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FUND OPERATIONS & MANAGEMENT**Mutual Funds Become Less Diversified As They Get Bigger**ABSTRACTED FROM: *How Does Size Affect Mutual Fund Behavior?*

BY: Prof. Joshua Pollet and Prof. Mungo Wilson

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Trouble with lackluster performance. Mutual funds have grown both in number and in size over the last generation. Between 1975 and 2000, the number of US funds more than quintupled, and the mean asset value of individual funds shot up nearly ten-fold, while fund families tripled in number. Given this rapid growth in assets, size seems to be affecting fund managers' decisionmaking. According to research by finance professors Joshua Pollet and Mungo Wilson, actively managed mutual funds on average do not beat the markets, the indexes, or passive investment strategies. While a few funds turn in stellar performances and many outperform from time to time, hardly any do so consistently. Owning too much of one stock hurts liquidity, since the holding cannot be easily moved without affecting the price. Yet managers maintain their original investment strategies and holdings beyond the point where size makes doing so less efficient. A cynic might say the manager had just a few good ideas and was clinging to them, without any new notions (or perhaps enough staff to support a new concept) to attract fresh inflow.

Diversification enhances returns, but managers demur. Faced with snowballing assets, managers just keep plugging along, the authors find, buying more shares of what they already own. Although mutual funds do add new investments occasionally, they do so at an extraordinarily low rate. The numbers tell the tale. Comparing fund diversification by size quintile, the largest quintile at the start of the decade controlled over 86% of all mutual fund assets, averaged \$6,189 million in assets under management, and held an average of 143.88 stocks. In comparison, the smallest quintile, with only 0.27% of all mutual fund assets, averaged \$19.75 million under management and held, on average, just 73.01 stocks. The average top-quintile fund was over 300 times larger than the smallest-quintile fund, yet it held not quite twice as many stocks. The next-to-smallest quintile accounted for a little over 1% of mutual fund assets, averaged \$84.64 million in assets, and held 90.31 stocks. The middle quintile had a

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bit over 3% of mutual fund assets, with an average of \$231.72 million in assets and 97.26 stocks. The next-to-largest quintile, containing 9% of mutual fund assets, averaged \$648.19 million under management and held 137.06 stocks. Although the largest quintile is nearly 10 times the size of the next-to-largest quintile, these megafunds hold only six additional stocks.

Memo from marketing: more funds, not more holdings. The study shows that diversification slows to a near halt as fund size increases, despite the fact that diversification is associated with better returns. (For small-cap funds, the diversity/returns correlation is even stronger.) Funds in large families diversify much more slowly than funds in small families, and their largest funds diversify barely at all. Increasing the size of the fund family—a decision driven by marketing concerns—also inhibits diversification within the individual funds at the larger fund families. These large complexes generally respond to burgeoning inflows, the authors find, by creating new funds to attract investors. This “product proliferation” strategy is easier for the fund family to market than a diversification of the familiar, existing funds.

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INVESTMENT MANAGEMENT COMPLIANCE & REGULATION

Status Of Litigation By Mutual Fund Shareholders Against Fund Families

ABSTRACTED FROM: *Taking Stock Of Three Waves Of Mutual Fund Shareholder Litigation*
BY: John Ertman and David Hartnagel, Ropes & Gray, New York NY (JE) and Boston MA (DH)
Investment Lawyer, Vol. 15, No. 10, Pgs. 3-8

Huge settlements and class actions to boot. Class actions by shareholders against mutual fund complexes over the last five years have helped to flesh out the case law on whether and when shareholders may sue. Investigations by the SEC and state regulators probed investment advisors that allowed, then failed to disclose, market timing of trades at a dozen or more fund families. The investigations led to settlements giving shareholders over \$1 billion in Fair Funds under Section 308 of the Sarbanes-Oxley Act. Nevertheless, attorneys John Ertman and David Hartnagel explain, shareholders argued that the Fair Funds could not make them whole and brought class actions against numerous complexes. The court consolidated 19 suits (some of which were later dismissed) to be heard by a multi-district litigation panel in the US District Court in Maryland, where the plaintiffs’ main accusation was that advisors had violated Rule 10b-5. One judge rejected two of the defendants’ threshold defenses (although the first was subsequently restored): that, absent a share purchase or sale, the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores* (1975) had forbidden private suits under Rule 10b-5; and that the shareholders named as plaintiffs lacked standing under the Constitution to sue on behalf of shareholders of funds in which the named plaintiffs held no shares.

Allegations of kickbacks. Shareholders have also filed federal class actions against roughly 25 fund complexes, the authors indicate, alleging that advisors had kicked back to broker-dealers portions of either the advisor’s own assets or 12b-1 fees for distribution and servicing paid by the funds. Shareholders further alleged that the rise in fund assets generated by the improperly incentivized brokers increased the advisors’ and distributors’ advisory and 12b-1 fees but did not benefit the funds or the shareholders. The damages sought included recompense of the fee increases. Plaintiffs contended that long-permitted marketing methods gave rise to many different causes of actions, almost all of which the

court rejected—including violations of the Investment Company Act of 1940, the Investment Advisers Act of 1940, the 1933 Act, and the 1934 Act—as well as breaches of fiduciary duty under state law. Most of the suits were dismissed, but three fund complexes settled.

Accusations of trampling on rights to fair fees. In the third surge of suits, shareholders accused advisors at 12 fund families of violating Investment Company Act Section 36(b) by charging advisory fees that were too high because they substantially exceeded those charged to institutional investors with comparable investment strategies. Most of the suits resulted in settlement, voluntary dismissal by the plaintiffs, or summary judgment for the defendants. The authors focus on one 2008 case, *Jones v. Harris Assocs.*, as particularly significant. In *Jones*, the Seventh Circuit has created a new standard for evaluating Section 36(b) cases, discarding the Second Circuit's widely followed, more lenient version set forth in *Gartenberg v. Merrill Lynch Asset Mgmt.* (1982). Under *Gartenberg*, an advisor violates Section 36(b) if the fees are so big that they are not reasonably related to the services performed and could not have been bargained for at arm's length. Under *Jones*, a plaintiff must show the fees to be "so unusual" as to permit an inference that the advisor deceived the fund's trustees who approved the fees or that the trustees abdicated their responsibility.

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BRIEFLY...

MARKETING

LOAD SHARES OVERTAKEN BY NO-LOADS AND THREATENED BY SEC RECONSIDERATION

The rise of no-load mutual funds over the past several years casts a cloud over the future of Class C shares and, for that matter, all classes of mutual fund shares based on transaction charges. In 2008, reports David Hoffman, no-load funds enjoyed net inflow of \$14.87 billion, while the total investment in share classes A, B, and C shrank by over \$171 billion. Further darkening the picture for B and C shares in particular, the SEC's reassessment of Rule 12b-1 is leading it to consider capping annual 12b-1 fees. Meanwhile, the popularity of wrap accounts offering no-load funds, especially at large investment firms, seems to be rendering C shares obsolete. The marketplace's shift away from transaction charges, coupled with the regulatory uncertainty, leaves the fate of B as well as C shares on shaky ground.

Abstracted from "Class C Shares Set To Go The Way Of The Dodo" by David Hoffman. *InvestmentNews*, Vol. 13, No. 16, Pgs. 3, 21. Available at www.investmentnews.com/article/20090419/REG/304199969.

FUND OPERATIONS & MANAGEMENT

STABLE VALUE FUNDS RIDE OUT THE DOWNTURN

Along with the rest of the financial world, stable value funds have been hobbled by the market downturn, explains *Managing 401(k) Plans*. Used mainly by corporate retirement plans, most stable value funds use a fixed-income portfolio supported by an insurance wrapper from a financial institution. If the portfolio's rate of return falls below a stated threshold, the insurer guarantees the difference between the portfolio's market value and the fund's book value. The stock market's relentless plunges

have upset the balance of this normally profitable arrangement. Insuring stable value funds has become so risky that insurers are reluctant to take on new contracts or renew existing terms. Still, the news is not all bad. Current contracts are being honored, and stable value funds have enough cashflow to give the asset managers flexibility to replace securities whose credit has deteriorated. Even before the downturn, some providers were questioning the profitability of stable value funds. The market malaise perhaps just accelerated the concerns. The current market conditions serve as a stress test of stable value funds and their managers: over time, a skilled, resourceful manager can engineer at least some recovery in a fund's market-to-book ratio.

Abstracted from "Are Stable Value Funds Getting Shakier?" *Managing 401(k) Plans*, June 2009, Pgs. 2-5. Available at www.ioma.com/issues/401K/.

MUTUAL FUND MANAGERS SEEK OUT THE OLD SCHOOL TIES

Information drives investment decisions (and therefore stock prices), but how does material information move through the market? Business professors Lauren Cohen, Andrea Frazzini, and Christopher Malloy investigated one area of exchange: social interaction between mutual fund managers and corporate executives who knew each other at business school. Comparing investment patterns with a control group reveals that fund managers favor companies run by school buddies and that they realize greater profits from those investments than from others. Most of the difference in returns (up to 7.8%) between "connected" and "unconnected" investments consists of profits associated with the release of corporate news. In the authors' view, this confirms that useful information flowing through these personal networks pays off. The authors further support their thesis by showing that newly hired fund managers often quickly dump the stocks of companies socially linked to the prior manager and simultaneously invest in companies with a connection to the new manager's own educational background. Given this evidently successful pattern, why do fund managers not seek an even greater advantage from their educational ties? The answer lies in the relatively small pool of "connected" securities available; despite the informational benefit from old school ties, excessive investment in just a few companies would endanger healthy diversification.

Abstracted from "The Small World Of Investing: Board Connections And Mutual Fund Returns" by Lauren Cohen, Andrea Frazzini, and Christopher Malloy. *NBER Working Paper No. 13121*. Available at www.nber.org/papers/W13121.pdf.

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