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Tricks of the Trade: Mutual Fund Follies

By Richard A. Ferri, CFA

Business is tough for the active mutual fund companies, especially since index funds are catching on with the public. Who can blame the trustees of active fund companies for trying to spice up the performance of their funds by using an assortment of reporting techniques? Other industries do it all the time, and until Enron crashed the party, creative accounting was considered a good thing on Wall Street. So, why should we care that active mutual fund people are cooking the performance numbers a little?

We should care, because playing with numbers to make a mutual fund company look good directly affects over one hundred million households who own mutual funds. Don't get me wrong, what the fund companies are doing is not illegal; it is just unethical and misleading. This article covers three tricks used by active fund companies to dress up firm-wide performance. These techniques describe only a few blatant examples. There are many, many others.

1. Incubator Funds

Incubator funds are small, actively managed individual accounts or private investment pools run by a mutual fund company. These funds are not available to the public, but may be available to employees or a large private investor. The company manages these private assets using new or improved investment methods. If a new strategy works, the fund opens to the public. If it does not work, the fund is shut down in most cases.

The idea of testing a new strategy before selling it to the public makes sound business sense. However, the problem is that the SEC allows the performance of the incubator fund to be used as part of the performance history of the new public mutual fund. That means a brand new mutual fund can claim a fabulous multi-year track record, and if the track record is more than three years, the new fund will likely get a coveted 4 or 5 Star rating from *Morningstar*. In addition, this historic incubator performance is included as part of a composite score that is created from all the funds in a family. Composite scores are published in popular magazines, including *Consumer Reports*.

Do fund companies have many eggs in incubation at one time? *The Wall Street Journal's* October 9, 2000 "Mutual Funds Quarterly Review" section noted that one fund company had 19 funds in incubation at that time. All the funds were less than three years old. This same fund company launched no less than 18 incubator funds three years prior. Exactly half of the 18 were liquidated and the other half introduced to the public. No one knows the performance of the funds that where closed. We only know how the public funds performed in the past. Is this fair disclosure? No. Is it legal? Yes.

Vanguard founder Jack Bogle isn't a big fan of the SEC's decision to allow fund companies to attach a fund's previous record as an incubator fund to its new record as a public mutual fund. Bogle says that a regular open-end fund record provides "little enough" useful information that allowing even shakier records in is a bad idea.

2. Me Too Funds

Mutual fund companies don't want to miss out on collecting investor assets because they do not have a fund that covers a trendy investment style. If one fund company introduces a successful new fund, all the major fund companies rush to the market with "Me Too" funds. The largest companies will introduce two to three funds with similar styles, but different names. Most funds are introduced with multiple share classes. Soon, the market is flooded with "Me Too" funds. The issuance usually peaks right about the time the bubble bursts on the style.

As you might expect, most "Me Too" funds do not survive very long. More than half are closed or merged by the third year. That way a fund company can claim success with their best performing new fund, while sweeping the performance of losing funds under the rug. Typically, about 5% of all mutual funds disappear during any 12-month period. However, 2002 is shaping up to be a record year. Scores of funds have already vanished, and many more are scheduled to close or merge.

Merrill Lynch recently announced it is pruning four technology and growth funds that they introduced during the technology boom in the late 1990s. Merrill said it is closing the funds because investors don't need three aggressive-growth options from one family.

Putnam announced the closing of two funds and the merging of nine others. The funds shutting down are the Technology Fund and the New Century Growth Fund. Both of these funds are less than three years old.

3. Priming the Pump

Many technology and aggressive growth funds launched during the tech boom had huge one-year gains from hot initial public offerings (IPOs) of new stock. A hot IPO is when a company issues stock at about $15 per share, and the first trade on the secondary market is $60 per share. Investors who are lucky enough to get $15 shares of the new IPO from the underwriter "flip" new stock at $60 and make a huge one-time gain.

This is free money for mutual fund companies, if they can get shares. Unfortunately, the way in which Wall Street distributes hot IPOs shares is a disgrace, and the SEC has taken a keen interest in the issue. Basically, the shares go to fund companies that do a significant amount of routine stock trading with the brokerage firm that underwrites IPOs. The commission on these routine trades is much higher than if the mutual fund used a discount brokerage house. The purpose of paying the higher commission is to "buy" access to the hot IPOs. In other words, the brokerage firm is paid off using the assets of mutual fund investors.

Now, you might think that the mutual fund investors in the big billion dollar funds would get the hot stock in their fund, since it was mainly their commission dollars that was used to build the goodwill with the broker. However, that's not the case. Most of the allocation of a hot IPO will go into one or two incubator funds or fledging "Me Too" funds. Since there are not a lot of assets in the new funds, the investors in those funds could not have possibly built up enough goodwill to get IPO shares. So, management steps in and decides that the shares paid for by the big fund will be given to the little fund, because hot IPOs can quickly "pump up" the performance of a small fund.

When a new fund is stuffed with hot IPOs, there is a good chance it will be a stellar performer. "Priming the pump" helps build assets in the fund quickly as investors throw hundreds of millions and possibly billions of new dollars into it. This is how the Munder *NetNet* fund went from nothing in 1997 to over $8 billion in early 2000. Unfortunately, nothing fails like success. The large fund begins to wane as assets get in the way of nimbleness. It would take an impossible number of hot IPOs to keep the performance up. So, management shifts all the good deals to a new incubator or a small new public fund, and the process begins again. The practice of selective allocation guarantees that there is at least one fund in a family that is a stellar performer.

This article barely scratches the surface of the shenanigans in the mutual fund business. As fund companies struggle to survive by scrambling for new investors and new assets, we are likely to see many more creative ways to hide poor performance and pump up numbers.

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