GARY GENSLER

Testimony on Mutual Funds before

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

March 12, 2003

Introduction

Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, members of the committee, thank you for the opportunity to appear here today to discuss the mutual fund industry. It is a great honor and a pleasure to again appear before you. Much has happened within the financial markets since I last appeared here during my tenure as Under Secretary of the Treasury. For that matter, much has changed for me as well. I have since then co-authored a book attempting to present common sense investing advice for middle income Americans and separately worked with Congress on the passage of the Sarbanes-Oxley Act.

Few issues before this committee touch so many Americans as those related to mutual funds. Millions of Americans invest in the stock or bond market to help achieve their long-term financial goals – a home, a college education for their children, a secure retirement. About half use mutual funds. Mutual funds are a convenient and potentially efficient investment vehicle for small investors. And yet, mutual fund companies run up approximately $70 billion per year in costs for their investors. With the dramatic declines in the stock market three years in a row, and with so many mutual funds failing to match the market's performance, investors may rightly wonder if all those fees and costs have been well spent. The book which I co-wrote explores issues of fees, costs, performance, and governance as well as suggesting better investing alternatives. Needless to say, given the title, *The Great Mutual Fund Trap,* I applaud this committee's willingness to explore these issues.

Background

Mutual funds originally were a boon to investors. People with small to moderate amounts of money had not had a realistic option for investing in stocks or bonds. Instead, they were relegated either to bank savings accounts or whole life insurance. If they did invest in stocks, they were unable to get the benefits of broad diversification.

The advent of mutual funds offered many investors a chance at the superior long-term performance of equity investing, and a convenient way to buy bonds. Mutual funds also offered risk reduction through diversification, as most funds owned a broad spectrum of the market. Lastly, when compared with the full-service brokerage commissions of the time, at first mutual funds' costs were relatively attractive.

Mutual funds have subsequently become the investment vehicle of choice for 54 million households, one half of the households in America. Approximately 125,000 households, on average, invest in mutual funds in each of your Congressional districts. They do so directly or through brokerage accounts and retirement plans. Approximately half of tax-deferred retirement plan assets [IRAs, 401(k)s, and 403(b)s] are now held in mutual funds. There are over 4700 stock funds and 2000 bond funds for sale to investors.

In total, long-term mutual fund assets (excluding money market funds) have grown steadily from $48 billion in 1970, to $58 billion in 1980; to $567 billion in 1990; to a peak of $5.1 trillion by the end of 2000. In light of the recent market decline they now stand at just $4.1 trillion at the end of last year.[i] Of this total, just under $2.5 trillion is invested in *actively managed stock* mutual funds – that is, those that pick stocks in an effort to outperform the market. Another $1.0 trillion is invested in actively managed bond funds and over $300 billion in hybrid funds holding a combination of stocks and bonds.

Those Ankle Weights - Costs

Like most choices, however, financial choices are relative: one choice can be judged only in comparison with those forsaken. Indeed, by many objective measures, actively managed mutual funds are failing their millions of devoted clients. That's understandable, given that the mutual fund companies impose costs on investors of approximately $70 billion annually. Most of this money – $50 billion per year -- goes directly to the fund companies in the form of management fees and sales loads. The rest -- largely made up of portfolio trading costs -- is paid to the brokerage industry, which happily executes the huge trading volume generated by active fund managers.

Ask most people about their mutual funds and they may have some vague notion that the fund charges an annual management fee. Yet that is only the beginning of the costs that one pays with a mutual fund manager actively investing for you.

In total, investors can expect costs totaling close to 3 percent to disappear each year for an actively managed stock fund. Invest in a fund with sales loads, as close to one out of two investors do, then one can expect costs averaging closer to 4 percent per year. While fees for bond funds are modestly lower, they still generally overwhelm the expected returns on bonds, particular in today's low interest rate environment.

Compound these costs over a lifetime and you'll see the serious bite they take out of Americans' savings ... ankle weights that could have even brought Carl Lewis to his knees. Further consider that a lifetime of monthly investments in a low cost passive account can yield nearly twice as much as the same amount actively invested. That's the case even if active investing leads to just 2 percent less earnings per year. For example, if a worker saves just $100 per month over a 40 year career and earns 8 percent annually, they can retire with a $348,000 nest egg. Invest in actively managed bond and stock mutual funds and the likely nest egg – $199,000 – fully 43 percent less money available for retirement.

Some mutual fund costs are disclosed to investors:

- Monthly management, administrative, and distribution fees averaging over 1 percent per year. A review of the 2,207 actively managed stock funds in the Morningstar database shows an average expense ratio of 1.44 percent.

- Sales loads charged by half of all actively managed mutual funds to buy or sell shares. The average load is 4.1 percent.[ii] With an average holding period of less than three years, the average load fund investor can pay an additional 1.4 percent per year. Loads don't even help to offset other costs. Expense ratios for such load funds also are high, with an average of 1.84 percent. And as a group, load funds actually earn lower average returns than no-load funds, *even without taking the load into account.*

While investors may not pay particular attention to these costs, at least they are disclosed. There also are very important other costs, though, that go undisclosed. They are hard for investors to measure and they do not show up on any statement. Yet all of these costs stand between investors and the returns they desire:

- Portfolio trading costs — the typical active fund manager turns over their entire portfolio once every 15 to 16 months, incurring brokerage costs and bid/ask spreads each year of approximately 0.5–1.0 percent of assets.

- The opportunity cost of holding idle cash, about 0.5 percent of assets each year during the 1990s bull market, though less now.

- Excess capital gains taxes incurred as the portfolio is turned over each year. Active fund investors, by definition forsaking a buy and hold strategy, burden taxable investors with short term capital gains taxes estimated to add costs of 1 to 2 percent of assets per year.

There is another reason why investors often don't consider the costs of investing. Mutual funds have constructed a system where the costs are practically invisible. We all have to write a check to our utility or mortgage company, but we never pay a bill for mutual fund management. Such costs are simply deducted from our monthly returns, or taken off the top if we buy a load fund. How else to explain the fact that many Americans react furiously to the $1.50 ATM surcharges they pay 20 times per year ($30) yet rarely utter a peep when they pay a 5 percent sales load on a $10,000 investment ($500)?

The Sad Averages

Those ankle weights have their effect. Looking at the results over the last ten years, Morningstar data shows that the average actively managed diversified mutual fund fell short of the market by 2.2 percent annually. Fund returns of 6.6 percent annually compare to the overall market return of 8.8 percent annually, as measured by the Willshire 5000.

Furthermore, currently reported performance results include only those funds that survived the entire period. The many funds which have been routinely merged or liquidated are not still included in these industry statistics. Looking at ten-year returns of currently active funds in 2003 will by definition exclude all the unfit funds that closed up shop during the last ten years.

This phenomenon is known as survivorship bias. It is like judging the contestants on a reality TV show simply by looking at the last few people left on the island. If someone asked a viewer how interesting the contestants were, they would probably forget the ones who were voted off in the first few weeks. What were their names again?

The most comprehensive look at survivorship bias was conducted by Burton Malkiel, who concluded that such bias was considerably more significant than previous studies had suggested. For the ten-year period 1982-1991, survivorship bias inflated average industry returns by 1.4 percent per year. Furthermore, the number of liquidating funds is rising. With 4 to 5 percent of all funds disappearing each year, survivorship bias today is likely to be even greater than during this earlier period. That, along with active funds' cash holdings may explain why reported results for active fund management look comparatively better during the recent bear market.

Triumph of Hope over Experience

There is some good news, though, for investors,. Index funds offer the choice of investing in the market as a whole – achieving broader portfolio diversification than the original mutual funds – at very low cost and with minimal current taxes. Exchange-traded index funds offer the same diversification and cost advantages with even better liquidity and tax consequences.

Yet, most Americans investing in mutual funds tend to pick actively managed funds in the hope of relying on the experts to beat the market. Worse, they pick funds based upon the hope that last year's best performers or "hot" funds will out perform the market once again next year.

Fund companies spend significant advertising dollars luring investors to this loosing strategy. A recent academic study, demonstrated that advertisements are a poor guide indeed for investors trying to decide on a mutual fund.[iii] Researchers examined two years of mutual fund advertising in *Barron's* and *Money* magazine. In particular, they looked at advertisements by diversified (non-sector) domestic stock funds whose ads reported past performance as an inducement to purchase. In all, 294 funds were examined.

The study reached three conclusions:

- First, not surprisingly, the advertised funds had performed well in the year *before* the advertisement was run. The *pre*-advertisement returns of those funds over the past year were 1.8 percentage points better than the S&P 500 Index.

- Second, the advertisements were extremely effective in attracting new money to the funds. Compared to a control group, advertising appeared to increase inflows 20 percent over what one would otherwise have expected.

- The third conclusion, however, is by far the most significant. The *post*-advertisement performance of the funds was quite poor. The funds' *post*-advertisement performance over the next year *trailed the S&P 500 by 7.9 percentage points.*

Mutual fund advertising is a classic example of closing the barn door once the horse has left.

Perhaps the most important study of the factors affecting mutual fund performance was conducted by Mark Carhart, a former professor at the School of Business at the University of California.[iv] He found that, basically, past performance does not predict future performance. Winning funds of the past are unlikely to be the winning funds of the future. Carhart found that if you take the top 10 percent of funds in a given year, by the next year 80 percent of those funds have dropped out of that top 10 percent ranking. For the top 20 percent of funds, 73 percent drop out the next year. For the top 50 percent of funds, roughly 45 percent fall out the next year. That's not much different from what you'd expect from random chance.

Who's Fund is it Anyway?

The whole idea of a mutual fund is, as the name suggests, *mutuality.* Funds allow investors to share the costs of professional money management, in the nature of a cooperative. Legally, investors actually control their mutual funds. The company managing the assets is distinct from – and legally simply a contractor hired by – a mutual fund. Investors are able to select a board of directors to oversee their savings and hire the money management group (known as an "advisor") to invest their money. In theory, the advisor works for them to get the best returns for the lowest costs and risks. If mutual fund investors don't like their advisor's approach or costs, they can hire a new one. That is, at least in theory.

This is not something, though, that advisors have any interest in highlighting. Mutual fund companies, as distinct from the funds themselves, have their own shareholders and profits to consider. They charge high management fees even though they come directly from investors' returns. They generally are willing to take added risks in an effort to attract assets in bull markets. And they trade frequently, even if that increases trading costs and investors' short-term capital gains taxes.

In practice, mutual fund investors have very little power over "their" company. Mutual funds are set up by advisors, not by individual investors. Funds have no employees of their own. All of the research, trading, money management and customer support staff actually work for the fund's advisor. And while shareholders do vote on the fund's directors, the advisor initially selects the directors.

Directors work part-time and rely on the advisor's staff for information. Furthermore, fund companies often set up a pooled structure, whereby fund directors serve on all of the fund boards in a fund complex. For efficiency, the industry association recommends use of such 'unitary boards' or similar 'cluster boards' whereby directors serve on groups of boards for a fund family. Not surprisingly, mutual fund boards fire their advisors with about the same frequency that race horses fire their jockeys.

The Role of Fund Directors

In an effort to address these inherent conflicts, the Investment Company Act of 1940, establishes specific roles for mutual fund directors. According to the late Supreme Court Justice William Brennan, the Investment Company Act was designed to place unaffiliated fund directors in the role of independent watchdogs, to furnish an "independent check upon the management of investment companies."[iv]

This standard, however, has never been interpreted very stringently. In 2001, the SEC took various actions in an effort to make fund directors more independent of their advisor. It raised the required percentage of independent directors from 40 percent to 50 percent. Independent directors, rather than the advisor, must also select and nominate other independent directors. The SEC also imposed more stringent disclosure requirements for those directors

In truth, though, the problem with mutual fund governance may be cultural, rather than simply regulatory. Even before the SEC acted, the great majority of funds had a substantial majority of independent directors. Nothing stopped those directors from negotiating the lowest rates for investors, even if they weren't legally required to do so. In practice, though, fund directors have a difficult time striking a proper balance between working with the advisor and vigorously pursuing investors' interests. Too often the outcome is simply acquiescence to whatever the advisor proposes. Many directors view their role as simply auditing the performance of the advisor and making sure there is no malfeasance or accounting problems, rather than acting as investors' vigorous advocates.

Why Governance Matters

The weakness in mutual fund governance affects investors in a number of ways. First, investors pay significantly higher fees than they would if they really ran their own company. A study conducted in 2001 showed that the largest mutual funds pay twice the amount to their advisors than public-employee pension plans do for the same services.[vi] In some cases, mutual fund advisory fees were 3 to 4 times higher than those of pension funds.

The researchers examined over 1300 diversified mutual funds and 220 separate pension portfolios. To make the analysis comparable, they looked only at advisory fees, which are paid for investment services and research. They excluded administrative and sales distribution fees, which are largely associated only with mutual funds, appropriately excluding fees for customer service, shareholder mailings and broker compensation.

They found that the larger the pension fund, the greater its ability to negotiate significantly lesser fees. As for mutual funds, size conferred far fewer benefits. For instance, the largest 10 percent of pension funds reviewed, having assets averaging $1.5 billion, paid advisory fees of only 0.20 percent. The largest mutual funds, having assets averaging nearly $10 billion each, paid advisory fees fully 2 1/2 times that.

The only explanation the authors could identify was bargaining power. Pension funds negotiate for lower fees, while mutual fund shareholders can only rely on their directors to do so. Unfortunately, it does not appear that mutual fund directors vigorously negotiate fees.

Soft Dollars

The second, hidden cost of mutual fund governance comes when the financial advisor, with the acquiescence of the funds' directors, benefits itself at shareholder expense. This is done through something Wall Street calls "soft dollars."

Most commonly, a fund company will negotiate a deal with the broker which is executing the trades for its 'family' of funds. A portion of every commission will be retained by the broker as payment for research advice or other services normally paid for by the fund company. Such agreements have a name, "commission recapture arrangements."[vii] Basically, any expense that the fund company can direct to the fund's broker adds to the fund companies' profits at the expense of individual funds and their investors.

The mutual fund industry's educational material on the role of directors has this to say about "soft dollars." (Emphasis added):

> Directors also review a fund's use of "soft dollars," a practice by which some money managers, including mutual fund advisers, use brokerage commissions generated by their clients' securities transactions to obtain research and related services from broker-dealers **for the clients' benefit**. Directors review their fund adviser's soft-dollar practices as part of their review of the advisory contract. They do this because **services received from soft-dollar arrangements might otherwise have to be paid for by the adviser.**[viii]

What's hard to figure out is how soft dollar payments can ever be "for the clients' benefits" when they "might otherwise have to be paid for by the adviser." That sounds a lot more like "for the adviser's benefit" to me.

Incubator funds & IPO Allocations

Mutual fund companies understand the rules of chance, and are not shy about using them to their advantage. When chance doesn't yield good enough results, though, they sometimes help it out a little. Through portfolio prospecting a fund company will start several small 'incubator' funds and run them for a year or two. These funds start relatively small, are not widely held, and gain little attention from the financial media. There's a reason for that: the fund company is waiting to see how things turn out before deciding whether to promote the fund.

Those funds that under-perform the market are often liquidated and disappear. The fund company suffers no embarrassment. It becomes just another fund on the survivorship bias pile. When one of the funds outperforms the market, however, it receives far different treatment. The fund company markets the fund and its extraordinary performance, hoping to build up the asset size of the fund quickly.

Through 'selective attention', fund companies can build superior performance for incubator funds through manipulation rather than chance. Fund companies have been able to steer the shares of initial public offerings ('IPOs') and other hot stocks to new funds.

Generally, to ensure interest an IPO the offering price is set by the Wall Street underwriter at a discount to the expected trading price. Investment banks allocate shares at the IPO price deciding where to bestow any discounts. The mutual fund families, in turn, can choose which of their funds will be winners. The hotter the stock or IPO, the more important it is to find the right fund. Just given the arithmetic, small funds can get more of a boost from such attention. A little bit of juice shared with a small incubator fund can go a far way. That's when the marketing department can start readying copy for next month's advertisement.

Policy Issues for Possible Consideration

In writing a personal finance book I felt there were many appropriate suggestions and bits of advice to offer average investors. At its core, *The Great Mutual Fund Trap* we advises investors to stick to fundamentals through a buy and hold strategy; broad diversification; and avoidance of excess costs and risks associated with active money management or stock picking. I believe, however, that this is appropriately largely the domain for individual choice.

Congress and the SEC have acted for over 60 years, though, to address the ever changing issues related to the inherent conflicts between mutual fund companies and mutual fund investors. In this regard, this committee or the SEC may wish to give further consideration to (a) possible greater disclosures; (b) fund governance & (c) tax deferred retirement plans.

Possible Greater Disclosure

The mutual fund industry currently provides a considerable amount of disclosure. Additional disclosures, however, may assist investors and further guard against the inherent conflicts within the industry's structure. The following thoughts on additional possible disclosures are offered as an aid in any further deliberations.

First, while the direct costs of management fees and sales loads are disclosed, many of the indirect costs are not. In particular, portfolio trading costs are generally not disclosed. This is somewhat remarkable given their significance to investor returns. They are also the largest controllable cost of a mutual fund. I believe that it would be beneficial to disclose total transactions costs, commissions as well as possibly an estimate of the costs of bid/offer spreads. If pursued, this would be most helpful if disclosed along with management fees as a percentage of average assets.

Second, while Congress took steps several years ago to require the disclosure of after-tax returns, the SEC does not require inclusion of this information in sales and promotional material unless a fund is claiming to be tax efficient. Investors wishing to know a fund's after-tax performance currently need to review the prospectus – something they should be doing, but generally are not. It may be appropriate to mandate broader use of after-tax performance data.

Third, there is a significant relationship between risk and returns. Many observers focus on risk adjusted returns to compare investments. Based upon modern theories of investing, risk adjusted returns are a way of comparing investments of different risks. There are many services that compute such statistics. It may be worthwhile considering requiring fund companies to readily disclose such information on their web sites or with promotional material.

Fourth, the SEC currently sets guidelines on the use of performance data along with promotional material. Given the persuasive evidence that past performance does not predict future performance, the Commission might want to consider further tightening these rules.

Fifth, given the natural desire of fund companies to ignore the poor results of liquidated or merged funds, it maybe worthwhile considering requiring fund companies to maintain such disclosure on their web sites. In addition, such returns could be included in reports on a fund companies' average performance. Survivorship bias has a perfectly innocent explanation. When investors are trying to decide with which mutual fund family to invest, however, they could benefit by seeing a firm's entire track record. Many outside services and publications could also summarize the information, once made publicly available, as well.

Sixth, the mutual fund industry relies heavily on others — brokers, insurance Companies, and financial advisers — to sell its products. Additionally, fund companies actively compete to win 401(k) and 403(b) plans from large corporations and institutions. Recognizing their commercial leverage, brokers have developed sharing agreements whereby they get paid handsomely for every new sale they make. Large corporations and institutions have developed somewhat similar arrangements whereby they receive part of the mutual fund fees on plan assets. In both venues, most mutual fund families feel they have to pay, lest they lose access to new assets and market share. Consideration may be appropriate to greater disclosure of these revenue sharing arrangements.

Mutual Fund Governance

Mutual funds, like other types of commercial entities must be operated for the benefit of its owners. Unlike most businesses, however, mutual funds are typically operated on a day-to-day basis by a third party – a mutual fund company. Being separate and distinct from the funds which it advises, a fund company has a primary responsibility and loyalty to its own shareholders. For instance, each publicly traded mutual fund company has a primary responsibility to its public shareholders above any duties to the investors in the many funds it manages.

Certainly, the mutual fund industry is competitive. There are thousands of funds and hundreds of fund companies. They disclose costs to the considerable extent required by law. Each fund company also prefers that the funds they manage do well relative to other funds. That does not mean, however, that the mutual fund industry competes on cost.

There are hundreds of casinos at Las Vegas, but that does not mean that you'll find one where the odds are in your favor. Casinos compete on glitz. While they want their customers to always have hope and leave feeling like winners, at the end of the day the house wins. Casinos owe it to their shareholders. Mutual funds compete on a range of services and a hope of earnings performance. They, too, owe their primary duty to their shareholders. In both cases, cost is all too often an afterthought for the customer.

While the Investment Company Act of 1940 and the SEC have addressed this inherent conflict of interest in many ways, it may be appropriate to consider whether the current framework is adequate to the task. In particular, there is significant evidence suggesting that fund directors generally do not actively pursue fee reduction or changing money managers. Public pension plans and corporate retirement plans switch asset managers on a regular basis, either due to fee or performance issues.

- Why don't we ever see reports of 'request for proposals' by mutual funds for their money managers? Fees are the largest controllable cost of a mutual fund.

- Why don't we see reports that at least a handful of funds each year have chosen a new fund advisor? Thousands of mutual funds under-perform the market each year. Numerous ones lose money each year.

To address these short comings, it may be appropriate to consider some sort of requirement that fund directors seek competitive proposals on a periodic basis or prior to renewing advisory contracts. An alternative approach might be to consider requiring fund boards to fully disclose the basis and reasoning for not seeking such competitive proposals. Imagine any other board of directors fulfilling its fiduciary duties without seeking competitive proposals for its principal supply contract.

The current nature of mutual fund governance also has allowed for mutual fund companies to enter into soft dollar arrangements with brokers at the expense of the mutual funds which they manage. One alternative might be an outright ban on such arrangements. Short of a prohibition, would be to require mutual fund fee disclosures to include the amount by which any soft dollar arrangement is picking up costs for the fund company.

With regard to the use of IPO allocations to enhance the performance of incubator and small funds, consideration might be given to requiring the SEC to promulgate new rules to limit such activities.

Tax Deferred Retirement Plans

With over $1.75 trillion held in 401(k) and 403(b) plans, mutual fund companies are very interested in these assets. Nearly 70 percent of these assets, or $1.2 trillion were invested in mutual funds as of year-end 2001.[ix] The government bestows numerous tax advantages to these accounts to promote savings in America. In addition, legislation currently is being considered by the Congress to allow mutual fund companies to offer investment advice to plan participants.

It light of this, it may be appropriate to consider having all 401(k) and 403(b) plans include as investment alternatives a low cost broad market U.S. equity index fund and bond index fund. Major pension plans and other institutional investors are investing passively in increasing amounts. According to Greenwich Associates, by year end 2001, public sector pension plans had fully 57 percent of their domestic equity investments indexed. Corporate pension plans had nearly one third of their domestic equity investments indexed.

Including such a choice for all workers would simply allow them a low cost index alternative to consider while not limiting choice. Such a provision would give workers a benefit similar to those Congress has provided for all Federal Government workers through the Thrift Savings Plan. It could be particularly appropriate if mutual fund companies are allowed to offer investment advice directly to plan participants, as this new provision would add a potential new conflict of interest in the world of mutual funds.

Conclusion

Thank you. I would be happy to answer any of your questions.

[i] Investment Company Institute. As of year-end 2002, money market funds held $2.3 trillion.
[ii] Morningstar Principia Pro as of December 31, 2002. Search was for all mutual fund share classes charging a sales load, excluding index funds, exchange-traded funds, and institutional funds—3,674 funds in all. The 4.1 percent came from adding the average front-end and back-end load.
[iii] Jaij, Prem C., and Joanna Shuang Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows," *Journal of Finance15*, (April 2000): 937.
[iv] Carhart, Mark M., "On Persistence in Mutual Fund Performance," *Journal of Finance 52* (March 1997): 57.
[v] Burks v. Lasker, 441U.S. 471, 484 (1979).
[vi] Brown, Stewart, and John Freeman, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *University of Iowa Journal of Corporation Law*, (August 2001): 609-73.
[vii] Berkowitz, Stephen and Dennis Logue, "Transaction Costs: Much Ado About Everything," *Journal of Portfolio Management* 27 (Winter 2001): 65.
[viii] Investment Company Institute, "Understanding the Role of Mutual Fund Directors" (1999): 16.
[ix] Investment Company Institute and the Employee Benefit Retirement Institute, "The EBRI/ICI Participant-Directed Retirement Plan Data Collection Project" (February 2003)