

## **Chapter 10**

### **Mutual Fund Follies**

*The illusions of hope are apt to close one's eyes to the painful truth.*

*Harry F. Banks*

The mutual fund industry is a tremendous success story. It has grown from a few hundred funds twenty years ago to over ten thousand today offering almost every investment style imaginable. The number of mutual fund companies has also mushroomed. There are over 500 fund companies in existence today. Mutual funds have become a household word and are the investment of choice for many people. Over forty million Americans have an interest in at least one mutual fund, and assets in those funds total almost five trillion dollars.

### **Mutual Fund Growth**

Mutual fund companies compete in a fiercely competitive industry. As a result, they must develop new products that attract the attention of investors. This is accomplished by ensuring one or more funds beat the market each year. The best way to increase the odds of having a winning fund is to have many funds. Most fund companies carry ten or more funds and continually introduce new funds each year. From 1985 to 1995, the average number of funds per family nearly doubled from 6 to 10<sup>1</sup>.

---

<sup>1</sup> Richard M. Ennis, "The Structure of the Investment Management Industry; Revisiting the New Paradigm", *Financial Analysts Journal*, July/August 1997, pg. 6-13

Table 1  
**Mutual Fund Proliferation**

Year	Number of Mutual Fund Companies	Number of Mutual Funds	Funds per Company
1985	252	1,528	6.0
1990	423	2,917	6.9
1995	558	5,761	10.3

Source: The Investment Company Institute

The more funds that are added, the greater chance that a fund will be a winner. As you can see from Table 2, a fund family with 10 funds has a much greater probability of having at least one winning fund. Fidelity is the premier mutual fund supermarket. With over 100 funds, Fidelity expects to have several funds beat the market each year.

Table 2  
**Probability of Beating a Benchmark**

Number of Funds in the Family	Probability of at Least One Fund Beating the Market	Probability of at Least Three Funds Beating the Market
3	75%	5%
6	90%	50%
10	95%	75%

Source: Richard M. Ennis, CFA

### ***Creating New Funds***

Ideas for new funds come from a variety of places. Some originate with portfolio managers and security analysts while others come from the marketing departments of these firms. Many ideas are in the best interest of investors, but the funds that are ultimately created are the ones that the marketing department believes will sell well.

While it is noble to think fund companies come up with all their own original ideas for funds, I believe this is more the exception than the rule. The fastest way to bring in money is to throw together a new fund based on a hot sector in the stock market. Ned Johnson, former president of Fidelity Investments, said if the public would buy a fund, he would create it, although he himself would not put one nickel of his own money into it<sup>2</sup>.

---

<sup>2</sup> Diane B. Henriques, *Fidelities World*, Scribner, NY, 1995, pg. 234. Quoted during an interview with former Fidelity money manager Mark Shenkman.

If one day the public decided chicken farms were a good investment, five or six chicken farm funds would quickly be created in the mutual fund industry.

Some new funds are really not new at all. They are reworked old funds that have been laggards in the portfolio and needed a facelift. A fund may be reworked and reintroduced with a zippy new name, an energetic portfolio manager, and new marketing blitz. It is less expensive to try and save an old fund that already has assets in it than to start a new one from scratch.

### ***Me-Too Funds***

Most fund companies have limited resources to research new ideas, so the chance of discovering a winning strategy is quite remote. Time is better utilized by selling funds rather than trying to discover superior investment strategies. As a result, most fund companies copy hot selling ideas in the marketplace rather than create them. If one fund company offers a popular new fund, it will not be long before dozens of “me-too” funds are born.

While I was working as a broker, it was possible to gauge the strength of a sector in the market by the number of me-too funds created. When it seemed like every mutual fund wholesaler was pushing a particular style of fund, the style was usually close to a market peak. In late 1997, real estate investment (REIT) funds were very popular. After two years of robust gains in the REIT market, almost every fund company had a new or improved REIT fund. Just like clockwork, during the 12-month period that followed, REIT funds were one of the worst performing categories. In the first half of 1999, nearly every fund company was touting their growth fund, which was loaded with high-tech stocks. Is this a sign that growth and high-tech may be peaking and that stodgy old value stocks may soon outperform? As of this writing it is too early to tell.

### ***Buying a Rising Star***

Mutual fund managers are frequently quoted in major publications such as the *Wall Street Journal* and *Barrons*. They also appear on television programs like *Wall Street Week* and *CNN*. The more a manager is exposed to the public, the greater following they gather. Some fund managers become outright celebrities. The mere mention of their

name adds credibility to an investment and can make or break a fund company. These are “star” managers and their name alone is worth millions to a fund company.

When a fund manager becomes a star, the company they work for typically exploits the opportunity by making them “Senior Portfolio Strategist” over several funds, including many new ones. Actually, the star’s real title should be “Senior Marketing Strategist”, because it is not their job to run the portfolios on a day to day basis, it is their job to get in front of the public and promote their firm. The star may be consulted on some portfolio management issues when they happen to be around, but most of the time other people make the decisions.

Mark Mobius of *Franklin Templeton* is a superstar emerging market manager. Between 1993 and 1995 Mobius was named senior advisor of five new funds. Although Mobius has overall responsibility for the funds, he does not manage them on a day-to-day basis. He goes around the world speaking to brokers and investors about the virtues of investing in *Templeton* funds.

Star managers can also be the source of embarrassment. In early 1990, Jeff Vinick caused quite a stir at Fidelity while managing the mammoth *Magellan* fund. He was caught *pumping and dumping* the stock of a particular technology company. After pumping up the stock price by touting the company in the press, he dumped shares during the rally that resulted from his comments. Fidelity managers can no longer comment on the stocks in their portfolios.

Many fund companies recruit star managers from the competition. If a fund manager jumps ship, he or she typically takes a number of their clients with them and can make big money. The star manager is in a good position to negotiate stock options, signing bonuses, and other perks.

### ***Change the Name to Protect the Guilty***

What did one investment company do with a tired old fund that had been performing poorly for years? It changed the name and reintroduced the fund as a top performer. After several years of mediocre performance, the *Smith Barney Strategic Investor Fund* was losing market share. Then, an astute employee noticed that the weak performance would have earned it the #1 spot as a Social Awareness fund category. The only problem

was the fund was not managed with a social awareness strategy. No problem! After filing with the SEC, the *Strategic Investor Fund* was renamed the *Concert Social Awareness Fund*, and the performance results were carried over from the old fund. By changing styles, the old fund went from a mediocre general equity fund, to the top performing social awareness fund in the country. The only indication of this switch was an ambiguous statement buried in the prospectus that read:

The financial information set out below represents the financial history of the Fund prior to implementing the social awareness criteria and the Fund's performance may have been different if it had pursued a social awareness criteria since its inception.

As indicated by the quote above, if the *Concert Social Awareness Fund* had been managed from inception as a social awareness fund, there is no telling what the performance would have been. The SEC must have been sleeping the day Smith Barney slipped this one by.

### ***Incubator Funds***

*If at first you don't succeed, destroy all evidence that you tried.*

*Anonymous*

When a fund company wants to try a new strategy, they often test it on a small, private account first. If the strategy is successful, then they may open the account up to the public as a mutual fund. If the strategy fails, the account will likely be closed and no one outside the firm will ever know it existed. These private accounts are called incubator funds, and a fund company may have several eggs in the incubator at one time.

If an incubator strategy is successful and the account is converted to a mutual fund, the SEC allows the past performance of the private account to carry forward. This is how a brand new fund can advertise a fantastic long-term performance record, even though the fund was not open to the public. While the SEC requires fair disclosure of these facts, few individual investors read the fine print. It is a clear case of legal fraud.

In 1996, the performance of the *State Street Aurora* fund was up over 56%, earning it the #1 spot among 407 small-cap value funds according to the Morningstar mutual fund rating service. Aurora also beat the Russell 2000 small stock index by a whopping 40% that year. Unfortunately, the fund was not available to you and me. It was only open to State Street employees. No public investor could buy in until 1997.

When the incubator fund became publicly available, there was only \$1.2 million of employee money invested in it. However, new investors were attracted to the fund like a magnet, and money began pouring in. Within a few months, the fund held over \$200 million in assets. As you may expect, the rapid inflow of cash had a profound negative affect on the funds ability to invest. In 1998 Aurora significantly under performed their benchmark.

I disagree with the SEC's decision to allow mutual fund companies to use the performance of private accounts. There are huge operational differences between managing a one million dollar private account and two hundred million dollar mutual fund. If a mutual fund company must resort to advertising incubator funds to attract new capital, that does not say much for their ability to manage existing funds.

### ***Other Marketing Claims***

Mutual funds companies go to great lengths to create brand names in a mostly homogeneous industry. Barring the worst funds with the highest fees, the performance of most funds in a particular style or category can be expected to fall within a narrow range of returns over the long-term. It has to be this way. There is only a finite selection of stocks to choose from within each category. Nevertheless, fund companies will say just about anything to stand out from the pack. Here are a couple of examples:

#### ***Myth #1 - Experienced portfolio managers are better.***

Some mutual fund companies try to sell the age and experience of their portfolio managers. The idea is to create the image that older is wiser, and more experienced managers are better stock pickers than younger managers.

There is no academic evidence to support this claim. To the contrary, the evidence suggests that older fund managers cannot keep pace with younger managers.

One recent study measured manager performance based on race, sex, age, college attended, SAT scores, MBA or non-MBA degree, and a variety of other factors. The study concluded that young managers perform better than older ones. The researchers speculated that younger managers worked longer hours, used technology effectively, and took more risks<sup>3</sup>. A screen of large-cap funds in the Morningstar Principia database reveals that managers with more than ten years tenure at a fund generally had the worst performance in the category.

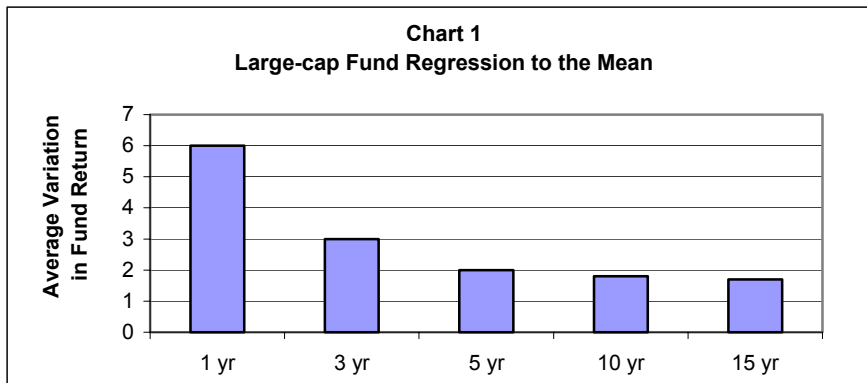
***Myth #2 - Bigger funds are better funds.***

“You can’t get hurt in a big game,” or so the saying goes. Many large mutual funds promote their funds as solid bedrock performers, able to withstand the worst bear market. This is a marketing myth. Big funds can have big problems. A comparison of risk and return of the ten largest US stock funds, excluding the Vanguard Index 500 fund, show that they do not perform any better than the average mutual fund according to Lipper. About half the large funds performed below the Lipper average and half were above it. Only one large fund beat the performance of the Vanguard Index 500 fund, and that was by .10%. Large funds are not better, just bigger.

“Bigger is better” may have validity in respect. Due to the amount of money in a large fund it must hold many of the same stocks as the S&P 500, therefore, it should perform close to the market return. There should not be a time when a large fund grossly under-performs the market average. Large funds become large because at some point the fund achieved superior returns. But those returns are not likely to occur again in the future because the fund is so large. Shareholders can expect performance fairly close to market return, less operating fees and other expenses.

---

<sup>3</sup> Judith Chevalier and Glenn Ellison, “Are Some Mutual Fund Managers Better Than Others? Cross-Sectional Patterns in Behavior and Performance”, May 1998



### ***In the End it is Regression to the Mean***

There are about 5,700 stock funds to select from today. This is interesting since there are only about 1000 or so stocks are large enough to be included in most of those funds. That means many funds hold the same stocks, and consequently, perform similarly over time. This phenomenon is called regression to the mean.

The regression tendency of mutual funds can be shown with a study of the Morningstar Principia database (see Chart 1). Screening the data for large-cap mutual funds with 15-year track records turns up about 65 names. Year over year the average variation between funds is about 6% per year. However, over a 15-year period, the variation falls to 1.7%. As the time horizon increases, regression to the mean in all categories begins to occur. Most of the variation in long-term performance can be explained by operating expenses and trading costs, not by a funds style or the skill of the manager.

### ***Part II and the Performance Gap***

Part II of this book explored a number of conflicts that exist between the sellers of investment products and the buyers. We could fill ten volumes on this subject and still not hit all the sales gimmicks used in the investment industry, but there is little point. The fact is Wall Street *encourages* people to invest in a manner that *causes* a performance gap. Remember that the industry exists to make money from you, not for you. There is nothing wrong with paying for investment products and advice, as long *your* best interests are at hand. *Caveat emptor*, let the buyer beware.