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Starting Your Own Mutual Fund May Be the Way to Make Money

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If you want to make money in mutual funds, here is the trick: Launch your own fund company.

At first blush, that might seem daunting. But as long as you don't mind riding roughshod over a few investors, you shouldn't have any problem hauling in a truckload of money.

Intrigued? Here's the seven-step program:

Step 1: Set up half-a-dozen stock funds. To prepare for the marketing battle ahead, include the full array of share classes, each with different sales commissions and hefty "12b-1" marketing and distribution fees.

Don't bother promoting the funds quite yet. Instead, invest the company's money. Pursue outrageously risky, but somewhat different, strategies with each "incubator" fund.

Bet heavily on dubious stocks. Dabble in options and futures. Time the market. With any luck, one or two funds will post dazzling one-year returns, even as the others crash and burn.

Step 2: As the funds approach the end of their first full calendar year, look to juice up the results of the best performers. But how? If there are any overheated initial public stock offerings to be had, stuff those in the hottest funds.

Meanwhile, just before the market closes on Dec. 31, put in orders to buy shares of the winning funds' major holdings. Your buying pressure should push the price of those shares higher, thus giving an extra boost to each fund's one-year return. While this "portfolio pumping" is illegal, it seems to be a favorite practice of funds hoping to rank among the year's top performers.

According to a study by Mark Carhart, Ron Kaniel, David Musto and Adam Reed that will appear in April's Journal of Finance, each year's top performers typically outperform other funds by 0.42% on the last day of the year.

But those gains prove fleeting. On the first trading day of the new year, these top performers lag 0.29% behind their competitors, as the temporarily inflated share prices subside.

Step 3: Merge the losing funds into the winners. That will kill off the bad records. But before you go ahead with the mergers, boost the expenses of the soon- to-be-extinct funds, so they are above those of the surviving funds.

"You want the fund that's getting merged to have higher expenses, because it's easier to get the merger past shareholders and regulators are less likely to object," says Mercer Bullard, a former assistant chief counsel in the Securities and Exchange Commission's Division of Investment Management.

Once the mergers are approved, "liquidate all the holdings of the nonsurviving funds before the merger, so those funds' shareholders will eat the transaction costs," he adds. Mr. Bullard now runs Fund Democracy, a Chevy Chase, Md., advocacy group for mutual-fund shareholders.

Step 4: Promote the heck out of the winning funds. In advertisements, play down risk, ignore costs, and scream about performance.

"If there's some particular factor that influenced performance that's unlikely to replay itself, you have to disclose that," Mr. Bullard says. "But putting that in a small footnote is sufficient."

As it turns out, pushing performance and playing down costs is the trend in fund advertising, according to an analysis of ads in Money magazine conducted by Professors Michael Jones of the University of Tennessee at Chattanooga and Tom Smythe at Furman University.

Fund performance was mentioned in 52.4% of ads in 1999, up from 2.8% in 1979. Meanwhile, only 52.9% of ads in 1999 mentioned pricing characteristics, such as fund expenses and sales commissions, down from 86.1% in 1979.

Step 5: Put those 12b-1 fees to work, by using them to compensate discount-brokerage firms that sell your funds through their mutual-fund supermarket. Meanwhile, direct the funds' brokerage commissions to those full-service brokerage firms that sell the most fund shares.

Sound unseemly? Mr. Bullard says that as long as you disclose what you are doing and as long as you offer a reasonable justification, you can engage in practices that are bad for shareholders, provided the practices aren't actually fraudulent. "It's hard to prove that bad practices for shareholders are legally fraud," he notes.

Step 6: Now that the money is flowing in, don't do anything that might scare off investors. With that in mind, look to dump rotten stock picks before the reporting date for each fund's annual and semiannual report.

Such window-dressing will generate unnecessary trading costs. Indeed, such nonsense may cost U.S. stock-fund shareholders more than $1 billion a year, according to a study by Wake Forest University finance Professor Edward O'Neal. But shareholders probably won't notice the small deterioration in performance.

Step 7: Once your stock funds have hauled in a decent chunk of assets, immediately drop all risky bets and turn the funds into closet index funds. You need great returns to attract investors. But to keep these shareholders, middling returns should suffice.

Next stop: Your neighborhood investment bankers. While they try to find a buyer for your fund company, you can start shopping for Aspen real estate.

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