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Scandals sow 'seed of doubt' in funds ; But industry still attracts investors

Record, The; Bergen County, N.J.

Nov 07, 01:26 PM

Investors are still putting money into mutual funds, but experts say recent scandals have planted "a seed of doubt" about the industry.

"The mutual fund scandal is so broad, and it's becoming broader," said Thomas Orecchio, an Old Tappan financial planner. "It's not just one type of impropriety. Some of them will affect you financially and some will not, but certainly they will shake your confidence in the industry."

"This plants a seed of doubt in the minds of many investors," said Jeffrey Ptak, an analyst with Morningstar, the Chicago mutual fund rating firm. "It's been an industry that has been free of scandal."

Although investors have yanked money from the funds tainted by scandal, the $7 trillion mutual fund industry continues to attract investment dollars overall, according to California-based trimtabs.com, which tracks investment flows. As long as the bull market is making them richer, most of the nation's 95 million mutual fund investors seem to be shrugging off the scandals, according to Charles Biderman, trimtabs' chief executive.

The scandal began unfolding in September, and regulators say more charges are likely.

The allegations fall into two categories. One was that some mutual funds illegally allowed privileged investors to trade after hours, getting that day's 4 p.m. closing price instead of the next day's price.

The other allegation is that some funds improperly allowed investors to jump in and out of their funds, a practice called market-timing that hurts long-term investors in the funds.

Market-timing increases transaction costs as fund managers buy and sell stocks to accommodate the "hot" money. After-hours trading hurts other investors because those who are allowed to do it "are able to trade based on information that other people can't trade on," said Wayne financial adviser Karl Graf.

So far, regulators have targeted Putnam Investments, a unit of Marsh and McLennan; Prudential Securities, a unit of Wachovia Corp.; Bank of America Corp.; Bank One Corp.; Strong Financial Corp., and Janus Capital Group.

Investors who are troubled by the scandals can - and should - look for signs that a mutual fund will behave with integrity, financial experts say.

First, mutual funds should charge redemption fees and take other steps to discourage market-timing.

For example, the Vanguard Group of mutual funds in Valley Forge, Pa., says it charges redemption fees for money that is taken out in less than two months, cuts off trading early for international and index funds, and screens large transactions.

"In fact, we turn down tens of millions of dollars of what we consider speculative money each year," said Vanguard spokesman John Woerth.

In addition, said Graf, "I would look for funds that are not afraid to close a fund if it gets too big." That shows that the fund managers put the current shareholders' interest before their own profits, which would be boosted by a larger client base.

At the same time, fund companies should not be too quick to jump onto investing fads, Ptak said. Many fund companies, for example, created tech and telecommunications funds in the late 1990s, drawing in investors who "got the worst of that trend," Ptak said.

Advisers also like to see mutual fund managers put their own money on the line - or in industry jargon, "eat their own cooking."

"If the managers themselves are heavily invested in the funds that they run, the odds that the fund is being run ethically certainly improve," said Marnie Aznar, a Morris Plains financial planner.

Graf frowns on funds that advertise their recent short-term gains because the message is that they're "looking for hot money," he said.

Graf is advising clients who have Putnam funds to sell those investments if they don't have to pay too large a sales load.

His logic is that Putnam employees are likely to be so distracted by their legal problems that "their ability to manage money is compromised."

"They could be the Arthur Andersen of the mutual fund industry," he said, referring to the accounting firm that collapsed in the wake of the Enron scandal.

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E-mail: lynn@northjersey.com
