

# Shining the Sun on Mutual Funds Portfolios

by Mercer Bullard

Mutual funds are the investment choice for Americans, but funds are failing to adequately disclose their portfolios, contends the author. The SEC is scrutinizing portfolio disclosure and portfolio "manipulation," but in the meantime investors and their advisors must be vigilant. The author examines such practices as style manipulation, window dressing, portfolio pumping, misleading fund names, portfolio overlap, and limited portfolio information.

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Mutual fund portfolio disclosure has been a hot topic lately. The Open Fund and the Community Intelligence Fund have generated much publicity by providing real-time disclosure of their portfolios on the Internet. Representatives of these funds, along with Morningstar and the National Association of Investment Clubs, made news in May when they asked the Investment Company Institute to encourage funds to disclose their portfolios more often.

In June, Fund Democracy and the Financial Planning Association petitioned the Securities and Exchange Commission (SEC) to require funds to be more forthcoming about how they invest shareholders' money. The Consumer Federation of America, Consumers Union and eight other consumer groups filed similar petitions last month, and the AFL-CIO has announced that it plans to file a petition as well.

The SEC is beginning to pay attention. Earlier this year, it formed a task force specifically to root out evidence of portfolio manipulation. Lori Richards, who heads the SEC's fund inspections program, told Fund Democracy, "We are focusing very hard on evaluating trading data that would indicate manipulation—we're looking for signs that stocks may be manipulated at quarters' end to bump up performance, [and] for instances of managers window dressing their funds' portfolios to create a misleading impression of how the fund's assets were invested during the period."

The task force is a sure sign that the SEC is looking to bring a portfolio manipulation case and make an example of someone. Richards warns, "To the extent that these practices may exist, I believe that bringing just one enforcement action in this area would go a long way toward making fund managers think twice before engaging in these kinds of practices."

But unfortunately, for investors and their advisors, the SEC has yet to take steps to craft a better enforcement mechanism than its proverbial shotgun behind the door. Americans are more dependent on mutual funds for their financial security than ever before, yet the SEC's current disclosure requirements amount to government-sanctioned concealment of portfolio manipulation.

Behind the cloak of semiannual portfolio disclosure currently required by the SEC, fund managers engage in a variety of practices that are harmful to investors and their advisors. Funds often invest in ways that are inconsistent with their names or stated investment styles, making it difficult for investors to allocate their assets with confidence, and exposing them to hidden risks. Practices such as style manipulation, window dressing and portfolio pumping harm investors and undermine their confidence in the integrity of mutual funds and our securities markets—and, indirectly, in the advisors who trust mutual funds with their clients' assets.

## Style Manipulation

The most egregious portfolio abuse is style drift. Empirical research suggests that style drift is commonplace among mutual funds. In 1999, for example, Dr. Craig Israelsen, a professor at the University of Missouri-Columbia, studied 580 mutual funds to measure "their propensity to migrate from one classification within the Morningstar Style Box."<sup>1</sup> Remarkably, Israelsen found that 291 of the 580 funds had significant style drift.

The style drift that Israelsen discovered is hardly innocent. Funds routinely describe themselves as investing according to a particular investment style or in a particular asset class, while secretly making outside investments in order to improve their performance relative to their peer group. Investors who are taken in by deceptive labeling are unwittingly gambling with their financial security.

Stephen Brown, a business school professor at New York University, and Will Goetzmann, a business school professor at the Yale School of Management, found evidence that fund managers "deliberately mislead investors about the strategy they pursue" and manipulate their funds' investment styles in order to boost the funds' performance relative to their peer groups.<sup>2</sup> Based on an analysis of the monthly returns of 276 funds, Brown and Goetzmann found large discrepancies between funds' purported and actual investment styles.

Fund managers have a strong incentive to make bets not authorized under their fund's investment guidelines on investments that are outside on their fund's style disciplines. Studies have found that, while investors flock to superior short-term performance, they are less likely to abandon a fund when its performance heads south. This means that it's worth taking the risk that unauthorized investments will underperform securities that are consistent with the fund's stated style, because the attendant risk of shareholder redemptions is less than the potential for substantial sales if the manager guesses correctly. Current disclosure rules, which mandate only semiannual disclosure after up to a 60-day lag, are wholly inadequate to enable shareholders and their advisors to determine how funds are investing fund assets, and thereby keep fund managers honest.

## Window Dressing

Another form of what the SEC views as portfolio manipulation is known as "window dressing." Fund managers often buy and sell securities around disclosure dates in order to conceal the way the fund has actually been managed the rest of the year. This insidious practice is intended to mislead investors and their advisors into believing that a fund is what it isn't, and is not what it is.

According to Brown and Goetzmann, "[w]indow dressing is a common end-of-period ploy." For example, according to Morningstar, the number of funds holding Qualcomm rose 65 percent during the second half of the year, as indicated by December 31, 1999, filings. This is not surprising, as Qualcomm rose 2,619 percent in 1999. Window dressing with Qualcomm has proved quite costly for many shareholders, however, as the stock has dropped 64 percent this year. One fund manager confessed: "It's one I thought I needed to own," admitting that "he felt like he was late to the party when he started by buying shares in October and late November."<sup>3</sup>

Studies show that even managers of mundane money market funds commonly engage in window dressing. In a 1997 study, David Musto, a Wharton finance professor, found that money market fund managers were buying more government securities just before disclosure dates, and selling them just after disclosure dates, to make their portfolios appear safer than they really were.

Although the SEC task force is specifically targeting window dressing, it is difficult to prove without a smoking-gun memo in which a fund manager says the purpose of a trade was window dressing or portfolio pumping. Lori Richards laments, "Proving that a fund manager bought a stock to manipulate the fund's performance would be, I think, extremely difficult, but not impossible."

## Portfolio Pumping

Window dressing isn't the only impetus for one-day shopping sprees. Managers frequently buy stocks that they already hold in order to give their funds a one-day performance boost, a practice known as "portfolio pumping." A 1999 study by Dr. Musto found that the best-performing funds generally posted their best returns on the last trading day of the year, and their worst returns on the first trading day of the new year. The hottest stocks generally peaked during the last hour of the last trading day of the year, and dropped within 30 minutes of the opening of the next trading day. The study found that fund performance followed the same pattern at quarter-end as well.

The effect of portfolio pumping on funds can be dramatic. A 1997 *Money* magazine study found that 62 percent of the funds that lagged the S&P 500 by as much as 25 basis points on the year's next-to-last day beat the market for the year based solely on their last-day performance, as did 49 percent of the funds that lagged the market by as much as 50 basis points. These data call to mind Molly Baker's likening of portfolio pumping to "the seemingly inordinate number of police ticketing speeders on the last day of the month, just to make a quota."

## Misleading Fund Names

Another portfolio-related problem is funds' use of misleading names. Remarkably, the SEC's current position permits a fund to commit a mere 65 percent of its assets in securities suggested by its name. This allows a fund to invest a substantial portion of its assets in securities that are simply inconsistent with how the fund holds itself out to investors—as long as its true intentions are disclosed somewhere in the depths of its prospectus.

In recognition of this problem, in October 1996 Congress granted the SEC specific authority to adopt rules to rein in misleading names. The SEC responded promptly, proposing a rule less than four months later that would prohibit a fund from using a name that suggested that it invested in a particular type of security unless it invested at least 80 percent of its assets in that type of security. Over three-and-one-half years later, however, the SEC has yet to fulfill Congress's mandate by taking final action on the rule. The SEC has been petitioned by Fund Democracy to adopt the rule, and to impose a more effective minimum of 85 percent.

## Portfolio Overlap

Another pitfall for investors and their advisors is that funds with purportedly different investment styles often will have substantially overlapping portfolios. This problem is aptly illustrated by the holdings of four funds in a prominent fund family. According to Morningstar, an equally weighted investment in these funds would have 45 percent of its value represented by investments in only 15 companies, with 12 percent in Nokia and Cisco Systems alone. With Nokia down 23 percent in the last few months, it's not surprising that this portfolio of funds is in the red for the year.

A shareholder in this fund family who reasonably assumed that it offered different funds to provide exposure to different types of investments could suffer significant losses if a handful of stocks experienced sharp downturns. The infrequency of portfolio disclosure makes it more difficult to determine whether a group of funds is, in fact, simply clones designed to increase sales, rather than genuinely dissimilar investment options. To illustrate, the analysis provided above was based on the funds' April 30, 2000, holdings.

Investors will have to wait until 2001—when the funds' October 30, 2000, positions are released—to update this information.

## Limited Utility of Portfolio Information

Even the stale portfolio information currently provided to investors is of limited utility. Fund filings are difficult to download electronically into a format for analysis, and portfolio holdings are not provided on the SEC's Electronic Data Gathering, Analysis and Retrieval system (EDGAR) in a language that is easy to analyze, such as Extensible Markup Language (XML). Nor do the filings include widely used identifiers, such as ticker symbols, that would facilitate analysis of funds' true investment styles. To remedy the limited utility of online fund portfolios, the SEC has been petitioned by Fund Democracy to require funds to post portfolio holdings on the Internet in a format that is easy to download and analyze. Interestingly, mutual funds often do make their portfolio information available in a more accessible electronic format, and more frequently than semiannually—but not to their shareholders. About half of all funds provide portfolio information on a quarterly basis, and some on a monthly basis, to Morningstar, Weisenberger and other financial information providers. Although the funds' shareholders own this portfolio information, their funds won't let them have it. And many portfolio analysis services provided by information providers, such as Morningstar's Stock Overlap analyzer, are available only to paying subscribers.

Portfolio analysis would be far more likely to infiltrate the marketplace if it were provided free of charge in a format that facilitated analysis of fund portfolio holdings. The Internet and software technology developments have made sophisticated analysis of the significance of financial data feasible for millions of investors and their advisors.

User-friendly disclosure of portfolio holdings would promote the development of inexpensive software that investors and their advisors could employ to monitor style manipulation, window dressing, portfolio pumping and portfolio overlap, rather than having to rely on—and pay for—large financial data providers to analyze the data for them.

## **An Entrenched Industry**

Notwithstanding the evidence that current portfolio disclosure requirements deprive investors of needed investment information and facilitate portfolio manipulation, the mutual fund industry has resisted all attempts to improve portfolio disclosure rules. Most recently, the Investment Company Institute, the principal trade organization for fund management companies, reiterated its position that current disclosure requirements "remain appropriate," notwithstanding substantial evidence that fund managers are using weak disclosure regulations as a screen for portfolio manipulation, and that investors do not have the information they need to make informed investment decisions.

The mutual fund industry has objected to reforming portfolio disclosure rules because there purportedly has been no market demand for more information about portfolio holdings, and additional portfolio disclosure would (1) be too costly, (2) enable traders to use information about fund trading activities to benefit themselves to the detriment of funds and their shareholders, and (3) expose funds' proprietary trading strategies to their competitors. Not only are these concerns greatly outweighed by the need for investors to be able to make informed investment decisions and for the prevention of portfolio manipulation, they also are factually incorrect and misguided.

A 1999 poll of 2,500 online investors by the Montgomery funds found that 97 percent wanted more information about fund portfolio holdings.<sup>4</sup> Furthermore, even if investors were not actively interested in additional fund portfolio disclosure, this is no excuse for failing to take steps to protect them against portfolio manipulation.

The practical problems cited by the industry also are without merit. Portfolio holdings can now be widely disseminated on the Internet at little cost. Requiring monthly portfolio disclosure on the Internet while reducing the amount of paper disclosure required in semiannual shareholder reports would result in a net reduction in costs.

Permitting funds to post their monthly portfolio holdings after a 60-day delay will prevent traders from exploiting a

fund's trading activity by frontrunning fund trades. In addition, there simply is no evidence that monthly portfolio disclosure with a 60-day lag would enable traders to determine fund managers' proprietary trading strategies. Even if this were a problem for a small minority of funds, that is no justification for continuing to facilitate portfolio manipulation and deprive investors of information they need to make informed investment decisions. If certain funds might be harmed by additional disclosure, they could request the SEC to grant them an exemption from enhanced disclosure requirements.

## Toward Truth in Mutual Fund Investing

Mutual funds have become Americans' investment vehicle of choice. With half of U.S. households investing in mutual funds today, the importance of mutual funds to Americans' financial security has never been greater. It therefore is more important than ever to ensure that investors have the information they need to make informed investment decisions, and that they are adequately protected against misleading sales practices and other abuses.

Unfortunately, existing portfolio disclosure requirements are inadequate to meet these needs. Semiannual disclosure leaves investors to make critical investment decisions on the basis of portfolio data that may be up to eight months old. In today's rapidly moving markets, where a fund's investment style or focus can change dramatically in a matter of weeks, existing disclosure rules can often leave investors and their advisors flying blind. Even the portfolio information currently filed with the SEC is inaccessible or difficult to analyze.

Furthermore, this lack of adequate portfolio disclosure facilitates style manipulation, portfolio pumping, window dressing and other practices harmful to investor interests. Portfolio manipulation misleads investors regarding the true risks posed by their investments, imposes unnecessary costs on shareholders and undermines investors' confidence in the integrity of mutual funds, our financial markets and, indirectly, in their advisors.

Regulators are becoming increasingly aware of these problems, an awareness that will only grow as investors, the financial press and consumer activists learn more about the ways in which mutual funds can operate to the detriment of their shareholders. As SEC chairman Arthur Levitt has often said, "The best time to fix the roof is when the sun is shining." The time to require mutual funds to provide the information about their investments that investors need, and to take steps to deter portfolio manipulation, is now.

## Endnotes

1. "Drift Happens: For Planners Who Seek to Create Portfolios That Tap Into Different Equity Styles, Style Drift Can Present a Significant Concern," Financial Planning Interactive (November 1, 1999).
2. Stephen Brown and William Goetzmann, "Mutual Fund Styles," 43 *Journal of Financial Economics* 373, at 374 (1997).
3. Ian McDonald, "A Must to a Bust: Scores of Funds Get Burned on Big Qualcomm Bets," [TheStreet.com](http://TheStreet.com), June 15, 2000. McDonald noted that one in five of the 177 funds posting triple-digit returns in 1999 owned Qualcomm, and that one in three large-cap growth funds owns shares, as do 29 percent of all large-cap funds.
4. Dawn Smith, "Should Fund Portfolios Be Secret?" [SmartMoney.com](http://SmartMoney.com) (April 20, 2000).

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