

## ***Investment Bulletin - The Mutual Funds Scandal November 7, 2003***

Unfortunately, the scandals that have been plaguing the financial services industry in recent years have now reached the mutual fund companies. We believe the accusations while serious are not often very well explained the financial media. We would like to address this situation by explaining the allegations, putting them in context and the impact on Capital Strategies clients.

Several mutual fund companies have been accused of violating their fiduciary duty to their investors by trading ahead of investors or allowing others to that in exchange for compensation. The term “mutual fund timing” is sometimes used but the correct term is “time arbitrage”. The first form is late trading. This is where certain fund companies allowed outside entities to buy or sell after the financial markets closed (3 p.m. central time). For example, let’s say Intel reported after the close of the market that profits were going to fall short of expectations. Investors would know that the market was likely to fall the next day because Intel is an influential technology firm. If one could find a firm willing to let them out of the market at the 3 p.m. closing price, they would not lose money the next day like everybody else. One prominent hedge fund is reported to have made \$40 million in one year through such arrangements. This is what the Janus, Strong, Bank One, Alliance, and BankAmerica mutual fund companies are accused of. Alger and Prudential are also accused of similar improprieties.

The second form is time zone arbitrage. This involves capitalizing on the differences in trading hours of various world markets. On days where the U.S. stock market was up sharply, one might anticipate that Hong Kong and Japan might open strong when their markets opened the next day (technically, about 9 pm our time). If one could buy international funds on days when the U.S. financial market is up 150 points or more and sell them the next day to lock in their profits, one could make a lot of money. If you or I tried this, fund companies would rescind our ability to trade because we would be poaching some of the profits of long-term investors. But that is exactly what six international fund managers at Putnam are alleged to have done. This is not illegal in general, but in the case of Putnam it is prohibited by prospectus, so doing so was illegal.

It is important to put this in context. If true, these funds breached their fiduciary duty to their investors and that alone may be reason to avoid these mutual fund companies. However, in terms of losses to investors, it pales in

comparison to the brokerage and analyst scandals that have been uncovered in recent years. When securities firms have their analysts recommend purchase of stocks they themselves know are overvalued and they themselves are selling, investors can lose large sums of money. When companies conspire with firms like Enron, Worldcom, and Healthsouth to make transactions specifically designed to hide the fact there are losing lots of money, investors (and employees) can be financially devastated. When mutual funds companies allow others privileged trading access, investors make a little less than they should on up days, and lose a little more than they should on down days. There is no question that this is flat out wrong, but it is not particularly devastating to any individual investor. Putnam International Equity rose 21.3% in the year ending September 30<sup>th</sup>. What we don't know is, should investors have really gotten 21.6%? 21.8%? 22.5%?

*Capital Strategies clients have no direct exposure to these mutual fund companies.* We pride ourselves on knowing both the individual fund managers and the culture of the companies in which they operate. There are many mutual funds that have very good track records but we are uncomfortable using them. We can't promise that improper trading practices will never affect a fund we do business with. We can only assure you that if we find they did not honor their fiduciary duty, we will replace them as soon as possible.

*We continue to believe that mutual funds still make sense for most investors due to their accessibility, variety, flexibility, and liquidity.* The great majority of mutual fund companies still operate according to the highest business standards. There are many extremely capable, scrupulously honest managers out there, and we endeavor to pick from the best of them. We are as dismayed as you are with what has transpired in our industry. We will, as always, continue to look out for our clients' best interests and keep you apprised of any significant changes or developments as they occur. Please feel free to call us with any concerns or questions.

## **Capital Strategies Financial Corporation**

**Mark A. Carlton, CFA**

**Eric C. Graber  
President**