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Heard Off the Street: After-hours trading just a bugaboo compared to this tactic

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By Len Boselovic, Post-Gazette Staff Writer

A lot of ink is being spilled over New York Attorney General Eliot Spitzer's crusade against a marauding investor who pillaged mutual funds. The most egregious behavior involved mutual funds that let Canary Capital Partners, a hedge fund, purchase funds after hours. Spitzer compares it to being allowed to bet on yesterday's horse race. Late trading is prohibited by law.

How the game is played

Two years ago, the Securities and Exchange Commission outlined how investors who actively trade shares of mutual funds can profit from big swings in the market. In a letter to industry officials, the SEC cited how a 10 percent drop in Asian markets, followed by a 10 percent increase in U.S. markets the same day, would affect a foreign stock mutual fund with \$50 million in assets, 5 million shares outstanding and a net asset value, or NAV, of \$10 per share.

If managers of the fund based the NAV on closing prices in Asia, the 10

But the far more pervasive game being played isn't. It's a game academics, mutual funds, the Securities and Exchange Commission and savvy traders have known about for years.

The problem stems from how mutual fund companies set the net asset value -- or NAV -- of their funds. NAV is the overall value of the investments held by a fund divided by the number of shares outstanding. A fund with \$10 million in assets and 1 million shares outstanding would have an NAV of \$10 per share.

Fund operators buy and sell shares of their funds at the NAV. Typically, the price is determined daily a few minutes after U.S. markets close. Calculating the NAV seems easy enough: multiply the closing price of each stock in a fund by the number of shares the fund owns, add them all together and divide by the number of fund shares.

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percent drop in stock prices there would reduce the fund's assets to \$45 million, resulting in a NAV of \$9 per share.

Knowing the NAV didn't reflect how the Asian stocks would react to the 10 percent rise in the United States, fund traders purchase 1.11 million shares of the fund at \$9 per share.

The next day, the fund's NAV is based on fund assets of \$60 million -- \$10 million provided by the fund traders' purchases and \$5 million from the jump in Asian stocks -- and 6.11 million shares (the original 5 million plus the 1.11 million the traders purchased.) That results in a NAV of \$9.82 per share.

Fund traders sell their 1.11 million shares at \$9.82, pocketing a one-day profit of about \$910,000 on their one-day wager of \$10 million.

-- Len Boselovic

next day.

It didn't take long for investors to exploit the discrepancy. Their strategy: buy a foreign stock fund on days when the U.S. market jumps and sell it the next day after the NAV moves higher based on what happened the previous day. (*see accompanying box.*) Among those who noted the phenomenon were academics, not all of whom were operating with strictly scholarly intent.

"We were thinking: 'Gosh, with our knowledge, we could retire,' " recalls Gregory Kadlec.

The Virginia Tech finance professor says he resisted invitations from hedge fund operators who asked him to fine tune their pursuit of mutual fund trading profits.

"To me, it's flat out unethical," he says. "It's legalized theft is what this

Students of the market have known for years that the more often a stock trades, the more its price reflects the latest information on which investors base their decisions. If all of the stocks in a fund trade within an hour of the market's close, the NAV will more accurately reflect the value of the fund's holdings.

But what happens when stocks don't trade as often, as is the case with stocks of medium and small companies? What happens when a small stock trades for the last time at noon and Federal Reserve Board Chairman Alan Greenspan announces a big interest rate cut at 3 p.m.?

The rate cut won't be reflected in the price of the small stock until it trades the next day. Yet the mutual fund company will price the fund's NAV based on the noon price even though it is probably unrealistically low.

The impact is even greater with overseas funds. Foreign stocks trade on exchanges that close long before Wall Street calls it a day. But funds that own them typically set their NAV based on closing prices overseas. What consequently happens in the U.S. market the same day can dramatically affect the value of those stocks, but it won't be reflected in the NAV of the fund until the

game is."

The game hurts investors who buy and hold funds. By selling shares too cheaply after good days and overpaying to buy them back the following day, mutual funds have penalized long-term investors. There are also trading costs and tax implications. Kadlec says one study of trading activity in international funds during the 1990s estimated the cost at \$1.4 billion.

It would be one thing if the traders were making money the old fashioned way, but they aren't.

"This has nothing to do with the fundamentals of the fund. It's more of a function of an imperfect market," says Wake Forest University finance professor Edward O'Neal.

The academic community began detailing the problem in scholarly journals in the late 1990s. They also hashed it over with the Investment Company Institute, the Washington lobby group for mutual funds.

"They knew something funny was going on because they saw the flows in certain funds were going crazy and they were correlating with what the market was doing the previous day," Kadlec says.

Funds have tried to thwart traders by imposing trading restrictions and redemption fees. Their efforts have dissuaded some and diminished the profits of others. But as O'Neal points out, what's a 1 percent redemption fee to a trader who's capitalizing on a market move of 5 percent? Moreover, critics say the restrictions penalize long-term fundholders who have already suffered enough.

The ultimate solution is to eliminate the one-day lag between a fund's NAV and market reality. Previous SEC guidance on the issue has been based on a 1940 law that allows funds to use "fair value" pricing when closing prices don't tell the whole story. In those cases, directors of the fund must make a good faith effort to value the stocks. Kadlec says the SEC's advice was too nebulous to be of much help to fund companies, who are worried about being sued by investors over their methods of determining fair value prices.

"They need the SEC to take a stand and they will follow," he says. "If there is no pricing problem, there is no problem with exploitation."

Just as Spitzer prodded the SEC on reforming Wall Street analysts, perhaps his investigation of the mutual fund industry will bring some progress on the pricing issue. Federated Investors and BlackRock, the fund company majority owned by PNC Financial Services Group, are among those subpoenaed by Spitzer.

Meanwhile, the industry worries about how long-term investors who

have been hurt most will respond to Wall Street's latest scandal.

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