American Enterprise Institute for Public Policy Research

AEI

September 2004

On the Issues

Mutual Funds Bounce Back

By James K. Glassman

The mutual fund industry has quickly recovered from scandal, thanks mostly to the ability of the industry and shareholders to recognize and act in their respective self-interest. Fund companies went beyond government pressure and established sensible new standards, and shareholders punished the tainted by shifting their assets to other funds.

A year ago this month, New York attorney general Eliot Spitzer charged that mutual funds were cheating customers by giving special deals to hedge funds and other large clients. The scandals that followed were shocking and unprecedented and threatened to shake confidence in the most successful investment vehicle of all time—and one that is key to the "ownership society" programs that President George W. Bush announced at the Republican convention.

But the good news is that, over the past twelve months, Congress, government agencies, the industry and, especially, the public have responded admirably, even brilliantly. It is a rare success story, a real man-bites-dog tale—which is probably why most of the media are ignoring it.

Restoring Investor Confidence

In contrast to the reaction to the savings and loan crisis and the corporate accounting scandals, the reaction to the misdeeds involving mutual funds was swift, sure, and cooperative. Confidence was restored.

In the first seven months of 2004, for example, investors pumped $128 billion in net new cash into mutual funds that own stocks, compared with $57 billion for the same period in 2003. That represents a spectacular turnaround, especially when you consider that stock prices have been stagnant this year.

A year ago, Spitzer's revelations, and others that followed, rocked an industry with a nearly spotless reputation. Mutual funds, which are portfolios managed by a private firm for the benefit of many thousands of investors, hold more than $7 trillion in assets for 48 percent of U.S. families. As recently as 1980, mutual funds had only $100 billion in assets and served just 6 percent of families.

Funds will play an even bigger role in American life if Bush wins reelection and enacts such important ownership-society reforms as private accounts to replace part of Social Security.

Spitzer, the Securities and Exchange Commission (SEC), and other authorities accused more than a dozen mutual funds, including some of the nation's largest, of letting large clients engage in practices called "market timing" (jumping in and out of funds over brief periods) and "late trading" (taking advantage of outdated stock prices) that were denied to other shareholders, who were left with the bill. The practices were not especially costly, but they reflected a cynical disdain toward shareholders, who naturally wondered whether they were being exploited in other ways.

James K. Glassman is a resident fellow at AEI. A version of this article appeared in the *Washington Times* on September 8, 2004.

So far, nine mutual fund companies, ten brokerage firms, and three hedge funds have settled with regulators. The funds have paid more than $2 billion in fines, a huge sum for an industry with roughly $40 billion in revenues. Meanwhile, the SEC last month enacted five new rules as part of a large package to address not just market timing and late trading but other activities the regulators saw as abuses, including secretly directing business to brokers as a reward for their selling fund shares to investors.

In my opinion, the SEC has gone too far with a few of these rules—especially a requirement, which goes into effect in January, that all funds have chairmen with no connection to management. That rule could lead to higher fees and less choice for investors.

But other regulations were reasonable, and mutual funds did not resist them. In fact, they moved on their own to change standards. They realized it was in their best interest to get the scandals behind them quickly and take steps to prevent new ones.

Mutual funds do not deserve medals. They were acting selfishly—and correctly—in the aftermath of the scandals, responding not simply to government but, more importantly, to customers.

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For example, using data from Financial Research Corporation, I calculated that in 2003 and the first half of 2004, two of the larger fund companies involved in the scandals, Putnam and Janus, suffered net outflows of $70 billion, as investors pulled their money out. By contrast, two large companies that were untainted, American and Vanguard, had net inflows over the same period of $188 billion.

The public punished companies seen as evildoers while continuing to reward the innocent. Putnam, Janus, and other implicated firms have revamped their managements and changed their practices. They are regaining their reputations, but it has been painful.

The lesson could not be clearer. Get caught cheating your clients, and you will pay dearly. That is the way a free-market system is supposed to work, and it is one reason that Americans can be confident that the president's ownership society, built on consumer choice and corporate variety, with sensible but not overbearing regulation, has every chance to succeed.