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Critics Slam Focus of Mutual Fund Probe

By JUSTIN POPE
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BOSTON - Regulators may be cracking down on the mutual fund business, but some people think they're missing the forest for the trees.

The string of allegations against fund executives at Putnam Investments and several other firms have turned "market timing" into the latest dirty word in finance. But some want the spotlight on another term - "stale pricing" - which they believe is the real source of the \$7 trillion mutual fund industry's woes.

In short, stale pricing - the fact that many mutual fund prices are adjusted just once a day, and may not reflect the true value of their underlying assets - may be the reason market timing is a temptation in the first place.

"The SEC has consistently ignored that problem over a number of years," said Mercer Bullard, a former Securities and Exchange Commission official who now heads the Oxford, Miss.-based watchdog group Fund Democracy.

Market timing is a nebulous and even misleading term that refers to trading quickly in and out of mutual funds. It isn't illegal, though many companies discourage or prohibit it. Regulators aren't going after market timing per se; instead, they're alleging fraud by the fund companies for turning a blind eye to the practice, or by individual employees for using deception to skirt the fund companies' rules.

The scandals may prompt further limitations on market timing by regulators and fund companies, whose tools for discouraging the practice include charging stiff fees for frequent fund redemptions.

But there's a limit. Investors have legitimate reasons to maintain some freedom to trade in and out of funds at least somewhat regularly, especially if markets are volatile.

"If you said there will be no market timing, how do you define market timing?" said Michael Caccese, a securities law expert at the Boston firm Kirkpatrick & Lockhart. "(Is this) somebody who's really moving in and out or somebody who's closing on a house?"

That's why some think it makes more sense to go after stale pricing, which would make market timing less attractive.

The prices of stocks and bonds are updated constantly based on whatever the market is offering. But most mutual fund prices change just once a day, usually at 4 p.m., when the U.S. stock markets close.

Constantly recalculating the value of funds, by adding up the ever-changing values of the underlying assets, would be a huge headache. Besides, most funds are intended for long-term investors who aren't supposed to care much about swings within 24 hours.

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But a lot can happen in 24 hours, and 23-hour-old mutual fund prices may not reflect the true value of the underlying assets, especially if those assets are spread across different time zones.

For example, if a fund owns shares in an Asian company that announces poor results after the market closes there, at 2 a.m. EST, the fund price may not incorporate that news even though it's an excellent bet the price in Asia is headed down.

Not surprisingly, traders see money to be made by taking advantage of the price lags. Eric Zitzewitz of Stanford University's business school has estimated such trades might skim \$5 billion a year from other investors.

Of course, identifying undervalued and overvalued assets is really just what every investor does every day. But some say this is more like shooting fish in a barrel. It isn't about predicting where the market's going. It's noticing where it already is.

"You know where it's been, the price just hasn't gotten there," said Greg Kadlec, a finance professor at Virginia Tech who has written about the issue. "These people aren't rocket scientists."

Putnam was at the forefront of a movement dating to the 1980s toward "fair value pricing," which many fund companies now implement. Instead of adding up net asset values (the "NAV" method), funds make "a good faith effort" to determine a fair price. In the Asia example, for instance, they may use the after-hours trading value of the stock.

"The SEC said this is what you should do, but they really didn't give you much guidance," Caccese said.

Cindy Fornelli, deputy director of the SEC's division of investment management, said the SEC has given "comprehensive guidance" about fair value pricing in two letters published in 1999 and 2001.

But fair value pricing is as much art as science, and the SEC worries that getting too specific in its instructions to fund companies could tie their hands. Fund companies would likely be better at pricing their own funds than the SEC would.

But, when asked about possible reforms to fair pricing, Fornelli said: "We are taking a step back and canvassing the entire mutual fund industry to see where else we might need reforms, what else we might need to do."

Bullard, of Fund Democracy, is disappointed that regulators haven't moved against stale pricing. He thinks some types of stale pricing violate federal securities law, and said regulators should have sued Putnam for that, not fraud.

"I'm still quite disappointed that the most significant harm to shareholders is continuing to be left untouched," he said.

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