular finance in America, Joseph Nocera, editorial director of Fortune magazine, wrote:

> Mutual funds became the investment vehicle of the middle class because they…struck people as making a good deal of sense. If anything, mutual funds made more sense than ever after the crash [of Oct. 19, 1987, when the Dow Jones Industrial Average lost 22 percent of its value in one day]. For one thing, even the most aggressive mutual funds outperformed the market on Black Monday, and in so doing provided at least a little comfort to small investors. More importantly, as the financial life of the middle class became ever more complicated, connected irrevocably to such arcane as the state of the Japanese market and the shape of the yield curve, Americans took increasing solace in the central notion behind mutual funds – that by putting money in a fund, they were hiring a professional to make market decisions they felt increasingly incapable of making themselves.[6]

Mutual funds created a revolution in investing by providing average Americans with the same professional management and financial reporting enjoyed by the rich – and at roughly the same cost. Because of private research institutions like Morningstar Mutual Funds, investors can easily compare the performance and fees of thousands of funds. Nocera quotes Don Phillips of Morningstar as saying, "One of the hidden advantages of the fund industry is that by packaging investments in consumer wrapping, mutual funds tap into the consumption skills baby boomers have spent their lifetimes refining…. Funds make investing very much like shopping."[7]

One of the many problems with proposals for mutual fund reforms is that the shopping will become much more difficult – with a profusion of new requirements that will mainly serve to confuse investors and add costs that will be borne by fund shareholders or taxpayers. The SEC alone has approved or is considering 17 separate

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[5] *2003 Mutual Fund Fact Book*, 43rd edition, Investment Company Institute, May 2003; updated information from the ICI website, www.ici.org.

[6] Joseph Nocera, *A Piece of the Action: How the Middle Class Joined the Money Class*, Simon & Schuster, 1994, p. 369.

[7] Ibid.

rules changes[8] – and these are in addition to those that may be enacted by other regulators or through legislation.

A better approach is to increase incentives of investors to discipline funds through their own choices – and to increase incentives of funds to communicate forcefully and clearly to investors and of government to educate.

Investor Discipline Is Harsh

The discipline of investors is far more harsh than anything regulators can dream up. Consider the new inflows and outflows of new money into major mutual funds during 2003[9]:

Fund Company	Allegations of Impropriety?	Net Inflow or (Outflow) In billions of dollars
American	No	66
Vanguard	No	36
Fidelity	No	31
Putnam	Yes	(29)
Janus Capital	Yes	(15)
Amvescap (Invesco)	Yes	(8)
Alliance Capital	Yes	(2)

Putnam, for example, charges an annual expense ratio of between 1 percent and 1.55 percent for its equity funds, in addition to a 5.25 percent load, or up-front fee.[10] Imagine that Putnam merely loses 1 percent on the foregone assets each year. Based on an asset decline of $29 billion in 2003, that's a loss of $290 million in revenues – with much of it dropping straight to the bottom line – in the first year alone. Assume that a typical client who redeems her shares would have kept an account for five years; the total loss (assuming no more new redemptions in subsequent years but growth in assets of about 8 percent annually) is well over $2 billion.

The business of mutual funds is asset-gathering. Investors are willing to entrust their money to fund companies for many reasons: high historic returns, low expenses, good service, and confidence in the fund's integrity and safety.

When confidence is shaken – as it has been in the case of Putnam, Janus, Amvescap (specifically, its subsidiary Invesco Funds Group, which is accused of allowing favored clients to make short-term trades), and Alliance – investors take appropriate action. They were encouraged in that action by analysts and commentators, including me.[11]

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[8] "Taking a Closer Look: The SEC's Fund To-Do List," Ian McDonald, The Wall Street Journal Online, Jan. 14, 2004, at http://online.wsj.com.

[9] "Putnam Led Industry," Bloomberg, Jan. 28, 2004, op. cit., and "American Funds Get Highest Inflows in U.S., Report Says," Bloomberg, Jan. 29, 2004. Both articles use Financial Research Corp. of Boston as their main source for data in the table that I have compiled.

[10] These figures and all others regarding the individual expense ratios, loads and returns of mutual funds come from Morningstar Mutual Funds, at www.morningstar.com.

[11] "Don't Panic, But Start Selling," James K. Glassman, The Washington Post, Nov. 9, 2003. I wrote, "It's time to dump Putnam, Strong and Alger funds, unless you have a very good reason to keep them, such as avoiding a big tax bill or wanting to hold on to a fund that has been a superb performer…. In my view, it is reckless to entrust your money to institutions that have proved rotten at the top, no matter what their

Instead of adding rules, policymakers could perform a more useful service by using the bully pulpit to condemn executives and firms who abuse their clients' trust and to laud those that act responsibly. That would encourage investors themselves to take action. Such statements should be part of a strategic program of investor education. There are other steps as well that would enhance competition and give mutual funds stronger incentives to communicate vigorously with the public.

Response and Recommendations

Let me now comment on specific recommendations and offer some of my own:

Late trading. A rule that would require a hard 4 p.m. market close on all trading activity, including reconciling trades from financial intermediaries, would hurt small investors. It would, in practical terms, require small investors to make decisions to buy or sell shares in a fund well before the 4 p.m. close – without knowledge of late-day market events. The change "would require deadlines several hours earlier [than 4 p.m.] at intermediaries such as brokerage firms and 401(k) plans. Thus participants would have less flexibility."[12] Large professional investors, which either trade securities directly themselves or place their orders directly with fund companies, would have an advantage over small investors. The rule should state that all orders must be placed by buyers and sellers before 4 p.m. and time-stamped accordingly, with the understanding that the execution of those orders may not occur until after that time. A stronger national clearinghouse should be responsible for verifying the orders were placed before the closing time.

Fund companies have been chastened. Further illegal late-trading activity is unlikely, considering the high costs already imposed on the miscreants. At any rate, regulators should hold funds responsible for late trading in their funds, no matter who participates in the practice. Fidelity Investments has properly called the shortened deadline an overly simplistic approach that "ends up hurting the shareholders, not helping."[13] A new rule is not needed. Proper compliance with the current rule is.

Market timing. If a fund states in its prospectus and other written materials that it discourages market timing, then it must adhere to that policy for all investors, large and small. But funds should be free to adopt policies that allow, or even encourage, short-term trading. The choice should be that of the fund itself, but it must be clearly communicated to investors.

Why do funds allow market timing in the first place? In order to gain more assets, which in turn can lower costs for the fund and its smaller shareholders. As D. Bruce Johnsen, professor of Law at George Masson University, put it:

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intentions for the future." Morningstar's more sweeping admonition to investors preceded mine and was certainly more influential.

[12] "Mutual Funds Vow to Fix Their Clocks," Karen Damato and Tom Lauricella, The Wall Street Journal, Oct. 31, 2003.

[13] Robert Reynolds, chief operating officer of Fidelity, quoted in "Mutual Funds Vow to Fix Their Clocks," op. cit.

> According to the SEC's own findings, large accounts contribute far more than the average to scale economies in management. It is therefore no surprise that the SEC's perplexing rules prohibiting lower fees for larger accounts would lead fund advisers to compete for hedge fund dollars by tolerating large-scale internal timing. It is by no means clear that this reflects a breach of trust. Quite the contrary, fund advisers may have done nothing worse than cut loss-minimizing deals with hedge funds. By allowing the adviser to keep hedge fund money in the complex, all investors are likely to be better off compared to the alternative.[14]

Funds should be free to charge investors different fees according to the size of their investments, and the scheme for such pricing should be left to the mutual fund itself. Discriminatory pricing helps, rather than hurts, small investors, since it draws more large investors into the fund to share the costs.

The SEC is also expected to propose a mandatory fee of at least 2 percent on shares that investors sell within days or even weeks of purchase. Unfortunately, this rule, like the hard 4 p.m. deadline, has been endorsed by the Investment Company Institute, the mutual fund trade group.[15] This misguided rule will merely penalize small investors who need to move their funds in an emergency – or some other valid reason, such as poor performance by a fund or the revelations that the fund has been engaged in unsavory ethical practices.

It is perfectly valid for a fund to charge a high exit fee in an effort to keep shareholders invested – thus avoiding pressure on the fund manager to sell stock at importune times in order to raise cash. But, again, the choice must be that of the fund management itself. Investors, in turn, can choose whether they want to own a fund with a high redemption fee (perhaps adding stability to the fund's holdings) or a low or non-existent redemption fee (to give the investors themselves some flexibility).

By mandating the high redemption fee, the SEC would be dampening competition among funds and providing all of them with serendipitous income in case of emergency withdrawals. A bad idea.

Independent Directors. Proposals have been advanced that would require each fund to have an independent chairman and for funds to increase the proportion of their independent directors from a majority to at least 75 percent. The reasoning here is that directors without an ownership stake or other financial interest will protect shareholders' interests. That may or may not be true. Enron Corp. had 11 independent directors (out of 15), but they failed to stop fraud and misrepresentation.[16]

[14] "An Economic Defense of Mutual Fund Timing," D. Bruce Johnsen, unpublished paper presented as a draft at a conference at the American Enterprise Institute on Jan. 28, 2004, titled, "Mutual Fund Regulation and Litigation: Is the Cure Worse Than the Disease?"
[15] "Mutual Funds Vow to Fix Their Clocks," op. cit.
[16] A Senate subcommittee found, "The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States." ("The Role of the Board of Directors in Enron's Collapse," Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, July 8, 2002.) The

Mark Hulbert, editor of the Hulbert Financial Digest, the respected scorekeeper for financial newsletters, wrote in The New York Times, "Almost all of the several dozen academic studies on board independence have found [either] that it has no correlation with company performance or that companies generally perform worse when they have more outsiders on their boards."[17] Why worse? Probably because directors with a direct personal stake in a firm put more time and effort into governance.

Requirements like this one present a moral hazard problem for investors. Regulators are sending the signal: "We will require lots of independent directors on mutual funds, so investors won't have to worry about good corporate governance." In fact, investors should worry, and, if they do, mutual fund companies with have an enormous incentive to reassure them. Perhaps having lots of independent directors provides that assurance. If it does, the funds will advertise the fact. That is the proper dynamic to ensure integrity.

Disclosure and Fees. It is hard to be against disclosure, but the absurd amount of detail that the SEC is now requiring – and is proposing to require – may do more harm than good. Most disclosure involves expenses. My experience with readers is that their main interest in choosing a mutual fund is not the expenses, but the return. Ask any investor, and you will get the same answer: He would rather pay $100 in expenses to get a net return of $300 then pay $2 in expenses to get a net return of $299. In this judgment, small investors in mutual funds are no different from sophisticated investors in hedge funds. A typical hedge fund charges a 1 percent annual fee plus 20 percent of the profits. That can amount to far more than a mutual fund investor pays. In a year when the market is up 30 percent, a hedge fund investor pays about 7 percent in expenses, compared with an average of about 1.5 percent for a mutual-fund investor.

The problem for all investors, however, is that past performance is no guarantee (or, in most cases, even indication) of future performance. Since markets tend to be efficient, most funds, over time, will produce returns that are close to those of the market as a whole, reflected, for example, by the Standard & Poor's 500 Stock Index. If funds tend to perform alike, then the fund with the lowest expenses will produce the highest net returns.

Life isn't quite so simple. Last year, for example, the top quartile of diversified stock mutual funds produced returns that averaged about 10 percentage points higher than the average fund, and there are gifted fund managers whose long-term records seem to show they have the ability to beat the market with some consistency. Still, expenses count, and it is difficult to get investors to believe that fact.

Despite the urging of practically every writer on the subject, despite the clear statement of fees at the start of every mutual fund prospectus, despite the detail on expenses in every Morningstar write-up, despite the industry's outreach,[18] despite the fact

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chairmen of Enron's executive committee, finance committee, audit committee and compensation committee were all independent (and, by any conventional observation, distinguished) independent directors.

[17] "Outside Directors Don't Mean Outside Returns," Mark Hulbert, The New York Times, June 15, 2003.

[18] For example, "Frequently Asked Questions About Mutual Fund Fees," booklet, Investment Company Institute, 2003.

that about three-quarters of fund purchases are made through advisors whom investors can simply ask about fees, and despite the SEC's own excellent online fee calculator,[19] many – perhaps most – investors don't even know the fees that their funds charge. Since expenses are netted out of returns (that is, investors do not have to hand over a check for a fund's services), they are largely invisible.

Will more disclosures help? I doubt it. "Mutual fund fees are subject to more exacting regulatory standards and disclosure requirements than any comparable financial product offered to investors," says the Investment Company Institute, which is obviously an interested party but which is speaking here with accuracy.

Beyond the basics that are required today and are explained at length in the prospectus and "Statement of Additional Information" and are summarized by services like Morningstar, disclosure – in its extent and presentation – should be left to the funds themselves. They know how to communicate best with consumers. The job of the regulators is to ensure that the disclosure is accurate and that companies do what they say they will do. Companies and individuals that commit fraud should be vigorously prosecuted, as they have been – appropriately – in recent cases involving late trading and market timing.

Funds already have an incentive to advertise low fees, just as grocery stores have an incentive to advertise low prices on bananas. The paucity of such advertising indicates that investors don't care about fees as much as they care, for example, about returns, and no amount of disclosure will change that fact. Additional disclosures will simply cause additional confusion and may lead policymakers to think they have done their job. One mutual fund CEO told me that only two people, out of the many thousands that are shareholders in his fund, request the Statement of Additional Information annually, and the CEO assumes that the two are "competitors rather than investors."

The SEC is also considering a requirement to disclose "incentives and conflicts that broker-dealers have in offering mutual fund shares to investors."[20] Disclosure would come through a confirmation form. I have examined this form and find it so complicated as to be unusable. It includes a complete page, in dense type, of "explanations and definitions," and it requires "comparison ranges," but it is unclear what is being compared with what: small-cap funds, all funds, equity funds? The SEC should drop the disclosure approach and instead adopt an education approach (see below).

Structure. Much of the confusion and problems related to mutual fund governance can be traced back to 1940, when a law established the industry's current legal structure, characterized recently by Business Week as an "antiquated set-up,"[21] and that's putting it mildly. Under the law, each mutual fund (and there are more than 8,000 today) is a separate company, "but it's essentially a shell, with directors but no employees. The fund board contracts out for all key services, from stock-picking to record-keeping. In theory, the board can choose any

[19] At www.sec.gov/mfcc/mfcc-int.htm
[20] Testimony of William H. Donaldson, chairman of the SEC, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Sept. 30, 2003, at www.sec.gov/news/testimony/ts093003whd.htm
[21] "Funds Need a Radical New Design," Amy Borrus and Paula Dwyer, Business Week, Nov. 17, 2003, p. 47.

adviser, but in reality, a fund company usually sets up a fund, appoints a board, and the board then hires the management company that founded the fund."[22]

It's doubtful that many investors understand this structure. They believe that the fund adviser owns the fund. The way to rationalize and modernize the current system is to treat mutual funds as investment products instead of companies. "It might make sense to permit funds to structure themselves the way people actually think of them – as services bought based on performance and cost," says Steven M. H. Wallman, a former SEC commissioner who now runs the investment firm FOLIOfn.[23] The board that runs the funds, then, would be the board of the asset management company that's now the funds' adviser.

Competition Enhancement. Rather than adding rules, policymakers should seek ways to enhance competition. Already, the mutual fund industry is fiercely competitive – and getting more so. The five largest fund houses accounted for just 33 percent of mutual-fund assets in 2002, down from 37 percent in 1990. The 10 largest fund houses accounted for 46 percent of assets, down from 56 percent in 1990. With 4,700 equity mutual funds, investors have vast choices.[24] Some funds charge commissions, or loads, at the time of purchase; others at the time of sale. Others impose no loads at all, instead getting all their investor income from annual fees, charged as a percentage of total assets.

The most popular mutual fund, Vanguard Index 500, carries no load and charges just 18 basis points in annual expenses. The second-largest, Fidelity Magellan, also imposes no load and charges only 76 basis points. There are abundant low-cost choices.

"The actual costs borne by average stock mutual fund shareholders have dropped 45 percent since 1980," said Brian Reid, deputy chief economist for the Investment Company Institute, reporting on a recent study by Peter Tufano of Harvard and Erik Sirri of Babson College. The study found that 60 percent of shareholder assets are invested in funds with total expense ratios under 1 percent.[25] An extensive study of fees found a decline in the weighted-average annual expense ratio for stock mutual funds from 2.26 percent in 1980 to 1.28 percent in 2001; for bond funds, from 1.53 percent in 1980 to 0.9 percent in 2001.[26] Fidelity recently did away with its 3 percent loads on sector funds. Fees don't fall, of course, because fund company executives are nice guys. They fall because costs drop through economies of scale and, more important, because competition puts pressure on prices.

Investors do not, however, opt for low costs alone. Nor should they. They consider financial returns and service as well. PIMCO Total Return, a bond fund, has accumulated $74 billion in assets despite a 4.5 percent front load plus annual expenses of 0.9 percent. The reason is simply that the fund's manager, Bill Gross,

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[22] Ibid.
[23] Ibid.
[24] These figures and subsequent industry are from the *2003 Mutual Fund Factbook*.
[25] "ICI Economist Reports that 'Total Shareholder Cost' of Investing in Stock Mutual Funds Has Declined 45 Percent Since 1980," press release, Investment Company Institute, Feb. 18, 2004.
[26] Frequently Asked Questions," op. cit., p. 13.

has compiled such a spectacular record in recent years. Similarly, Legg Mason Value Trust, with a lofty expense ratio of 1.72 percent, has increased its assets from less than $1 billion in 1993 to $14 billion today largely because its manager, William Miller, has beaten the benchmark Standard & Poor's 500-Stock Index in each of those years (plus two more), an astounding record.

Last December, two top Republicans on the House Financial Services issued a press release stating, "All mutual fund shareholders deserve lower fees. Not just shareholders who invested in funds that engaged in questionable trading practices; not just shareholders invested in one fund family; but all mutual fund shareholders deserve relief from fees that continue to rise."[27] First, it appears that fees are not rising, but, second, in a competitive market, with few supply constraints, higher fees (if they did arise) would be a reflection of higher demand. The concept that any consumer "deserves" a particular price is an artifact of poor economic thinking. Efforts to push down costs by government fiat or intimidation (an approach of Spitzer) are misguided and misinformed. It is competition that holds down prices.

A good way to enhance competition and get the lower fees that some policymakers seek is to increase the supply of funds – that is, the choices of investors.[28] But adding new regulations – even disclosure requirements that appear innocuous – will have the opposite effect. Some funds will simply not be able to afford the added legal, accounting, research and publishing costs. They will either close down, merge, or boost expenses beyond the reach of small investors.

An attraction of mutual funds is that they offer small investors much the same professional services that well-off investors have enjoyed for years. Recently in New Orleans, I visited the firm St. Denis J. Villere & Co., founded in 1911 to manage the money of institutions and wealthy investors – a task it has performed exceptionally well. Villere requires a minimum starting account of $500,000 for its advisory clients. In 1999, after requests from smaller investors, the firm launched a public mutual fund, Villere Balanced, which requires an initial investment of just $2,000. The fund, which combines stocks and bonds, has been an exceptional performer, beating the S&P by an annual average of 7 percentage points over the past three years. But it remains small: just $17 million in assets.

Such a fund – and there are many – will bear a heavy burden if the regulatory wish-list goes into effect. More important, small investors could lose choices like Villere Balanced. Calamos Growth, by some accounts the top diversified stock fund in America, had only $12 million in assets in 1998 and now has $5 billion. It won those assets through impressive performance (returning an annual average of 21 percent for the past five years), but, with heavy regulatory

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[27] "Oxley, Baker: All Mutual Fund Investors Deserve Lower Fees," press release, House Committee on Financial Services, Dec. 17, 2003. The press release is quoted in my article, "Spitzer vs. the SEC," James K. Glassman, TechCentralStation.com, Dec. 19, 2003 (http://www.techcentralstation.com/121903G.html), which contains a discussion of the competitive nature of the mutual fund industry.

[28] Another way to lower expenses would be to decrease the demand for funds, which would best be accomplished if funds did not perform a service that consumers wanted. In other words, if funds would only do a worse job, prices would fall.

expenses, it might have been killed in the cradle. By the way, Calamos charges a front load of 4.75 percent and annual expenses of 1.4 percent. Is that too much? Evidently not for the investors who have piled into the fund to benefit from the talents of the Calamos family, who last year produced returns of 42 percent of their shareholders.

Another way to enhance competition – and improve the governance of funds -- is by making it easier for investors to exit funds that have failed to meet financial or ethical expectations. A major obstacle to redemption of fund shares is the capital gains tax. Investors are reluctant to leave a fund they have held for a long time if they have to pay federal taxes of 15 percent on their profits.

Bruce R. Bent, who invented the money-market fund in 1972, proposes that "investors be permitted to sell shares of a mutual fund for any reason…without incurring tax, provided that the proceeds are reinvested in a similar fund…within 30 days."[29] In this rollover plan, Bent would require investors who sell shares in a small-cap fund, for example, to buy shares in another small-cap fund. This seems to me needlessly complicated; I would allow purchases of shares in any fund, or in individual stocks and bonds, for that matter. But either way, Bent has the right approach. Public policy should be directed at intensifying competition and increasing the anxiety of funds that, if they betray their customers, they will lose a great deal of business.

Investor Education. As boring as it may sound, the most important step that policymakers can take to improve governance of mutual funds and to help small investors is to focus on investor education. Today, lip service is paid and a small amount of money is spent. Far more effort is required, and it needs to be centralized. The SEC, the Treasury Department and the Labor Department all have investor education programs. Instead, there should be a single office, with sufficient funding and dynamic, marketing-oriented leadership.

Let me close on a disturbing paper by Ali Hortacsu and Chad Syverson.[30] The two University of Chicago economists looked at 85 retail index funds geared to the S&P 500 (an index fund is constructed to mimic the performance of a popular stock or bond index; the S&P 500 is the most popular such index, in part because it reflects about 85 percent of the total U.S. stock-market capitalization in only 500 stocks). The number of S&P index funds has quintupled since 1992, so, clearly, investors have wide choices.

What is disturbing is that "the highest-price S&P 500 index fund in 2000 imposed annualized investor fees nearly 30 times as great as those of the lowest-cost fund: 268 vs. 9.5 basis points" (a basis point is one one-hundredth of a percentage point, so 268 bp equals 2.68 percent). The authors continue, "This striking divergence is not restricted to the far ends of the distribution; the seventy-fifth/twenty-fifth and ninetieth/tenth percentile price ratios are 3.1 and 8.2, respectively."[31]

[29] Bruce R. Bent, private correspondence, Jan. 30, 2004.
[30] "Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds," October 2003.
[31] Ibid, pp. 2-3.

The authors ask, "How can so many firms, charging such diffuse prices, operate in a sector where funds are financially homogeneous?"[32] In other words, why do funds that return the same (that is, they all pretty much return, before expenses, what the S&P 500 returns) charge fees that are so different?

The principal answer they give is that there has been an "influx of high-information-cost novice investors."[33] Very simply, many investors are unsure about the investments they are purchasing. The costs – that is, the value of the time spent – in investigating the expenses of one index fund over another are so high that these investors just pick a name they know, or rely on the suggestions of friends or advisors. "While average search costs were declining, costs for those at the upper percentiles of the distribution actually tended to increase through our sample years."[34] Again, to translate: Most investors have learned a great deal over the years about investing, so the costs to them of picking a fund are falling, but costs (again, in time) are still high for new investors.

This study shows, with glaring illumination, just how much education is needed, especially for novices. Not disclosure, not new rules, not onerous requirements, but simple education. Much of that education has been provided by mutual fund companies themselves and, of course, by journalists and research firms. But more education is urgently required, and here the government has a significant role to play.

Thank you.

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[32] Ibid., p. 3
[33] Ibid., frontispiece.
[34] Ibid., p. 32.