



Investment Insights

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Follow up to the mutual fund scandal

Over the past few weeks, we've been flooded with calls from concerned investors asking for recommendations on what to do with their mutual fund investments. With concerns mounting daily about the widening investigation into mutual fund improprieties, let's revisit the facts of the issue so all investors can make a sound judgment as to the actions they need to take with their mutual fund holdings.

The issues at hand

The first, and most common, grievance levied at the mutual fund industry is the policy of allowing "market timing" in their funds. Market timing involves making large, short-term trades to capture quick profits. Much of this occurred in international equity funds, where pricing methods are such that the opportunity exists for nearly risk-free profits on quick trades. It is important to note that market timing is not illegal, and the fund companies accused of this practice did not break the law. However, it is immoral, as the short-term profits of market timers come at the expense of long-term investors. Also, this practice is usually discouraged for individual investors, but big institutional investors have been given special treatment to make these types of trades. Regulators are looking at ways to create a law that would prohibit market timing in mutual funds, and it is likely that the practice will be outlawed in some way. A simple solution is for a mutual fund company to charge a penalty to investors who buy and sell shares within a short period of time. Many funds have begun to do this, and if they are serious about stopping this practice, they will all add this monetary impediment to discourage short term trading.

The second issue that has been uncovered is the blatantly illegal policy of allowing late trading in funds. Some fund companies have allowed large clients to buy funds based on outdated prices. If good news comes out after the markets have closed, or before they open in the morning, being able to buy at the previous closing price gives the short-term trader a nearly risk-free profit. This is in violation of existing laws, and is the most blatant abuse of shareholders trust found thus far.

What to do

Most fund companies have agreed to reimburse shareholders from any damages suffered as a result of all of these alleged actions, but the actual monetary damages are very minimal. In many cases, investors should expect the check they receive to be less than the amount of postage on the envelope. And with the amount of litigation involved, these checks won't likely arrive any time soon.

The bigger question is one of morals, and how comfortable investors are with the breach of trust made by the mutual fund industry. In this regard, there is no easy answer, but there are a few solutions investors can consider.

The first option is to invest in multi-manager funds, where a sponsoring company selects a variety of managers to handle different parts of the portfolio. This is typically referred to as a fund-of-funds. In this structure, the sponsoring company can hire and fire managers within the fund at will. We use a fund-of-funds solution for many clients, and already we've seen a manager fired within the portfolio due to his involvement in the scandal. The beauty of this option is that it doesn't require the investor to sell and buy funds, thus keeping costs and taxes low. It also allows investors to have a diversified group of managers using their specific talents to generate returns for shareholders.

A second option is to use separate accounts, which allow the investor to have their money managed by top-notch managers privately, rather than through public mutual funds. In a separate account solution, the investor actually owns the individual securities, and the managers manage that portfolio. In this way, most of the problems being investigated with public mutual funds are eliminated. This solution used to be limited to the ultra-wealthy, but due to technology and demand, vehicles now exist to accommodate a wider range of investors.

Regardless of the performance or promises any investment offers, we always put one rule ahead of all others when it comes to investing: you must be comfortable with, and have full confidence in, your investment strategy and the vehicles you invest in. If you do not, you should investigate options to get into a position where you are confident and comfortable. If this mutual fund scandal has you questioning the strategy you are pursuing, talk to a financial advisor today to get a solid game plan in place.

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