



Mutual fund investors need to do homework

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State Attorney General Eliot Spitzer's allegations of widespread misconduct in the mutual fund industry has financial planners emphasizing that investors need to do their research before putting their money in a fund.

Investors should read prospectuses and research reports, investment professionals said. They should check to see how a fund has performed compared to other funds and major stock indexes. They should be on the alert for subtle clues that a fund may be involved in improper trading.

"I think before you give your money to anybody you've got to investigate them," said Vernon Hayden, president of Hayden Financial Group LLC in Westport, Conn. "My policy is that contrary to the justice system in the country every mutual fund company and manager is guilty until proven innocent."

Spitzer said last week that at least 30 fund companies, including Bank of America, Janus Capital Group Inc. and Strong Capital Management Inc., let New Jersey hedge fund Canary Capital Partners LLC engage in market timing and late-day trading. Canary and its manager Edward Stern agreed to pay \$40 million in fines and restitution.

Late-day trading is illegal, while timing is legal but most mutual fund companies say in their public documents they do not allow it. Both practices allowed Canary to take advantage of profitable trading opportunities other investors did not have.

Investment pros point to several signs that can indicate whether a fund is a good investment.

Hayden said investors should look for signs that a manager may be engaging in "portfolio pumping."

That practice involves using cash to buy large blocks of shares in stocks that the fund already owns just to inflate the value of those stocks and inflate the price of the fund. Companies are most likely to do this at the end of a quarter or year, which is the time when they report their results, he said.

"At the end of a period all of a sudden you'll see the share price in that fund go up," he said. "It can go up 1 to 3 or 4 percent. They'll do anything to get performance statistics up sometimes."

Christine Benz, editor of the Morningstar FundInvestor in Chicago, said investors should be encouraged if fund managers and executives are big investors in their funds.

But she said fund companies are not required to make this information public, so the only way to find out is if the companies volunteer it.

A Web site for Longleaf Partners Funds, which are managed by Southeastern Asset Management Inc. of Memphis, Tenn., says Longleaf employees must limit their equity investments to the funds. The employees must report their securities transactions each quarter.

It's encouraging when members of a company's board of directors are independent — meaning free of business or other connections to managers and executives — Benz said. It's a good sign if board members are paid in fund shares because it means they have an incentive to make decisions that benefit shareholders, she said.

Experts also say companies should cap the size of their small-stock funds so they're not too large to manage.

Vijay Singal, a professor of finance at Virginia Polytechnic Institute and State University, said investors should closely examine funds to see if there are a lot of foreign stocks, which gives the fund company a chance to offer select clients the

chance to time the market.

If, for instance, the Japanese market closes at 2 a.m. New York time and a U.S. fund manager uses the closing price of the Japanese shares in a fund to arrive at a price at 4 p.m. in New York, the manager is relying on market information that is 14 hours old.

If there have been positive market moves during the New York trading day, that will cause the Japanese market to rise when it opens later and the "stale" Japanese prices will not reflect the good news, meaning those prices will be artificially low.

A trader who buys at the stale price is nearly guaranteed a profit by selling the next day.

An investor who is interested in a fund with a significant number of foreign stocks should call the manager and ask what steps the company takes to prevent shenanigans, he said.

A fund company can charge redemption to investors who buy shares and then sell them within a certain period of time, Singal said.

Vanguard Group, the second largest mutual fund company in the nation, said last week that it charges a fee equal to 2 percent of assets if an investor redeems shares funds of an international equity fund in less than two months. The company also limits an investor to being able to buy or sell shares in a fund twice a year.

The company, which denied it has participated in late-day trading or timing, said it also scrutinizes large transactions.

But the difficulty for average investors is that few have the time, savvy or access to conduct a thorough investigation of how a fund company operates.

"Unfortunately, I don't think any amount of research you do on a fund company is going to tell you whether they're committing fraud," said Jason Greene, a professor of finance at Georgia State University.

That means investors may have to rely on an adviser who has expertise and enough clout to get an audience with a fund manager.

Hayden, whose acumen has earned him the nickname "Mr. Mutual Fund" from commentators on cable television network CNBC, said he routinely grills fund managers over the phone.

He said he wants to know the manager's strategy for buying particular stocks. What's the manager's strategy for selling those stocks? How will the manager react to market of industry events?

Those who are so spooked by the emerging scandal that they want to bail out of mutual funds forever have choices.

Greene said he does not believe picking individual stocks is a good move for those who want out of mutual funds. The reason they got into mutual funds in the first place was to invest in a diverse array of securities and avoid the risk of individual stocks, he notes.

He suggests investors turn to fund companies that he believes have been good stewards of investors' money, such as Vanguard or T. Rowe Price.

Greene suggests investors also continue to invest in exchange traded funds. Those are pools of securities that are traded on major stock exchanges and that track specific market indices or sectors. Fans of exchange traded funds say they offer the advantages of index mutual funds and the liquidity of stocks.

"There you can get the exposure to a diversified portfolio without having to worry about some of the funny business that's been going on," Greene said.

Dale Bryant, portfolio manager at The Bryant Group, an investment advisory firm in Manhattan, said he believes people investing \$15,000 to \$100,000 should choose exchange traded funds over mutual funds because they offer lower fees.

"I'm a big fan of ETFs," he said. "You get the same exposure but it's almost a tenth of the cost."

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