Many mutual fund and ETF investors don’t realize that their securities can be lent out to short-sellers and other borrowers. As Jason Zweig explains on The News Hub, that translates to good and bad news for investors.

You wouldn’t want to make a loan to someone without knowing what you will earn on the loan. But if you own mutual funds or exchange-traded funds, you might be doing exactly that.

Hedge funds and other traders need to borrow stocks and bonds from time to time in order to execute their strategies. To do so, they often turn to mutual funds and ETFs. In return for lending their holdings, the funds pick up a bit of extra income.

But it is fiendishly difficult for shareholders in the funds to tell whether they are getting a square deal. That matters because, in today’s markets, small differences in income can make big differences in return.

A new study finds that some funds earn drastically less than others on their securities-lending operations even when the funds themselves are similar.

One possibility: "The people managing your money may sometimes be managing it more to benefit themselves than to benefit you," says finance professor John Adams of the University of Texas at Arlington, one of the study’s authors.

Mr. Adams says the gap in the amount of money investors ultimately collect for their lending largess is determined primarily by who acts as the middleman. More income for a lending agent that is related to the fund manager means less income for the fund’s investors.

When funds engage in securities lending, the borrower gives them collateral in return. A securities lending agent helps the cash and investments change hands. Funds can act as their own "internal" lending agent, can hire an independent third party or can use an agent affiliated with the firm that also manages the funds.

Mr. Adams and his colleagues found that when a fund uses an agent that is part of the same company that runs the fund, the returns to investors from securities lending are 70% lower than at funds that use other lending agents.

The potential payoff can add up. The average return earned by portfolios that lent U.S. stocks ran about 0.04% in the third quarter of this year, according to Data Explorers, a London-based firm that tracks...
securities lending.

The smaller and more rarely traded the stock, the more lending income it tends to produce. While companies in the Standard & Poor's 500-stock index generated just 0.02%, the average small stock produced 0.13%, says Data Explorers.

"If properly managed, a securities-lending program is a source of income for the fund with virtually no risk, and those are hard to find," says Bill Pridmore of William F. Pridmore Ltd., a consulting firm that specializes in the area.

Most mutual funds and ETFs get to retain 65% to 85% of the lending revenue, with the agent getting the rest, according to industry experts. While most funds make at least some money on their lending operations, there still is "a very wide disparity in how much lending agents charge funds for their services," Mr. Pridmore says.

Some industry experts dispute Mr. Adams's findings. Christopher Kunkle, director of securities lending and market risk at the Risk Management Association, a nonprofit trade group in Philadelphia, says that once you adjust for different investment guidelines and portfolios, "I don't know of any instance from my professional experience or from the industry showing that mutual funds are treated any differently than other clients, whether the lending agent is affiliated with the sponsor or not."

There isn't any requirement for funds to disclose how much of their loan revenue they split with the lending agent, and most don't include that information in their reports to shareholders. It virtually is impossible for investors to get anything but the most rudimentary information about how their own assets are being lent or to evaluate whether they are getting a fair shake.

Your fund's schedule of investments and its Form N-Q filing, available at www.sec.gov, show whether it is lending securities. You can try calling your fund company to ask how big a cut the agent takes of your fund's lending revenue, but your odds of getting a useful answer aren't good, Mr. Adams says.

"With more transparency, there would be more clear-cut information," says Bo Abesamis, a securities-lending and custody expert at Callan Associates, an investment-consulting firm in San Francisco. "Then we could put the portfolio managers and the boards of directors to task for how the program is structured."

Fund boards should question why they are using a lending agent affiliated with the manager and whether the lending could be more profitable if done by the fund itself. "For some funds, that may not be practical," says Mr. Adams, "but they should at least be asking those questions."

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