# THE COMPASS CHRONICLE

*Highlighting important financial planning and investment issues* *Winter 2004*

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A client-focused financial advisory firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our financial advisory services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Family Cash Flow Analysis

## In This Issue . . .



# Where has the Integrity Gone?

*Somewhere along the road, the industry has lost its way. In my view, too many fund complexes have put the business need for asset gathering, the better to enhance the profits earned by fund managers, ahead of the fiduciary duty to provide efficient asset management at the lowest reasonable price, the better to enhance the returns earned by fund shareholders.*

– John C. Bogle, *Bogle on Mutual Funds* (1994)
[John C. Bogle is the founder of The Vanguard Group]

### What's Going On?

Approximately 95 million Americans invest in mutual funds with assets totaling $7 trillion. The mutual fund industry has enjoyed a generally excellent reputation for keeping its shareholders' interests first and realizing that the industry's primary asset is really investors' trust. Unfortunately, recent events have shaken the confidence of many investors and led to large asset outflows from implicated fund companies.

The initial event that brought mutual fund improprieties to the forefront was New York Attorney General Eliot Spitzer's allegations a few months ago that Canary Capital Partners, a New Jersey-based hedge fund, pursued illegal activities that involved several mutual fund companies. The U.S. Securities and Exchange Commission (SEC) and the Secretary of the Commonwealth of Massachusetts, William Galvin, among others, have subsequently initiated their own investigations and additional fund companies, their executives, and portfolio managers have been implicated. Two primary allegations have been made against the fund companies and individuals: allowing market timing arrangements and the late trading of mutual fund shares.

### Market Timing

Market timing, in this context, is the frequent trading of fund shares in an attempt to take advantage of either (1) a fund's short-term price movements or (2) pricing discrepancies between a fund's share price and its underlying holdings. While market timing as an investment strategy is not illegal, it is illegal for fund companies that have expressly forbidden the practice in their prospectuses to allow preferred customers (e.g., hedge funds) to violate fund policies. Despite the anti-timing rules listed in prospectuses, a survey released by the SEC in November of the nation's 88 largest fund firms, which manage 90% of the industry's assets, found that one-half had timing arrangements with selected clients.

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Many mutual fund companies place restrictions on such activity due to the costs incurred by a fund's other shareholders. These costs ultimately are a drain on performance due to the higher transaction costs through the purchasing and selling of securities and a higher level of cash that must be maintained in a fund to meet redemption requests of market timers. The benefit to the fund companies for allowing market timing is higher fees from managing funds with larger asset bases, especially as some of the favored shareholders proposed investing additional money in a fund company's other funds in order to receive preferential short-term trading treatment.

According to testimony by Spitzer and the SEC before Congress on November 3, market timing by preferred customers costs individual investors between $5 and $6 billion per year and leads to $10 billion per year in unjustified fees. In addition, according to the SEC, more than 30% of the fund companies admitted that their managers gave sensitive portfolio information, such as holdings information, to favored shareholders. Funds are required by law to release their holdings information semi-annually in reports to shareholders, though some release top-10 holdings more frequently. Providing market timers with more frequent and nonpublic information provides them with another distinct advantage over long-term shareholders.

### Late Trading

Though market timing is not inherently illegal, late trading, or the placing of mutual fund trades after the market is closed but receiving the prior closing price, is illegal. It is akin to knowing the next winning number in the lottery—you can benefit by knowing the outcome in advance. Many stocks that are held by mutual funds trade after the U.S. stock market closes at 4:00 p.m. EST, either in aftermarket U.S. trading or overseas. If news is released after the normal market close, the price of the impacted stock can be expected to move in off-hours trading. For example, if Microsoft releases unexpectedly good earnings at 4:15 p.m. and you are able to purchase Microsoft Mutual Fund, which exclusively owns Microsoft stock, at the 4:00 p.m. closing price, you will be able to benefit from the stock's appreciation prior to the next trading day. The ability to late trade can significantly enhance the profits that market timers can achieve.

The SEC survey found that one in four of the country's largest broker-dealers allowed the late trading of funds even though it is an illegal practice. One such company, Security Trust, a Phoenix-based intermediary between funds and retirement plans, institutions, and financial advisers, was accused by New York Attorney General Spitzer of acting as the middleman to assist hedge funds, including Canary Capital Partners, in buying and selling mutual funds after the market's 4:00 p.m. EST close.

### Who's Been Implicated?

Many fund companies have recently received requests for information from regulators. We should note that these are merely requests and do not imply improprieties by those fund families that receive them. However, several fund families have been tainted by actions thus far:

**Putnam**—Lawrence Lasser, the CEO of the nation's fifth largest fund company, resigned after the SEC and Massachusetts regulators brought civil charges against Putnam for failing to prevent four former fund managers and two analysts from improperly trading in its international funds. Several state pension funds subsequently decided to replace Putnam, including Massachusetts, Rhode Island, New York, Iowa, and Vermont.

**Strong**—Chairman and CEO Richard Strong resigned in December from Strong Financial, a company he founded in 1974. He has plans to divest his controlling stake in the firm, which has $43 billion under management. Richard Strong has been accused of improper short-term trading of his fund family's own funds, in violation of Strong's prospectuses, earning profits estimated to be at least $600,000.

**Pilgrim Baxter & Associates**—In November, the two founders of Pilgrim Baxter and its mutual fund company, PBHG, Gary Pilgrim and Harold Baxter, resigned after the firm disclosed that the executives were connected to timing trades in shares of PBHG funds.

**INVESCO**—The New York Attorney General and the SEC filed civil fraud charges in December against the fund firm and its top executive, alleging that they violated the

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## Did You Know . . .

that for the 2003-04 academic year the average cost to attend college is $10,636 for 4-year public institutions and $26,854 for 4-year private institutions, according to the College Board? These figures include tuition, fees, room, and board, but exclude books, supplies, transportation, and other expenses. For parents to fully pay for a newborn's college education in 2021 will require $132,808 as an in-state resident of a public university and $335,316 for a private university, assuming a 6% inflation rate for college costs.

COMPASS Investment Advisors, LLC can assist you in establishing the most appropriate account(s) to help meet your education savings needs.

# Are Your Beneficiary Designations Current?

Do your beneficiary designations reflect your current intentions? With the start of a new year, we often review the year past and contemplate the year ahead. Yet, we may forget to consider some of the most rudimentary but important items. The beginning of a new year can be a good time to review those you have listed as beneficiaries of your retirement accounts and life insurance policies.

When you open a retirement account or establish a life insurance policy, you are required to provide primary and contingent beneficiaries for the account or policy's proceeds when you pass away. These beneficiary designations are legally binding and provide for the passing of assets outside of probate. For a retirement account, such a designation must be made whether it is an employer-sponsored account (e.g., 401(k), 403(b), or 457), an account for the self-employed (e.g., SEP-IRA, KEOGH Profit Sharing, or KEOGH Money Purchase), or an individual account, such as a Rollover IRA, a Traditional IRA, or a Roth IRA. The same holds true for life insurance policies, whether they are provided as a benefit of your employment or you have purchased them individually.

Events that may cause you to want to change your beneficiary designations include a marriage or divorce, birth of a child, or the death of a listed beneficiary. If you are unsure whether your current beneficiary designations reflect your current intentions, contact your financial services provider and complete new beneficiary paperwork if necessary.

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firm's own rules and harmed investors by allowing dozens of market timers to conduct short-term trading in at least ten INVESCO funds.

Regulators have alleged that other fund families, including Fred Alger Management, AllianceBernstein, Federated, Janus, Nations Funds, and One Group, allowed either market timing or late trading. [We presently use one mutual fund from the fund families listed here, Janus Small Cap Value. This fund is not managed by Janus personnel, but by Bob and Tom Perkins of Perkins, Wolf, McDonnell & Company of Chicago, the fund's subadvisor. The fund was previously part of the Berger Funds group until it was merged into the Janus fund family in April 2003. As such, Janus Small Cap Value has not been implicated in Janus' difficulties and we continue to recommend the fund to clients. Morningstar, an independent evaluator of mutual funds, has reached a similar conclusion, encouraging investors "to avoid Janus' in-house funds," while suggesting that Janus Small Cap Value continue to be held.]

### Impact on You

Ultimately, regulatory pressure and its consequences will result in more equitable policies and procedures for all mutual fund shareholders. Shareholders of impacted mutual funds may receive restitution from guilty fund companies, which will be fined and required to disgorge the profits they made from improper activities.

In addition, more fund companies may employ the use of devices designed to restrict the harmful effects of market timing and late trading. Redemption fees may be imposed on more funds, requiring short-term shareholders (normally a holding period of 90 days or less) to pay one to two percent on the assets redeemed. Note that these redemption fees are reinvested into the impacted fund and are not paid to the fund company. Exchange privileges, or the number of exchanges allowed within a fund per year, may also be reduced, as well as setting early trading cutoffs for fund purchases and sales.