



# Investment Insights

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## What the mutual fund scandal means to you

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In early September of 2003, New York Attorney General Elliot Spitzer announced an inquiry into illegal “market timing” occurring at several prominent mutual fund companies. This scandal comes on the heels of the research and investment banking investigations that have resulted in over a billion dollars in fines to major Wall Street investment houses. How does this new concern effect your investments, and what should you do to make sure your assets are not at risk as a result of what might come from this investigation?

First, let’s look at what exactly is alleged in these cases. The focus of Spitzer’s complaint is that certain mutual fund companies (Janus, Nations Funds, and Bank One, among others) permitted “market timing” trades by institutional clients. Here’s a simple example of how this might work: Suppose the US stock market rises strongly on good international news today. It would be a good bet that the Asian markets would also rally when they begin trading a few hours after the US close. However, the price of the (hypothetical) ABC Asian Stock Fund is based on the 4 p.m. New York Exchange close. Thus, the price would not reflect the rise in value of the Asian shares in the fund, as those shares have not yet traded that day. In the case of the “market timing” trades, ABC mutual fund company would allow a large investor to buy into the Asian Stock Fund at the low price after the US markets closed, giving them an almost sure profit on their investment. The large investor might then sell those shares the next day and pocket the short-term gain.

This hurts shareholders of the fund because it allows a large investor the ability to share in the one-day profit without assuming much risk. If the large investor were allowed to buy in only at times when a rise in value was a good certainty, he would be taking a portion of the profits that rightfully belonged to longer-term shareholders.

Some of the mutual fund companies named in this investigation have already stated that they will reimburse shareholders of the effected funds if they incurred any losses as a result of these “market timing” activities. They have also initiated internal reviews to try to prevent this from happening in the future.

We have had many investors ask us what actions they should take in regards to their holdings in some of the effected funds. In general, our recommendation has been to monitor the investigations closely, but to take no immediate action. At this time, most of the major mutual fund companies have received subpoenas, so it would be premature to sell holdings in these companies funds on just that basis.

We recommend watching for two important indicators to decide whether to hold or sell your mutual fund as a result of the investigations. First, see how your fund company reacts to the investigation. Are they simply disavowing any wrongdoing, or are they promising to review their policies and procedures thoroughly and make necessary changes? Also, are they vowing to compensate any effected shareholders for their losses?

The second indicator to watch for is employee defections from the mutual fund company. Your fund is headed by a fund manager who is in charge of selecting securities and making buy and sell decisions in the fund. Thus, the performance of your fund is to a large extent determined by his or her abilities. If, as a result of this investigation, your fund manager decides to leave for greener pastures, you should monitor very carefully the performance of the fund as a new manager takes over. Often, we use management changes as an indicator of when to sell a fund. Should fund companies like Janus see a defection of their most talented managers, shareholders may want to take their investment dollars elsewhere.

The bottom line for all investors is that actions like those taken by Elliot Spitzer will clean up the mutual fund industry and make the playing field level for all investors, big and small. In the short run, you may find reason to sell portions of your current holdings. However, in the long run we'll all benefit from a cleaner, fairer system for all investors.

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