CHAPTER 1

Why the World Needs Another Mutual Fund

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From its birth in the United States in 1924 to today, the mutual fund industry has witnessed its share of scandals, changing regulations, new products, and emerging players. Each change that the fund world has experienced over the years has created opportunities and bred innovation. Seize the opportunity and bring creativity to the marketplace. Start your own successful mutual fund.

WHAT IS A MUTUAL FUND?

This professionally managed, pooled investment vehicle allows individuals and institutions to combine smaller amounts of money into a larger sum for investment. This pooling of assets allows for these individuals and groups to attain economies of scale (that is, smaller brokerage commissions than an individual investing alone) and a reduction of risk through diversification.

The term *mutual fund* reflects the mutual relationship between the shareholder and the fund. The fund sells shares to investors or redeems shares from those wanting their money back, at a price that depends on the net asset value (NAV) of the fund. NAV is the price of one fund share at the end of the trading day.

SCANDALS

When Edward Leffler, a former securities salesman, created the first U.S. open-end mutual fund in 1924, it was shadowed by a more popular investment vehicle, the closed-end investment trust. These trusts issue fixed amounts of nonredeemable securities that are traded inside secondary

THOSE INVOLVED IN THE DAY-TO-DAY FUNCTIONS

A mutual fund generally does not have employees, although a recent SEC rule requires funds to have a "chief compliance officer" that reports directly to the fund's independent members of the board of directors. The fund has contracts with firms that provide services it needs. These contracts are with the investment adviser, fund administrator, principal underwriter or distributor, fund accountant, custodian, transfer agent, shareholder servicing agent, attorney, and independent auditor. The fund's board of directors or trustees oversees the contracts of these and other firms that provide services to the mutual fund.

Investment Adviser—the firm that manages the fund. The portfolio manager, the person who decides which securities to buy and sell to attain the fund's investment objectives, is typically an employee of the investment adviser.

Fund Administrator—interacts with each service provider. It ensures that all the fund's checks and balances are in place and that the fund complies with certain federal requirements.

Principal Underwriter or Distributor—is responsible for reporting commissions paid and received, state registration of shares sold, advertising and sales-literature compliance, and selling agreements between the brokerage firms and the mutual fund.

Fund Accountant—calculates the Net Asset Value (NAV).

Custodian—pays cash for securities (securities settlement) and makes sure all trades match (trade confirmation).

Transfer Agent—keeps shareholder account records, calculates and disburses dividends, and prepares and mails confirmation statements and federal income tax information, as well as a host of other services. The transfer agent is responsible for anything to do with account-owner shares.

Shareholder Servicing Agent—responds to inquiries from potential and existing investors, gathers information from them, and provides another means to deliver the fund's message. This agent is typically an extension of the transfer agent.

Attorney—specializes in the Investment Company Act of 1940 (40 Act), the primary law governing mutual funds, and is commonly referred to as a 40 Act lawyer. The attorney assists

the fund in understanding how to integrate the various federal and state regulations with the fund's business parameters.

Independent Auditor—certifies the fund's financial statements. The independent auditor is required under the 33 Act.

Board of Directors—in addition to overseeing the fund's contracts, the directors serve to protect the interests of the shareholders.

Shareholders—the fund's only owners and its only customers. They are critical to a mutual fund's success. Without them, the fund's assets stagnate or dwindle. They enjoy certain rights affecting the fund. Under the 40 Act, all shares issued by a mutual fund must be voting stock and have equal voting rights. The shareholders use these voting rights to elect the board of directors to vacant positions, approve or reject any changes deemed fundamental, and in some cases approve or reject any changes in the fund's investment advisory contract.

markets. By 1929, open-end mutual funds numbered 19, with $140 million in assets. In contrast, 89 closed-end investment trusts held $3 billion in assets. The dominance of the closed-end investment trusts, however, was about to change.

The impetus for change was the stock market Crash of 1929, which shed light on the investment trusts' inherent problems. Many closed-end funds did not disclose their underlying portfolio holdings. This allowed those funds to value their own shares at whatever price their fund managers wanted. It was also common for fund managers to borrow money to inflate the size of their fund. The leverage enhanced the investor's return, but exposed them to the potential loss of their stake to senior debt-holders. Also, many closed-end funds purchased securities as favors to help insiders unload undesirable stocks.

Speculation before the Crash drove prices of closed-end funds higher than the prices of the securities they owned. When the Crash hit, closed-end trust holders were hurt more than common-stock investors.

Open-end funds also lost value during the Crash, but their policy of redemption upon demand at NAV safeguarded them against many of the problems that devastated closed-end funds. Because open-end funds might have to sell portfolio securities at any time to meet investors' redemptions, they could not borrow heavily or hold any large proportion of their

portfolios in unmarketable securities. Also, pricing fund shares at NAV avoided speculation, since a fund could not be priced beyond the prices of its underlying securities.

Although growth in the investment market was slow after the Crash, by 1943 open-end funds' share of the market exceeded that of closed-end funds for the first time. At the end of 2006, open-end funds continued to be a more popular investment choice; there were 8,726 open-end funds with $10.4 trillion in assets under management versus 646 closed-end funds with cumulative assets at $298 billion.[1]

It took 74 years for another major scandal to strike. Regulators are currently investigating such abuses as excessive trading, late trading, and time-zone trading. Excessive trading is the rapid buying and selling of fund shares. While not illegal, excessive trading may increase expenses for long-term fund shareholders. Most fund companies prohibit it.

Late trading, which is illegal, takes advantage of price movements in securities held by a fund after the stock exchange is officially closed. Customers who place a trade after the 4 P.M. ET cutoff get the pre-4 P.M. price.

Time-zone trading takes advantage of price movements in foreign securities held by mutual funds after the foreign markets have closed, but before the NYSE has. If mutual fund companies do not use a fair-value price for the foreign securities, an investor may take advantage of a disparity in price by buying or selling fund shares.

REGULATIONS

With scandal comes regulation. Following the Crash of 1929, Congress passed four significant laws: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.

The Securities Act of 1933 (33 Act) established rules for any public offering of securities. Anyone who wants to offer securities to the public must register those securities. In addition, prospective investors must receive a prospectus that adequately discloses a description of the offering.

The Securities Exchange Act of 1934 (34 Act) created the Securities and Exchange Commission (SEC), whose role is to enforce federal securities laws. The 34 Act also established rules and registration requirements for the securities exchanges, broker-dealers, transfer agents, and distributors.

While the 33 and 34 Acts affected all public companies, the Investment Advisers Act of 1940 and the Investment Company Act of 1940 specifically

addressed the mutual fund industry. The Investment Advisers Act targets the investment adviser, the firm that manages the fund. The rules require, among other things, registration with the SEC, keeping certain records, and prohibit acting in a manner that would deceive or mislead somebody to whom the investment adviser owes a fiduciary duty.

The Investment Company Act of 1940 aimed its regulations at investment companies (for example, closed-end and open-end funds and unit investment trusts). It formed the foundation upon which all regulation specific to the mutual fund industry is based. Unlike the 33 Act, which is predominantly disclosure-oriented, the 40 Act prohibits a broad range of conduct and mandates various types of fund behavior.

Some of the provisions aim to:

- Counter inadequate disclosure to shareholders by requiring investment companies to register with the SEC, maintain specified accounts and records, and file annual reports with the SEC. Independent auditors must audit the financial statements in the annual reports.
- Circumvent management from pursuing their interests above the shareholder's by requiring the investment company's board of directors be composed of at least 40 percent independent members who are not affiliated with the management company. (Recent rules increased this number to 75 percent.) In addition, the shareholders must initially approve a written contract between the fund and its investment adviser and principal underwriter. Thereafter, the board must approve this contract annually.
- Further protect shareholders by requiring that investment companies' shares have equal voting rights and that shareholders vote on changes to fundamental policies.
- Avoid mismanagement by requiring that investment companies' officers and employees, who have access to cash or securities, be bonded with what is called a fidelity bond. A qualified custodian must hold the securities.
- Ensure an investment company has adequate assets or reserves by requiring that it begin with at least a net worth of $100,000, which is known as seed money.

As you can see, the 40 Act addresses many of the abuses by closed-end investment trusts that came to light with the Crash of 1929.

The SEC has also proposed a series of new regulations to address the instances of market timing, late trading, and other recent developments in the mutual fund industry. The scope and impact of this new body of regulations may be significant.

Not all regulation occurs to circumvent future scandal. Some create benefits. For example, Congress passed the Revenue Act of 1936, which established the tax pass-through treatment. It states that investment companies, such as open-end mutual funds, can avoid paying federal income tax on their income if they meet a number of requirements, including distributing all taxable income to their shareholders and redeeming their shares upon demand. This benefits shareholders. Instead of being taxed twice on their investments like a regular corporation, they are only taxed once.

PRODUCTS

Regulation can also create new products. For example, in 1974, the Employee Retirement Income Security Act (ERISA) passed and created the Individual Retirement Account (IRA). This pension reform act mandated that employees be vested in their pensions within 10 years and retain their pension rights as they move from one employer to another. Four years later, the Revenue Act of 1978 passed. This act permitted the creation of 401(k) retirement plans. Many other retirement vehicles were spawned over the years and with them we have seen a shift from employer-sponsored defined benefit plans to employer-sponsored defined contribution plans. As of the end of 2006, 32 years after the passage of ERISA, IRAs and defined contribution plans accounted for $4.1 trillion (or 39 percent) of mutual fund assets.[2]

The adoption of Rule 12b-1 in 1980 also created new products. Rule 12b-1 allows for funds to pay for distributions out of fund assets. This gave sponsors of load funds new ways to design commission arrangements. In addition to the traditional front load, the contingent-deferred sales charge (CDSC) and level-load arrangements were created.

The industry also benefits when regulations are dropped. In 1974, the SEC ended fixed stock commissions. This paved the way for the emergence of discount brokerages. Discount brokerages allow investors who do not need advice to execute their own trades. Customers pay a transaction fee to buy or sell a particular mutual fund.

Discount brokerages spawned fund supermarket platforms. In 1992, Charles Schwab created OneSource, the first mutual fund supermarket. With OneSource, the customer trades mutual funds on a no-transaction fee (NTF) platform. The mutual fund pays an ongoing fee, which is tied to the size of investor assets brought in through the platform. Both discount brokerages and fund supermarkets created new distribution opportunities for mutual funds.

PLAYERS

Charles Schwab was not the only player to shape today's mutual fund industry. Jack Dreyfus, Ned Johnson, Gerald Tsai, Peter Lynch, and John Bogle were also important innovators.

In 1957, Jack Dreyfus did something no one had done before: He introduced advertising to the mutual fund industry. The launch of this new era began with a TV ad featuring a lion that strolled out of a subway, past a newsstand on Wall Street, and into the Dreyfus office where it transformed into the Dreyfus company logo. Dreyfus again made mutual fund history in 1958 by publishing the Dreyfus Fund's entire prospectus as a supplement in the *New York Times*. Brand advertising came later and Ned Johnson was the one to do it.

In 1972, Ned Johnson took over the reigns of Fidelity Management and Research from his father, Ed Johnson. During his tenure, the younger Johnson helped transform the mutual fund from a service into a product. One way he did this was through brand advertising. Much as consumer-products companies sell detergent or cola, Johnson initiated an advertising campaign that emphasized the Fidelity name. Also supporting the transition from service to product, he and his management team initiated or popularized new features and services such as check writing against money market funds and expanded their product offering to include an exhaustive list of funds such as sector, international, and tax-exempt. By the late 1990s, every fourth or fifth dollar flowing into U.S. stock funds was invested in a Fidelity fund.

Gerald Tsai, another giant in the industry, came from Fidelity. After leaving Fidelity, Tsai started the Manhattan Fund (1965). Over its first year, the Manhattan Fund grew faster than any mutual fund up until that time. It attracted $100 million in one year, largely due to Tsai's portfolio management style that emphasized performance. This style rocked the world of mutual funds in two ways. People previously invested in mutual funds for diversification, professional management, and economies of scale. In this go-go era, people invested for performance.

Also, portfolio managers, previously considered fiduciaries of their client's assets, were now becoming stars. People in the investment industry knew where Tsai ate and what he was buying and selling. Tsai, along with other gunslingers of the time, created the mutual fund world we live in today. People chase performance and adulate the most successful portfolio managers like they do rock stars.

Peter Lynch, another Fidelity player, took star status up a notch to celebrity. In 1990, Peter Lynch ended his thirteen-year reign of the Fidelity Magellan Fund. His "Invest in what you know" strategy helped the Magellan Fund skyrocket from $26 million to $14 billion. Someone investing $1,000

in Magellan at the beginning of his reign and leaving it in there for the remainder of his tenure would have had $28,000, a 29.2 percent return each year for 13 years! His amazing track record combined with his personality elevated him to celebrity. He even starred in a series of Fidelity ads.

Portfolio managers are not the only shapers of the industry. John Bogle, founder of the Vanguard Funds, is a great example of this. In 1975, John Bogle started the Vanguard Group. What's unusual about the Vanguard Group is its structure. The funds themselves own the investment adviser. Bogle believes this not-for-profit structure is the way to minimize the cost to the funds, which in turn minimizes the cost to investors. Throughout his career, Bogle has been and continues to be an advocate of index funds because he believes that actively managed funds create more cost than returns for a shareholder over the long term. In the past thirty years we have seen the emergence of discount brokerages, fund supermarkets, defined contribution plans, IRAs, new fee structures, and the status elevation of the portfolio manager. Change continues today. Exchange-traded funds, the mutual fund's next evolution, are fully explored in Part II.

GOING FOR THE BRASS RING

Whether you want to be a star, take your current business to the next level, look to prove a theory, change your career, or make a social statement on a broader level, this is a great business. There are no accounts receivable, write-offs, bad debt, inventory, or heavy lifting. Your fee is built into your fund's NAV so you do not have to bill anyone to get paid. Also, through asset appreciation, revenues may increase even without any new sales.

In addition, compared with other financial products, people are comfortable with it. Even with the scandals that periodically arise, people are familiar with and trust mutual funds. If you ask someone to invest in a commodity fund, hedge fund, or to place her cash overseas, her natural inclination would be to run away. Even these scary products, however, wrapped within a nice veneer of a mutual fund would be more palatable to the average investor.

It is also a very profitable business. Studying the 1998 financial reports of eighteen publicly held management companies, Strategic Insight, an industry research firm, found an average 36 percent operating margin. The companies in the study were large firms totaling over $1 trillion in assets under management. I want to point out that bigger in this case is not always better. Some of the small funds I spoke with averaged even higher net margins!

WHAT'S YOUR MOTIVATION?

While managing a mutual fund is exciting and profitable, I wanted to know the personal reasons why individuals decided to take the plunge and start a mutual fund. To answer this, I picked up the phone and called an assortment of money managers who chose to throw their hat in to the ring. The funds they manage or managed were very different from one another. These money managers represented a variety of investment objectives, strategies, distribution methods, and fees. Where they also differed was on why they started their fund(s). Some of them:

- Wanted to add value for clients. While managing separate accounts, one registered investment adviser (RIA) got frustrated when he found a great value stock and was not able to allocate it effectively across his clients' accounts. By starting a mutual fund, he was able to take positions in the stocks within the mutual fund and have his clients own a portion of the fund.
- Hoped to grow the business. One RIA felt limited growth by managing separate accounts. He had increased the minimum investment for clients but did not like turning away smaller investors. By starting a fund, he was able to maintain the separate-account business and grow his total business by adding new clients to his mutual fund.
- Desired daily public exposure and greater visibility. One money manager had a great track record, but wanted the world to know. He started a mutual fund so people could see his investing skills daily in the newspaper.
- Wanted to create a profit center. One business was already managing money internally as a cost center. By starting a mutual fund and offering it to outside investors, they turned the cost center into a profit center.
- Aimed to enter the subadvisory business. Another RIA wanted to become a subadviser, but she could not find an entry point. By starting a mutual fund, she was able to get visibility and attract offers to subadvise for other mutual funds.
- Sought to prove a theory. Another RIA wanted real money invested so that no one could say her investment approach was just a theory in a computer and that it could not be done in real life.

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WHAT'S YOUR MOTIVATION (*Continued*)

- Meet a client challenge. One RIA heard this challenge from clients thousand of times: "If your model is so good, then why not run your own fund?"
- Wanted to make an impact. One money manager who had a social agenda wanted to make an impact on a broader scale.
- Others launched funds to make a change in their lives. Some simply enjoyed investing and wanted to get paid for it. Some wanted to prove something about themselves or switch careers. One individual got tired of being fired and another wanted to keep busy when he retired.

Not all these money managers' funds survived. Some closed within a few months of becoming effective, some years, and a few never happened. Regardless of their survival rates, it's important to learn from these managers. Their stories, words of wisdom, and warnings are sprinkled throughout this book. So too are the insights of more than 40 industry professionals who work with mutual funds.

In addition to being a great business, managing a mutual fund is an amazing career. A portfolio manager is like a detective. You examine individual companies, dig into the details, put together pieces of information, and create an informed decision to either buy or sell. Something new and exciting is always happening.

On top of this excitement is the awesome responsibility of managing people's money. People trust you with their money and that feels great. You are making a positive impact on the lives of your shareholders.

Managing an open-end mutual fund has awesome responsibilities and rewards associated with it. You get paid for doing something you love and have a positive impact on those who invest with you. As things change, new opportunities evolve. Change brings about new ideas, new products, and new players. You can lead the change. If you can do it a little different or a little better, then do it. Those who have come before you have been passionate and committed. Join them. To your success!