

The mutual fund industry has been playing fast and loose with your dollars. Will the SEC finally take action?

By Julie Creswell

Dirty Little Secrets

EVER SINCE ENRON

collapsed into a smoldering heap nearly two years ago, regulators and lawmakers have scrambled to shore up confidence in the nation's financial markets and corporate boardrooms. They've passed the Sarbanes-Oxley Act; they've slapped Wall Street firms with huge fines. But the cleanup is far from over. Regulators' next target? The \$6.8 trillion mutual fund business.

Turns out the industry that has long claimed to be the friend of the little investor and the champion of corporate responsibility has quite a few **unsavory secrets** of its own. Most of them center on **unseen fees and conflicts of interest** in the way funds are sold. "There are undisclosed financial motivations in damn near every transaction involving mutual funds." says Edward Siede, a former mutual

FORTUNE September 1, 2003

fund executive and attorney for the Securities and Exchange Commission who now investigates abuses at money—management firms for pension funds. The upshot: More of the dollars you've invested in mutual funds are being squandered than you've ever dreamed. And in trying to fix the worse abuses, regulators and lawmakers could deliver yet another blow to the already shaky Wall Street firms that peddle the lion's share of the fund industry's offerings. Several **iffy practices** spark the most concern at the SEC (see following interview with SEC chairman William Donaldson) One is directed brokerage, in which a mutual fund company agrees to do a certain volume of trades with a given brokerage if that firm agrees to distribute funds. Another is revenue sharing, in which a fund company pays brokers part of its own profits to push its funds to investors. Those deals, while legal, are little more than kickbacks. **Most shocking** of all, perhaps, are the so-called **soft dollars embedded in commissions that flow from fund companies to brokerage firms and back again.** They are supposed to be for research but often wind up paying funds' routine costs of doing business (more on that later).

Those practices are a big reason most large fund groups **pay a hefty 5 cents a share in brokerage commissions** when many trades can be done on electronic exchanges for less than a penny. **The money spent on those commissions belongs to investors, mind you, not to the fund companies.** Mutual funds are set up like mutual insurance

firms: The fund assets belong to the shareholders collectively, not the company. And while **sky-high transaction commissions** hurt the fund's overall return, they aren't part of its much touted "expense ratio." That **ratio includes management fees, marketing expenses** and is used by investors to gauge whether a fund is "low cost" or not.

All of those nickel-a-share trades add up. Last year the mutual fund industry paid brokers about \$6 billion in commissions. Anywhere from \$1 billion to \$4 billion – no one knows for sure – went to something other than simple trade execution (see chart). Trading costs can easily double the annual expense of a mutual fund. "Right now the average annual expense ratio for a mutual fund is about 1.3%, but when you add up trading costs and all the other fees, you can get up to 3% annual costs," says Gary Gensler, former undersecretary of the U.S. Treasury and co-author of *The Great Mutual Fund Trap*. Don't think 3% a year is a big deal? Well, since 1982, that's how much the average equity fund has lagged behind the S&P stock index. Translation: \$10,000 invested in the average equity fund is now worth \$56,765, vs. \$105,250 if it had been invested in the stock market.

You'd think the mutual fund industry would have plenty of other ways to compensate brokers. After all, for decades most funds have carried **"loads"** of up to **8.5%**, which go to the sellers. Funds also charge a so-called **12b-1 fee** to cover administrative and marketing costs, limited to 1% of the fund's assets annually.

That's in addition to those revenue-sharing arrangements.

Thanks in part to those broker incentives, over the past two decades the industry has exploded. Today some 400 mutual fund companies vie to sell investors more than 8,200 stocks and bond funds; assets have surged from \$56 billion in 1978 to around \$6.8 trillion. Only about 38% of funds (excluding money market funds) are "no loads" sold directly through toll free numbers or through fund supermarkets like Charles Schwab's OneSource (to be included on Schwab's list, fund companies do pay an annual fee of 0.4% of assets sold through Schwab.) The rest are sold through financial advisors, insurance agents, or brokers such as Merrill Lynch or A.G. Edwards.

But times have gotten tough for Wall Street firms. Their usual moneymakers equity underwriting and advising on mergers and acquisitions- are in the dumps for the third consecutive year. So, some mutual fund executives say, the firms' brokerage units are trying to **squeeze more money** out of them. "Almost every day I get a call from a broker saying another mutual fund group is willing to pay ten basis points in fees and I'm only paying six basis points in fees," says an executive at a mutual fund firm. He says the message is that if he doesn't match the other group's offer, the sales force won't **aggressively sell** his funds. "In essence, whoever the highest bidder is will get shelf space and be sold by the firm." He continues. "This is the way the industry operates. And if you

don't play by the rules, it's going to be difficult to succeed."

Regulators worry that investors don't know enough about broker-fund relationships. Revenue sharing may induce brokers to put small investors into a fund that gives a bigger piece of its profit pie to that brokerage, not into the fund that's best for the investors. Additionally, if fund companies are including revenue-sharing fees as part of the fund's overall expenses, **investors may be subsidizing their fund's marketing efforts more than they should.** Consider this: Large institutions such as pension funds pay as little as 0.1% in fees for money market funds. Some retail **investors are paying 1%, or ten times as much, for those same funds.** "There's no reason Calpers [the California state employees' pension system] pays one quarter to one-fifth as much as retail mutual fund investor in fees for the same large-cap value fund," says fund investigator Siedloe. "The only difference is that the **mutual fund company has to pay brokers to persuade investors to purchase their fund.**"

Then there's the practice known as directed brokerage, in which fund companies use trading commissions to pay brokers to distribute their funds. That's allowed, but only within certain limits. The commission costs are supposed to be accounted for in 12b-1 fee. But industry insiders and regulators say that's not happening. IN fact, some say that if fund companies did start accounting properly for the fees, it might send some of them over the **total brokerage compensation**

limit of 8.5% allowed by the National Association of Securities Dealers.

But the biggest gorilla that regulators are wrestling is what else – besides actual trading – mutual fund advisors get for their **nickel a share trading commissions.** Under the "safe harbor" law enacted in 1975, it's perfectly legal for mutual funds to receive research and other brokerage services in exchange for trading commissions as long as they believe they are achieving "best execution" for their trades. **Sound vague?** It is. And that's part of the problem says John Bogle, found of the giant no-load fund family Vanguard Group, who has become one of his industry's sharpest critics: "Under the rubric of research, all sorts of subtle and no-so-subtle abuses are occurring.