OBSERVATIONS: Mutual Fund Scandals March 2004

As you have undoubtedly heard many times by now, last fall, New York's attorney general filed a complaint alleging misdeeds involving several mutual fund companies. Since that time, evidence of wrongdoing has spread to numerous fund families. Though it does not appear that investors were materially damaged (and most accused firms are pledging to make investors whole (cynically, because it does not appear that investors were materially damaged), the allegations (most of which are almost certainly true) represent a troubling lack of regard for shareholders on the part of the identified fund companies.

But these issues extend beyond just the Spitzer complaint—other examples of fund companies putting their interests ahead of shareholders are common and have bothered us for years. They include fund companies that are poor or unreasonable in their managing of expenses, that charge unfair pricing to the funds they manage versus what they charge to institutions, and that allow assets to grow beyond the point at which they become detrimental to performance. *We consider all these issues carefully in our due diligence on the funds we us and will remain vigilant going forward.*

The Press has brought a great deal of attention to these issues, and for good reason. It is apprehensible that companies mandated with being stewards of the savings of their shareholders (and document their fiduciary responsibilities and pledges in writing) blatantly engage in activities that are unquestionably detrimental to the financial well-being of those same shareholders.

Up to this point, we have been very successful at avoiding the fund companies that have been implicated in the scandals. (We have one fund—Columbia Real Estate Equity—whose parent company has endured serious allegations. The allegations do not include the specific fund, but the severity of the allegations, combined with the fact that the fund has been recently sold to a commission-based parent, and is in the process of being sold again, has caused us to suspend new investments into the fund.) We feel that this reflects the significant due diligence that we apply to every investment that we consider for our portfolios.

We specifically look for, and give significant favorable weighting toward funds that demonstrate favorable shareholding policies and manage their fund and investment company with a high degree of integrity and understanding as to their role as a fiduciary for their shareholders. Often, our fund managers have significant personal stakes in the funds that they manage. Similarly, we avoid companies that seem to constantly put out new funds in response to the hot investment idea du jour, that fill the media with advertisements that tout their best performing funds, and that have above average expense ratios, even when economies of scale suggest that bulging assets under management should provide for lower administration costs per dollar managed. The bottom line is that it is possible to find warning signs from companies with respect to their regard for their shareholdings. Given the way shareholders have been treated in the past, it is not surprising (disappointing, but not surprising) that these more egregious transgressions have occurred now.

But it is my firm belief that not all companies are like this. I believe that while there are a not-insignificant number of companies/funds/individuals that engage in unethical behavior, there are conversely a notable number of exemplary examples also. And, of course, the entire range in between. Our due diligence process is intended to sort through the countless investment options and classify the funds as acceptable or not.

Of course, we can (and—I can almost guarantee—will) make mistakes, and it is possible that new revelations tomorrow could reveal a fund company that we do own. However, our efforts are made in good faith and done with complete concern for your best interests. We are accountable to our clients for the funds that we own, and I am always happy to explain the reason and justification for each one that we recommend.

Finally, I am still convinced that mutual funds are the most appropriate investment option for the vast majority of investors. During the last five years—the period during which most of the ethics violations are known to have occurred—our mutual fund portfolios have materially beaten their index benchmarks. Fund investing continues to give us the ability to easily hire and fire managers, find a handful of exceptionally skilled investors from a large universe of managers, and to opportunistically access many asset classes.

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