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STRATEGIES

Why an S.E.C. Hurdle Won't Stop Fund Speculators

By MARK HULBERT

THE Securities and Exchange Commission proposed last month that mutual funds be required to charge shareholders a 2 percent fee on all sales made within five days of purchase. While such a fee might well discourage short-term trading, it would not help ordinary investors.

That is because the proposal doesn't address the root of the problem: the stale pricing of funds. Stale prices result from the delay between the last trade of a fund's securities and the calculation of a fund's per-share value. Arbitrageurs have been able to exploit stale prices and profit at the expense of ordinary shareholders.

Gregory B. Kadlec, a finance professor at Virginia Tech, says the S.E.C. plan "is like trying to stop a freight train by placing a penny on the railroad tracks," because arbitrageurs do not need to sell fund shares within five days to lock in a profit.

Professor Kadlec bases his assessment on a study of stale prices he conducted in 1999 with John M. R. Chalmers, a finance professor at the University of Oregon, and Roger M. Edelen, a former finance professor at the Wharton School of the University of Pennsylvania and now managing director of research at ReFlow Inc., a firm that helps mutual funds manage the cost of inflows and outflows. In their research, they showed not only that stale-price arbitrage was profitable when holding periods exceeded five days, but also that speculators could increase profits by not selling immediately.

The professors' study appeared in December 2001 in *The Journal of Finance* after circulating as an academic working paper for more than a year.

To understand the researchers' argument, consider a Japanese stock fund that is based in the United States. Each day at 4 p.m. Eastern time, it calculates its net asset value based on the last trades of each stock it owns. Those prices are stale, of course, because they reflect the close of the Japanese market more than 12 hours earlier.

Stale prices give speculators a profit opportunity on days when economic news during the New York trading day is particularly good, and the United States stock market climbs sharply. On such days, the odds are high that the Japanese market will rise when it next opens. By buying the Japanese fund, speculators can invest in Japanese stocks at prices that prevailed before the good news was announced.

In the debate about stale prices, many people assume that such a speculator would sell this fund the next day. Undoubtedly, many speculators do, so the S.E.C. rule would deter them. But the researchers suspect that hedge funds and other institutional arbitrageurs typically do not sell right away, and that their profit, on average, has been double that of those who do.

Speculators who don't exit immediately can sell short an equivalent dollar amount of Japanese stock index futures contracts. Those contracts, traded in Chicago, are not calculated using stale prices. That lets speculators sell at a fair price in the futures market what they are buying at an artificially low price through the mutual fund. The profit they lock in is the difference between the two prices.

So long as this hedge remains in place, the speculators' profit is virtually assured. If the Japanese stock market declines, the short position in index futures should gain roughly the amount the mutual fund loses; if Japanese stocks rise, the mutual fund's gain should more or less equal the loss in the index futures position.

This hedge allows speculators to sell their mutual funds on a day when the United States stock market falls significantly. That gives them another chance to profit, because the odds are high that the Japanese market will decline sharply when it next opens. By selling the Japanese fund, and simultaneously covering their short position, the speculators realize an additional profit, which the researchers have found to be roughly equal to what the speculators captured when they first bought the fund and shorted the index futures.

THIS exit opportunity rarely comes within five days, the researchers found. But even if it did, the futures-based hedge lets speculators wait until a later day of market declines before leaving.

Although data is not available, Mr. Edelen said he would be "highly surprised" if significant numbers of hedge funds and other arbitrageurs were not using this hedging strategy. He said the S.E.C.'s proposed rule would not curb their activities, even though their trading inflicts the greatest damage on long-term fund shareholders. Furthermore, he suspects that the rule might encourage more speculators to try the hedge, causing more harm to long-term shareholders.

In proposing the fee redemption policy, the S.E.C. conceded that the "principal solution" to stale-price arbitrage "is the accurate calculation of net asset value each day, using current and not stale prices." Mr. Edelen worries that a focus on redemption fees will divert attention from that goal.

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