

November 21, 2003

NEWS ANALYSIS

## A Band-Aid for the Fund Industry's Broken Leg?

By DIANA B. HENRIQUES

**W**hat is the best way to fix what is wrong with mutual funds? The House of Representatives has offered a grab bag of options in a bill approved on Wednesday. But the bill may not sufficiently address the short-term trading abuse at the heart of the scandals that have come to light since September.

The abuse involves traders reaping extraordinary profits, at the expense of long-term investors, by quickly buying and selling the shares of funds whose purchase prices do not yet reflect gains in the prices of the funds' underlying assets.

The House bill's primary ammunition against this kind of trading seems to be to allow funds to increase redemption fees, from the current limit of 2 percent for investors who pull their money out too soon or who trade too often.

But many scholars who have studied the problem say that high redemption fees could wind up hurting the very people Congress is trying to protect - the long-term, middle-income investors in mutual funds - by making it riskier for them to invest money they might need for emergencies. The fees could backfire for the industry, as well, by making mutual funds less attractive in an increasingly competitive marketplace, several researchers said. Worse yet, the fees may not even be effective against the abuse that Congress is trying to prevent, a few of them warned.

It comes down to the difference between treating a symptom and curing the disease, said John M. R. Chalmers, a professor at the Lundquist College of Business at the University of Oregon. "If mutual fund shares were priced correctly, there would be no opportunities for market timers and thus redemption fees would be unnecessary," he said.

And funds are not always priced correctly, academics and industry experts agree, because federal law requires funds to set the share price once a day, usually at 4 p.m. Eastern time. At that hour, some fund investments - foreign stocks, high-yield bonds, thinly traded domestic stocks - may not have traded for many hours. If those stale valuations are used for calculating the share price, the price will not reflect market gains that occurred since those securities last traded. That gives traders a chance to buy the fund's shares, wait until the price does reflect those gains, and then cash out with big profits, a practice sometimes called stale-price arbitrage.

Mutual funds already have the option of adjusting those stale prices to reflect market moves through a process known as fair-value pricing. Funds that regularly use fair-value pricing - including many Fidelity and Vanguard funds - appear to have been much less vulnerable to the "market timing" abuses.

The fine print in the House bill requires federal regulators to "clarify" that funds are obligated to adjust their stale prices under certain circumstances. Though that has been the stated regulatory policy for more than two years, academic studies show that more than half of the fund industry uses the technique too rarely to have more than a minuscule impact on stale prices.

"It is critical that regulators understand that fair-value pricing should be the primary focus of the solution to the problem," said Gregory B. Kadlec, a professor at Virginia Tech and an author, with Mr. Chalmers and Roger Edelen, formerly of the Wharton School, of one of the earliest papers on the issue.

"While short-term transaction fees are probably a necessary part of the solution," Mr. Kadlec said, "transaction fees represent only a Band-Aid that is unlikely to ever eliminate all market timing if used in isolation."

For one thing, redemption fees will work only if they are universally applied and enforced. They are expensive to enforce, and they are difficult, if not impossible, to enforce in some of the biggest marketplaces for mutual funds - 401(k) plans, fund supermarkets like [Charles Schwab](#) and variable annuities. Indeed, many of the fund companies sucked into the current scandal had redemption fees to discourage short-term trading.

And a redemption fee "is a very coarse weapon - it affects everyone, not just the ones who are the target," said K. Geert Rouwenhorst, a professor at the Yale School of Management. "The longer the holding period and the higher the fee, the more we deter short-term trading, but the more we affect the long-term investors, too."

Since the invention of the American mutual fund in Boston in 1924, one of its historic advantages has been instant liquidity for small investors who may need their savings for a rainy day. Losing that classic advantage, experts say, could make mutual funds less competitive.

"The beautiful thing about mutual funds was that they gave you infinite liquidity," said Robert F. Whitelaw, a professor at the Stern School of Business at New York University. "You can imagine a situation where, hell, you just invested and you suddenly need the money. After all, stuff happens."

By reducing both the perception and the reality of liquidity, he said, redemption fees could make mutual funds less attractive to investors who have few other investment options.

And that could make the fund industry itself less competitive in the marketplace, said Professor Rouwenhorst of Yale. "There are competitors to mutual funds - like exchange-traded funds - that are competing on the basis of transaction costs and liquidity," he said. "And now, we're trying to protect mutual funds by raising their transaction costs and reducing their liquidity."

Some academics are convinced that fees will not even prevent the abuses now coming to light.

Eric Zitzewitz, a Stanford economist whose research has been cited by investigators, estimates that fees far larger than those contemplated in the bill, imposed on all shares sold within five days of purchase, would reduce the excess profits from stale-price arbitrage by only about half - from almost 50 percent a year to about 24 percent a year, still high enough to be attractive.

The problem with this bill, Professor Zitzewitz said, is that it reflects the regulatory and industry view that "stale-price arbitrage should be addressed with fees primarily, and occasional use of fair-value pricing."

"This," he added, "is essentially the status quo, and we know that the status quo is not working."