Memo To: Oaktree Clients

From: Howard Marks

Re: The Feeling's Mutual

Throughout the recent, seemingly endless series of scandals, complaints, settlements, indictments and meltdowns involving corporations, auditors, brokerage firms, investment banks and hedge funds, the mutual fund industry remained untouched. That held true until September 3, when the Attorney General of New York State announced that Edward Stern of hedge fund Canary Capital Partners had paid $40 million to settle charges relating to improper dealings between Canary and a number of mutual funds. Since then, sordid disclosures involving mutual funds seem to be emerging on a regular basis.

The Canary That Swallowed the Cat

What did Canary do wrong? It admitted to "mutual fund timing" and "late trading." Both of these tactics take advantage of what I would call "temporal disconnects" in the process through which the price for transactions in mutual fund shares is set. A fund's Net Asset Value is supposed to reflect the per-share value of the assets held in the fund's portfolio, so that people buying or selling fund shares at that NAV pay or receive a fair price for their portion of the fund's portfolio. However, the process is non-dynamic, in that the NAV is set just once a day based on the underlying securities' latest closing prices and isn't updated for events that occur subsequent to the market closings or subsequent to the time of the calculation. Canary acted to profit from instances when security prices used to calculate the NAV had become "stale."

Most forms of market timing consist of people undertaking trades in order to implement their views regarding the future direction of security prices. Mutual fund timing is different, however, because the fund timer acts to profit from events that occurred in the past.

The opportunity for mutual fund timing arises from the fact that every fund's Net Asset Value is calculated as of the close of trading at 4:00 p.m. Eastern Time, and orders for fund shares entered up to that time are executed at that price. (Under the rules, orders placed after 4:00 p.m. are executed at the next day's NAV.) In brief, the mutual fund timer acts to take advantage of knowledge that a security price factored into a fund's NAV is out-of-date and not reflective of recent events. For an example, think of a mutual fund that holds a U.K. stock, the trading of which ceased at 4:30 p.m. London time. Since 4:30 p.m. London time is equivalent to 11:30 a.m. in New York, it's the stock's price at 11:30 a.m. Eastern Time that'll be used to calculate the NAV at 4:00 p.m. Thus a timer has 4½ hours in which to watch for a development rendering the London closing price obsolete, be it a general market movement or a company-specific event. In extreme cases involving infrequently traded securities, a timer may gain an advantage from knowledge that security prices haven't been updated for days or weeks.

At first glance, this all appears relatively benign. It is not improper in itself to trade on knowledge that the prices of some fund holdings are stale. All investors have potentially equal access to this information, and they all have the same ability to enter orders for fund shares up to 4:00 p.m. Eastern Time. Further, most of these situations involve small pricing imperfections that relate to a small portion of the fund's portfolio, and trading on them isn't likely to materially change the return on a long-term investment in the fund.

However, these trades can be highly profitable if the impact is magnified through minimization of the holding period. (E.g., taking advantage of a 1¢ error in a $10 NAV will add just .1% to the annual return if the fund shares are held for a year, but taking advantage of a new 1¢ disparity every day will increase the annual return by 25%!) Obviously, then, the key to achieving unusual profits through mutual fund timing lies in rapid-fire trading.

The problem is that "knowledge-advantaged short-term trading" is inimical to the interests of a fund's other holders – **in essence, these tactics permit a bystander to occasionally dart into the game and appropriate for himself some profit that otherwise would accrue to the fund's long-term investors** (and also to run up the fund's costs). There are tools the funds can use to discourage short-term trading: they can impose exit fees, turn away investors based on their past behavior, or revoke trades. Many funds have policies of fighting short-term traders, and those policies and the actions the funds will take are set forth in their prospectuses. That's where the problem comes in.

The complaint against Canary Capital states that, "Canary entered into agreements with dozens of mutual fund families allowing it to time many different mutual funds." Some of these funds ignored or contravened the policies stated in their prospectuses, and some accepted compensation for doing so. It is these actions on the part of the funds – and what Canary did to induce them – that are improper.

Late trading is highly analogous to fund timing – it's another form of "knowledge-advantaged short-term trading." However, in this form it consists of placing a buy or sell order for a mutual fund after the 4:00 p.m. deadline, for execution at the previously set NAV, in contravention of the SEC's "forward pricing rule." This is done in order to profit from developments that have occurred since 4:00 p.m. and thus are not reflected in the security prices underlying the NAV set at that time.

Consider the example of a mutual fund that has 4% of its portfolio in a stock that closed today at $40. An hour after the close, the company announces startlingly good earnings. A "late trader" may conclude that the stock will trade tomorrow at $50, and thus that, everything else being equal, tomorrow's NAV will be higher by 1% (the 25% stock price increase multiplied by the 4% position in the stock). Thus at 5:30 he enters an order to buy the fund at today's NAV, implicitly buying the company's shares at $40 and trusting that the NAV will rise tomorrow. On average, these trades can be highly profitable . . . if the holding period is short enough.

Late trading is less ambiguous than fund timing. It's wrong (and illegal), and no one should be able to do it. It, too, takes away some of the profit that should have gone to the fund's long-term holders. Again, Canary made improper arrangements that allowed it to divert those profits to itself.

Eliot Spitzer compared these two tactics to "betting today on yesterday's horse races." **I seem to recall gamblers calling this "past-posting"; see the classic movie "The Sting" for a tutorial. You'd be surprised how easy it is to win when you bet on races that already have taken place.** All you need is a way to get the bet down. And although making the bet may not be illegal in itself, the things you have to do to get someone to take the bet probably will be.

Canary found mutual fund companies that were willing to permit fund timing and late trading in exchange for capital commitments and fees. **In exchange for benefits for themselves, they were willing to assign some of their investors' profits to Canary.** The relatively open manner in which these arrangements were negotiated, documented and communicated to senior managers (who seem not to have taken exception) suggests to me that the people involved were more stupid (and/or ethically tone-deaf) than they were larcenous. Regardless, however, the schemes went forward, and the NY Attorney General says Canary made "tens of millions of dollars" in this fashion. (Two additional examples have come to light this week. A portfolio manager at Alliance Capital was suspended on suspicion of permitting late trading in his mutual fund in exchange for commitments of capital to his hedge fund, perhaps to increase the incentive fees in which he would share. Also, a former trader at hedge fund Millennium Capital pled guilty to engaging in after-hours mutual fund trading.)

Is This A Big Deal?

The money Canary made from these machinations, while very meaningful to Canary, probably represents a "flesh wound" for the funds' investors. Even "tens of millions" wouldn't materially change the investors' return when spread over a number of billion-dollar mutual funds and a three-year period.

Spitzer's complaint cites an academic study estimating that these tactics divert $4 billion of profits per year from their rightful owners, the funds' long-term investors. Again, a large absolute sum but not material in relative terms: $4 billion equates to six one-hundredths of a percent of the $7 trillion total invested in mutual funds – $6 per $10,000. On September 19, the Wall Street Journal cited research estimating that in the fund classes where fund timing might be most profitable, it could reduce investors' annual returns by 1-2%.

So the damage done to an individual shareholder, or all of them put together, isn't enormously material relative to the amount invested, or even the annual return. And by the time the plaintiff's lawyers subtract their fees, the damages won for the aggrieved parties aren't likely to be noticeable.

It remains to be seen whether these tactics were widespread. In any case, I believe they're likely to be less so hereafter. The bottom line for me is that the Canary case, and the existence of fund timing and late trading, doesn't mean the mutual fund game is stacked against the investor. **So does that mean the mutual fund industry is free from major shortcomings? I don't think so.**

<u>The Client Comes First!</u>

Just as in other corners of the money management industry, mutual fund companies face opportunities to make tradeoffs between their own welfare and the welfare of their clients . . . the two of which are far from identical.

There's no question that the interests of clients should come first. Like lawyers, executors and trustees, money managers are fiduciaries. They hold positions of trust and owe a special duty to their clients. **They are not supposed to "split the loaf" between themselves and their clients. Rather, the whole loaf must go to the client, in whose favor all conflicts of interest should be resolved.** This is different from automobile sales, for instance, where it's completely acceptable – and universally understood – that the salesman will try to negotiate a higher sale price for a car in order to generate more revenue for his employer and more commission dollars for himself. Nobody's surprised to hear that car salesmen aren't fiduciaries.

But besides being fiduciaries, mutual fund companies – like other money management firms – are for-profit organizations and marketing machines whose ultimate goal is to collect assets and make money. (There's at least one conspicuous exception: the Vanguard Group – whose Convertible Securities Fund we run – is a not-for-profit company owned by the investors in its funds). Jack Bogle founded the Vanguard Group and is a constant gadfly on the subject of mutual fund company behavior. In an article in the New York Times of September 14, he put it simply:

> The Investment Company Act says that the interests of fund shareholders must be placed ahead of all others, but the interests of managers have taken precedence.

<u>Who Protects the Clients' Interests?</u>

In theory, a mutual fund is entirely separate and independent from the company that organizes it. The fund company doesn't "own" the fund or have the "right" to be its adviser. The directors of the fund are supposed to supervise the conduct of the fund, choose the adviser and revisit their decision annually. **I would characterize this arrangement as largely a legal fiction.**

The website of the Investment Company Institute, an industry lobbying group, states the following:

> The directors or trustees of a mutual fund, as in the case of other types of companies, have oversight responsibility for the management of the fund's business affairs. . . . Under state law, directors . . . are expected to exercise sound business judgment, establish procedures and perform oversight and review functions, including evaluating the performance of the investment adviser . . . Directors also owe a duty of undivided loyalty to the fund.
>
> Overlaying state law duties is the fundamental concept of the 1940 Act that independent fund directors serve as watchdogs for the shareholders' interests and provide a check on the adviser and other persons closely affiliated with the fund.

In my opinion, a number of significant issues surround mutual fund directors:

- **First and foremost, I am highly skeptical of their collective performance, given that it is unheard of for a fund company to be terminated as the investment adviser of one of its funds.** Have you ever heard of fund company XYZ being relieved of its duties as adviser of the XYZ Fund? From the fact that it never happens, we're supposed to believe that **in every case** the independent directors review the award of the management contract and conclude that XYZ continues to be the best possible manager for the fund. Can we possibly believe this process takes place? And that the fund company **never** deserves to be replaced?

- It seems unlikely that some of the directors in big fund families can know enough about all of their funds to make informed decisions. For example, the New York Times mentioned that the chairman of one fund board monitors 191 funds, and that a director oversees 60. How much can these directors know about the operation of each fund?

- There is good reason to question the independence of some of the funds' "independent directors." A good number of them are former employees of the fund companies. How likely are they to take away an advisory contract from their former firms? And how likely is an independent director to remain a director after he votes to fire XYZ as the manager of the XYZ Fund?

- Lastly, as in the case of corporations, there's the paradox of director compensation. Being a good director involves a lot of work, and it probably won't be done without a lot of compensation. But if the compensation is high enough, directors will want the job too badly to allow them to rock the boat. The board chairman referred to above was paid $816,000 last year. How likely is he to vote to fire the management company?

The September 14 Times article included the following statements from observers of the mutual fund industry:

> Mutual fund directors sit on too many boards, and they are paid too much money for the time they devote to each individual portfolio. Under existing law the investment adviser is able to exercise a pervasive influence over the board. (Lewis D. Lowenfels, a securities lawyer at Tolins & Lowenfels)
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> Directors certainly aren't doing much. We don't see much in the way of fee reductions – we see fee increases. When funds do terribly badly we don't see any management changes. We see directors' pay going up every year, and we see some pay that is just beyond the rule of reason, often paid to former executives of the management company. Fund boards only meet four times a year on average and they are still dominated heavily and intellectually by affiliated directors. (John C. Bogle)

There were also a number of quotes from fund management company spokesmen:

> The Putnam trustees have a long record of independence. They were the first to have an independent nominating committee and the first to have an independent chairman. (John A. Hill, Chairman of Putnam's board)
>
> The Fidelity board always is conscientious and diligent in the service of the fund shareholders. We are proud to have on our board individuals who have the highest standards of integrity and business ethics. (Vincent Loporchio, Fidelity spokesman)
>
> Our fund directors are without exception distinguished leaders from business and government whose experience and insight serve our fund shareholders well. (Phillip J. Purcell, Morgan Stanley CEO and fund director)

These protestations of diligence and independence would mean a lot more to me if the directors of these funds had a history of occasionally terminating the fund company as investment adviser.

<u>Issues Regarding Marketing</u>

Ever since I was a teenager, I've heard that "mutual funds aren't bought; they're sold." In this regard they're like many other consumer goods. People don't decide they need them and figure out which one is the best. Often, rather, people are convinced to buy mutual funds through salesmanship.

Mutual fund families are money-raising machines. They include some of the best marketing companies in America. But some of their excellence serves to enhance their treasuries at the possible expense of their clients.

- Of course, the industry stands for the delivery of active investment management to the masses (although some firms also provide passive management through index funds). Sales are achieved on the basis of comparisons against other mutual funds. **Little is said about the long-run ability (or inability) of funds to beat the market.**

- Some mutual fund families offer so many funds, of such an amazing variety, that it's not illogical to wonder whether their motivations don't include a desire to always have **something** in the top quartile, and something to advertise with four stars.

- The funds in the bottom quartile, on the other hand, have a striking tendency to be merged out of existence – causing their performance records to disappear.

- The industry can be criticized for hyping (and selling) funds in whatever market sector is "hot." Certainly we don't see any warning labels to the effect that "hotness" can be synonymous with elevated prices, and thus with the potential for subsequent losses. The mutual funds that were on magazine covers during the tech bubble buried their clients**. It's not a coincidence that the average fund investor does worse than the average fund**; it's because investor money is constantly being lured into the funds that have been performing best, and thus are the most precarious.

- Lastly, compensation arrangements at mutual fund sales organizations can be adverse to the clients' best interests. For example, there may be incentives to steer capital to a brokerage house's in-house-managed funds as opposed to selling competing funds – because a dollar invested in an in-house fund brings the firm more profit. Once I described a fund to a marketer in terms of its current yield, yield to maturity and yield to call. He said, "Forget about that; let's talk about the thing that matters most: YTB" . . . meaning "yield to broker." There was no doubt where his motivation came from.

<u>Issues Regarding Expenses</u>

Most mutual funds operate in "efficient markets," where it's hard for one portfolio manager to get an edge versus the others. It's rare in the long run for any fund to beat its market benchmark or the other funds of similar riskiness in its niche. In efficient markets, expense minimization is the surest route to better net results, and it's for this reason that Jack Bogle pioneered the creation of index mutual funds. The performance of an index fund is certain to mirror that of the market, and expenses truly are minimized.

But almost all mutual funds are actively managed, and their expenses are anything but minimized.

- The average mutual fund carries investment management fees far above those paid by institutional investors, even those investing far smaller amounts of money.

- The administrative expenses borne by the funds are high and, most significantly, have not demonstrated a tendency to decline in percentage terms as the size of funds has increased. That is, they haven't reflected any economies of scale.

- Many fund shareholders pay continuing marketing charges. Why should the costs of selling funds be borne by the shareholders? The usual response is that a bigger fund benefits its shareholders. But then, shouldn't increasing size result in a declining expense ratio?

- Even as the total assets of the top 25 equity funds were increasing 845 times over the last 51 years, the average expense ratio rose from .64% of assets to 1.50%, **an increase of 134%.** (Source: "The Mutual Fund Industry in 2003: Back to the Future," by John C. Bogle)

As the total assets of the top 25 equity funds grew from $2.2 billion in 1951 to $1.9 trillion in 2002, the charges for managing and administering a dollar of assets more than doubled. One wonders how many of the "diligent, independent" directors resisted those increases.

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Are mutual funds good for America? In delivering market participation to retail investors and capital to America's companies, they're invaluable. In hyping hot investments and charging high fees for modest performance, they provide no great service.

Are mutual funds safe vehicles for investing? They're no safer than the markets in which they invest, or passive funds. But cost aside, they're not much worse.

Are mutual funds scandal-ridden? The Canary Capital incident doesn't worry me, but I think the long-term structural issues discussed above are very troubling.

Mutual funds are a good thing overall, and they could be made even better. But that will require a conscious decision to always place the interests of fund shareholders above those of the fund companies. In many cases, that's going to take a while.

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