

Chapter 1

Mutual Funds: A Painful Birth

In the Beginning

Investment companies, including what we now call mutual funds, gained a foothold in the United States in the 1920s. As the stock market was rising, and rising again, people who had previously relied on banks as a place for their savings turned toward the new investment companies as a convenient way to get into stocks. Riding with them, however, were some well-dressed—and quite respectable by the standards of the day—bankers and promoters who eagerly sponsored these investment funds not just for the management fees they could earn but also as easy targets for self-dealing and even outright theft. For readers who are aware of the recent market-timing and other mutual fund abuses, it is useful to see the veritable cesspool of abuses into which the industry was born.

But first, let's go back a bit. In the nineteenth century, the British had created investment companies or trusts to pool and manage money for smaller investors. The Foreign and Colonial Government Trust, founded in London in 1868, was the first such fund, and the purpose was to invest in the debt of various governments. (Stocks were thought to be too speculative for the general public back then.) By 1875, there were 18 similar trusts, including one, the Scottish American Trust Company, designed specifically to invest in the United States.¹

Almost a century before, the Dutch had created similar trusts, also with the aim of permitting investors with limited means the opportunity to diversify and to achieve a greater degree of liquidity than the underlying investments could provide.² One of those early Dutch funds noted that it hoped to buy some "solid securities [at prices] *below their intrinsic value*" (italics added), suggesting it may have been the true forerunner of Benjamin Graham and then Warren Buffett.³

Is there nothing new under the sun? Within the past year the financial pages have carried lots of stories about a potential collapse of the so-called carry trade, wherein huge sums were being borrowed at extremely low interest rates in Japan, and to a lesser degree in Switzerland, and then flipped into high-yielding bonds in Europe, the United States, or New Zealand. It's a neat trick: borrow low, lend high. The difference in the two interest rates is the profit. Sounds too good to be true, right? The risk, and it's real, is that the Japanese yen will quickly increase in value, so that when the U.S. bonds, for example, are cashed in, they may not suffice to repay the yen due on the loan from the Japanese bank. (Indeed, as the book goes to press, the yen has risen precipitously to an 18-month high against the dollar.) But back in the 1880s, those ingenious Scots were already playing the same game, using their investment trusts to borrow in England at 3 percent and then lending to American railroad companies at rates up to 8 percent.⁴ It sounded so good that by 1890, a trust mania was under way, and the Scots found that the supply of quality railroad mortgages was drying up, and only junk bonds remained. Too many railroads, too many shaky bonds, too many failures. Nothing new.

The bull market of the 1920s gave many Americans familiarity with stocks, and as the excitement rose, investment banks and brokers created hundreds of investment companies of one sort or another to meet the

demand of the small investor looking for a convenient way to enjoy a diversified portfolio. Until 1926, there were still relatively few funds, and their assets totaled less than \$1 billion in all. But over the next three years, hundreds more were formed. The individual accounts were small, mostly under \$500, but the total invested grew to a more impressive \$7 billion. To put that sum in context, the electric lighting industry, as it was called, was rapidly expanding during the 1920s, and it raised in all \$14 billion to finance its growth.⁵ Back then, the \$7 billion in investment companies represented big bucks.

John Kenneth Galbraith liked to say that in prosperous times no one bothers to question how the money is being made; it's only after the tide runs out that we get to see the "bezzle," the inventory of undiscovered embezzlement.⁶ By the late 1930s, the two million investors in these funds had lost \$3 billion; only half the original 1,300 funds survived. Much of that money had been lost in the collapse of the market, of course. But beyond that, the promoters of the funds had committed just about every piece of skullduggery imaginable, and even some "duggery" that most skulls could *not* grasp. At 22 failed funds studied by the Securities and Exchange Commission (SEC), the security holders had lost, in all, 90 percent of their capital contributions of \$560 million. Charles Kettering, a vice president and research director of General Motors, said that he did not understand investments but that he saw his \$260,000 stake in a fund as somewhat akin to being deposited in a bank. In fact, the sales promotions had created the general impression that the funds were not unlike savings banks and insurance companies. Ultimately, Kettering lost all but \$20,000 of his "deposit."

The promoters of the funds had largely used them as vehicles for self-dealing. Cash and negotiable securities are very flexible, mobile assets. Without the benefit of any real disclosure requirements, it was all too easy for the bankers to trade securities in and out of the funds to their own advantage. Sometimes they just stole the stocks. And complex capital structures, far beyond the ken of the small investor, allowed the management to dilute the holdings of the public and to monopolize the voting rights. Fund promoters issued securities to themselves at unfairly low prices.⁷ Remember, these were the 1920s, when market manipulation, insider trading, and almost anything except outright theft were still considered legitimate. The public was just hoping to be part of the game, and to piggyback the insiders.

The public had assumed that in dealing with, say, Dillon, Read, they would enjoy the benefits of that estimable firm's expertise and the skills of Clarence Dillon. Dillon didn't see it that way. When the firm floated the United States and Foreign Securities Corporation in 1924, the public purchased a "*first* preferred" stock for \$25 million, while the bankers bought an ostensibly junior "*second* preferred" for \$5 million (of which \$1 million was immediately recouped in underwriting fees). That may sound reasonable, but in fact "*second*" was better than "*first*." And then, by investing the trivial additional sum of \$100,000 to buy the lion's share of the common stock, the bankers wound up with the voting rights plus 75 percent of the potential profits. Later, acting as the fund's banker, the firm proceeded, 16 times over, to unload into the fund large blocks of slumping railroad securities.⁸

Much as the public had been champing at the bit to sit alongside Dillon 80 years before, it was happening again in 2007, when investors stood in line to buy shares of Fortress Investment Group, the first U.S. hedge fund to go public. The offer was subscribed 25 times over by people hoping to sup at Fortress' table.⁹ Here, too, the insiders kept all the so-called Class B shares, which, like Dillon's second preferred, owned the voting rights.¹⁰ To be sure, the now enhanced disclosure requirements should have enabled investors to get a grasp on what was being offered, but with so many investors impatient to buy into Fortress, no one had time to read the small print. Nothing new?

Some examples of the looting back in the 1920s make gruesome reading even now. One fund, Utility and Industrial (U&I), had been organized by an investment bank, Byllesby & Co., which raised \$30 million for the fund. Acting for its own account, Byllesby then sold to U&I the stock of Federal Public Service, a misleadingly named company that was about to go broke. It also sold to U&I a waterworks firm in Mexico, which was soon confiscated by the government. It sold U&I a block of Deep Rock Oil, which had been broke from its inception. In the end, the fund had lost all but \$2 million.¹¹ The Senate hearings held in 1940 were filled with over 1,000 pages of tales of similar abuses.

The SEC had spent six years uncovering and cataloging where the "bezzle" went. The 5,000-page report ultimately issued in 1939 and 1940 was excellent, but the SEC had allowed far too much time to pass; it was truly a case where less would have been more. By 1940, with the

clouds of World War II growing darker daily, and a less than sympathetic, anti-New Deal 76th Congress, the prospects for anything other than a compromise bill had dried up. Fortunately, the industry was eager for *some* bill to pass, so as to remove the taint and regain some credibility. There followed five weeks of intense closed-door negotiations between representatives of the fund industry and the SEC. A consensus bill emerged, representing what the SEC would call the minimum workable set of regulations. Self-dealing was outlawed, at least the more egregious forms; board approval of the management contracts would henceforth be required, and boards would need to include at least a minority of independent directors; independent audits and better disclosure became mandatory; and those complex, leveraged capital structures were outlawed. The bill was quickly adopted by both houses of Congress. As we will see in Chapter 9, the Investment Company Act of 1940, with some modifications over the years, has stood the test of time remarkably well.

A Good Idea

Was there no one back in the 1920s with a more constructive vision of what an investment company could provide for the small investor? With minor exceptions, all the funds were like those in Britain, the traditional closed-end companies, meaning that once the stock had been floated to the public, an investor who wanted to cash out his or her shares would have to find a buyer on Wall Street, with no assurance of receiving their fair value. The quality of disclosure by the funds was poor, allowing the fund sponsors to manipulate prices to their own advantage. Moreover, they had almost invariably injected debt and preferred stock into their funds' capital structures, which worked well enough when the market was rising but led to horrific results for the common stock when it crashed.

Lo and behold, Massachusetts Investors Trust (MIT), created in 1924, became the first *open-end* fund in the United States, or indeed anywhere, and it was conceived by some proper Bostonians as a new and useful vehicle for providing low-cost, professional management to those same small savers who were likely to be exploited elsewhere. In an open-end fund, investors who want to liquidate some or all of their investments could at any time sell them back to the *issuer*, MIT, at a price equal to

the then value of the securities in the portfolio, divided by the number of shares of MIT outstanding at the time—the net asset value (NAV). (Subject to a front-end sales commission for a broker, they could also buy additional shares at the net asset value.) The fund was thus free from the speculative frenzy and skullduggery that had beset most closed-end funds, many of which refused to disclose what securities they were holding, indulged in insider trading, and often traded at prices that bore little relation to their intrinsic value. Think about it: Why would anyone pay more—or less—than the net asset value for a share of MIT? Given a policy of redemption on demand, MIT made a point of providing full disclosure of the trust's portfolio, long before federal law required it. This transparency and flexibility, and the security and comfort thus offered to small investors, made MIT a uniquely American contribution to finance.

Being open-ended, MIT was also a so-called Boston-type fund, meaning that it issued only one class of shares, the common. It would, of course, have been difficult to sell senior securities in a fund where the common holders could liquidate their holdings at any time.

In July 1924, when MIT published its first report, its portfolio consisted of industry leaders—companies that paid steady dividends, including 10 railroads, a handful of utilities, and even a few shares of General Motors. Twenty-five years later, in 1949, *Fortune* magazine found that MIT was still buying the stocks of industry leaders, and with minor exceptions, the then \$250 million portfolio was largely invested in companies that had continuously paid dividends for at least 10 years.¹² Given its broadly based portfolio, the fund had roughly matched the S&P 500, which suited the public just fine. So popular was MIT that by 1949 it had become the largest owner of common stocks in the country.

Massachusetts Investors Trust was conceived as a *trust* fund, not just in form but in substance. As the then chairman explained in 1954, its purpose was to bring “professional investment management” to those who had “neither the means nor the experience, nor the necessary time at their disposal.”¹³ The structure of the fund had been the brainchild of a relatively obscure Boston securities salesman, Edward Leffler, who designed MIT and became one of its three initial trustees. Recognizing that investors rarely succeed when they buy stocks on their own, he studied the British and Dutch trusts, but realized that something was missing, notably a truly full-time management, and, in his words, “a provision that

investors could present their shares and receive liquidating values at any time.”¹⁴ By creating continuous liquidity and the transparency that inevitably followed, Leffler put investors’ interests first.

Good ideas usually have simple beginnings; it’s the very simplicity of the concept that makes them ultimately successful. This one was brilliant.

Today almost every mutual fund is managed by an external corporation, often a bank or insurance company operating through a subsidiary, which is thus responsible to its own, separate shareholders to maximize fees and therefore income. MIT had avoided that conflict of interest by having the fund managed internally by trustees responsible solely to the fund’s investors, trustees whose total pay would be a minor portion of the *income* generated by the trust, which was how management fees were calculated in those days. No income one year? Okay, no fee. Initially 6 percent, their compensation was soon reduced to 5 percent of income.¹⁵ Then, in the 1940s, seeing how the fund had grown and concerned lest they be making *too good* a living, the trustees asked the shareholders to approve a further cut, to about 3.25 percent.¹⁶ In 1949, the total management and all operating expenses were a very modest 0.4 percent of *net assets*, the formula by which fees and expenses are measured today; and by the 1960s, that already low annual expense ratio had dropped to a truly remarkable 0.19 percent of net assets.¹⁷ (Today the annual all-in expense ratio of a fund is likely to be 10 times that, and the managers take their cut regardless of whether the fund turns a profit.) Unlike today, when investors casually flip in and out of funds, the investors in MIT redeemed less than 3 percent of their shares in 1949, and the turnover rate within the portfolio was just 3.6 percent that year.¹⁸ Given a portfolio of industry leaders, there was little incentive for either share owners or managers to churn their holdings.

Cracks in the Good Idea

Times change, markets evolve, and one size, even if cut from such excellent cloth as MIT, will not fit all. As the industry grew, the inherent conflicts of interest came to the fore, overwhelming the sense of trusteeship that had infused the early days. Several distinct pressures were at work, as fund managers, seeing the growth, went about creating really good businesses for themselves. *First*, substantially all the fund managers gravitated

away from the trusteeship model of MIT, using instead a structure whereby the funds would be managed by a separate, external corporation, owned by the managers. These management companies would provide not just advisory services but also the ancillary distribution, administration, and marketing functions. These were, of course, seen as profit centers, not merely service centers. The managers had their eyes on an eventual sale of their companies at prices that would enable them to harvest a handsome capital gain based on a substantial multiple of their profits.

When, in 1969, MIT also switched to an external management structure, now called Massachusetts Financial Services (MFS), it was clear that making too good a living had ceased to be of concern. The 0.19 percent expense ratio of 1968 would double to 0.39 percent by 1976, and then triple to 1.2 percent by 2003.¹⁹ In 1981 MFS was sold to Sun Life of Canada. Subsequently, in 2006, after MFS had suffered sorely from the disclosure of its market-timing abuses and from poor performance in some major funds, Sun Life tried to sell MFS, but for whatever reason soon took it off the market.

In addition to higher fees, the fund complexes have steadily focused on gathering more assets, whether within existing funds, by adding new ones, or by managing accounts for corporate retirement plans and other sponsors. There are huge economies of scale in the investment management business. The cost to manage \$100 million of assets is nowhere near 10 times the cost to manage \$10 million. The back office and administrative systems don't grow as rapidly as revenues, and the team that manages one fund may often manage others. The number of U.S. stock funds alone grew from 288 in 1980 to 1,099 in 1990 and to 4,770 in 2006, all in an effort to attract investors as they wander about the investment universe. Put a higher rate of fees on a larger pool of assets, and the impact is geometric; while MIT's assets grew seven times from 1969 to 1999, the total fees grew 36 times.²⁰ Guess what? The investors' interests no longer came first.

In addition to MIT, there was a second Boston-type, open-end fund created in 1924, State Street Investment Corporation, and like MIT, its history tells us much about the evolution of an industry. When the founders, a Cabot, a Paine, and a Saltonstall, discussed their proposed new concept with some veteran financiers, such as the treasurer of Harvard and members of J. P. Morgan & Company, they were met with incredulity. "Insane," they were told, to start a company that the

stockholders could liquidate anytime they chose! So much for conventional wisdom.²¹ State Street was managed more aggressively than MIT, and for the first 15 years or so it showed better results.

Like MIT, the partners at State Street could see during the 1970s that Fidelity Investments and other funds had formed separate management companies, which, if the managers chose, could then be sold to insurance companies and the like at what Paul Cabot called “ridiculously high prices.” Echoing the views of the SEC, Cabot still thought that a “fiduciary does not have the right to sell his job to somebody else at a profit.”²² In 1982, however, one year after MIT was sold, the State Street Research & Management Company, joining the trend, was sold to Metropolitan Life. Under Met Life ownership, 32 new funds were created, and assets under management rose 15-fold, to \$7.5 billion at year-end 1999.²³ But the end was nigh; values fell sharply in the dot-com crash, and assets under management fell by 60 percent. In 2004, Met Life called it quits, and the management contracts were sold to BlackRock, which promptly merged the funds into others.

American essayist and *Masterpiece Theater* host Russell Baker once observed, in a different context, “The new calendar reward[s] incessant and swift activity and penalize[s] the reflective pause.”²⁴ Investment translation: Today, the average mutual fund trades in and out of its stocks about 100 percent a year, meaning that instead of investing carefully and patiently, as MIT had done years ago, it is furiously trying to stay abreast of the market trends, whatever they be. Investment translation #2: There are, indeed, a few funds, but very few, that still show the same patient, long-term perspective as had MIT. For the discerning investor, they illustrate the opportunities available when managers are willing to put their investors’ interests first, even demonstrating their commitment by investing the bulk of their personal savings alongside the public’s. Someone who, having done some homework and found one of these so-called value funds, can turn off CNBC, relax, and allow the manager to fret over whether the price of oil will help or hurt the portfolio. Investment translation #3: These managers, with their distinctive investment philosophy and willingness to be out of step at times, hold a useful mirror to the painful habits of the industry as a whole.

Let’s take a look now at some of these patient, strong-minded funds.

