

**MUTUAL FUND  
MISCONDUCT 2003:**

**A BREACH OF TRUST**

**(AND WHY SEPARATELY MANAGED  
ACCOUNTS CONTINUE TO BE AN  
ATTRACTIVE OPTION)**



**Arcataur Capital Management LLC**

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### Summary of the Current Mutual Fund Scandal

In September 2003, Eliot Spitzer, New York Attorney General, leveled serious charges against four well-known mutual fund families: Bank of America's Nations Funds, Janus, Strong and Bank One. Spitzer alleged that Bank of America's Nations Funds allowed a hedge fund to buy and sell shares in its mutual funds after the market was closed and net asset values had been calculated. This allowed the hedge fund to trade on information and market movements that would not be incorporated into the mutual fund prices until the next day's close. The second part of Spitzer's complaint alleged that Bank of America, Janus, Strong and Bank One allowed a hedge fund to make rapid trades in and out of their mutual funds, a practice referred to as market timing. This allowed the hedge fund to profit at the expense of long-term investors. The incentives for the fund companies to agree to these arrangements included the promise of additional business and additional management fees that would benefit the fund companies but not the fund shareholders.

Since the initial charges, the fund probe has implicated a number of asset managers. Set forth below is a summary of the current state of allegations, charges and findings thus far:

- **Alger:** The money management firm found indications that a hedge fund client was involved in both late trading and market timing, and the firm may soon face civil charges for allowing market timing in its funds. In October, the head of fund sales for Alger, James Connelly, settled civil charges with the SEC for permitting market timing and obstructing the investigation. In the SEC's settlement documents, it found that "from the mid-1990s until 2003, Connelly was involved in allocating timing capacity in Alger mutual funds to timing investors. Connelly regularly authorized select investors to time the Alger Fund."
- **Alliance:** An internal probe revealed that several large investors were allowed to make rapid trades in a mutual fund. In late September, Alliance suspended a portfolio manager and a sales executive for letting certain big investors make rapid trades in and out of one of its funds in exchange for long-term investments in Alliance hedge funds. On November 10, Alliance announced that its president and chief operating officer, John Cañfa, and the chairman of its mutual fund distribution unit, Michael Laughlin, were dismissed. The SEC and the New York Attorney General's office are expected to file civil charges against Alliance for market timing within the next few weeks, and Alliance has said that it is likely they will have to pay fines and make restitution to its shareholders and funds.
- **Bank One:** Spitzer's complaint said that One Group allowed Canary Partners to market time several equity funds in exchange for fees collected from other Canary investments. The head of the in-house funds has since left the firm.
- **Federated:** Federated launched its internal investigation after the SEC and Spitzer subpoenaed the firm for information concerning trading irregularities. To date, neither the SEC nor Spitzer's office has brought charges against Federated. On October 22, the asset manager announced the firm had allowed both market-timing and late-trading by select investors—there were circumstances in which it appeared that a few investors were allowed to conduct frequent trading in certain funds for long-term investments in other funds. In addition, it appeared as if orders were placed in certain funds after the funds' 4 p.m. EST closing time.
- **Janus:** In September, Spitzer announced a probe of the mutual fund industry, and specifically named Janus as allegedly allowing "market timing" trades and late trading. Spitzer presented internal Janus company e-mails clearly indicating that some of its executives sold a hedge fund the right to market time some of its funds to the detriment of its long-term shareholders. In a Form 10-Q filing made on November 13, Janus disclosed that it "has been conducting an internal review, which, to date, leads Janus to believe that there were 12 discretionary frequent trading arrangements across its U.S.-based mutual fund business, and that significant discretionary frequent trading appears to have occurred with respect to four of those arrangements."



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- **Loomis Sayles:** On November 13, Loomis Sayles posted a letter on its Web site that stated the firm “found two instances where we accepted investments that might lead to increased trading activity in the Loomis Sayles Bond Fund.”
- **Nations Funds (Bank of America):** In September, Spitzer alleged that Nations Funds allowed a hedge fund to buy and sell shares in its mutual funds after the market was closed and net asset values had been calculated. Spitzer also alleged that Nations Funds had permitted market timing in its funds. The fund unit of Bank of America has since fired three executives that Spitzer accused of helping Canary Capital engage in late trading and market timing of Nations Funds.
- **Pilgrim Baxter:** Two of the founders of Pilgrim Baxter & Associates resigned on November 13, after an internal probe revealed questionable mutual fund practices. A press release issued by PBHG stated that “at issue is a passive investment on the part of Mr. Pilgrim in a private investment limited partnership, unaffiliated with Pilgrim Baxter, that, with Mr. Baxter’s knowledge when he was CEO, actively purchased and redeemed shares of certain PBHG Funds and other mutual funds using a quantitative tactical asset allocation model based solely on publicly available information.”
- **Prudential:** Massachusetts and the SEC have filed charges against several former Prudential brokers for alleged improper mutual fund trading. On November 14, Prudential said it had received a request for information from the NYSE regarding its mutual fund practices, and Spitzer has made a formal request for information regarding Prudential’s variable annuity business.
- **Putnam:** The SEC and Massachusetts regulators charged Putnam with securities fraud, making it the first fund to be formally charged. The allegations claim Putnam did little to stop market timers, including some of its own fund managers. When Putnam initially found out in 2000 that short-term trading was occurring, the firm did nothing but tell those involved to stop. Putnam did not notify the funds’ boards of directors, and it did not set up additional monitoring of these employees’ trades. In the first week of November, approximately \$14 billion moved out of Putnam funds, in response to federal and state regulators charging the unit of insurer Marsh & McLennan Cos. with civil securities fraud related to improper short-term trades in its funds. In early November, Putnam dismissed the investment professionals who made short-term trades in their personal accounts, and removed the CEO. On November 13, the SEC announced that it had agreed to a settlement with Putnam on charges that Putnam breached its fiduciary duty in allowing managers to make inappropriate trades in their funds and in failing to take adequate steps to detect and deter such trading activity. The agreement spells out new standards for compliance, corporate governance, and restitution. Putnam still has not yet resolved charges brought by Massachusetts regulators.
- **Strong:** In September, Spitzer named Strong in a scheme allegedly permitting hedge fund Canary Capital Partners to make short-term trades in Strong funds and gain inside knowledge of certain portfolio holdings. More recently, in addition to the initial charges of market timing by a hedge fund, it was alleged that the firm’s Chairman and Founder, Richard Strong, engaged in market timing of the funds on behalf of himself as well as family and friends. On November 2, Richard Strong resigned as Chairman of the Board of the Strong Funds, but he remains a member of the Board and Chairman of the investment advisory firm. On November 11, Spitzer announced that his office is considering filing criminal charges against Strong Capital Management and Richard Strong, for allegedly profiting personally from improper trading in Strong mutual funds. The SEC is also considering civil charges against Strong.
- **U.S. Trust: Company:** On November 14, 2003 U.S. Trust, a n investment management subsidiary of Charles Schwab and Company announced it is investigating incidents in which a “small number of parties were permitted to engage in short-term trading of U.S. Trust’s Excelsior Funds.” U.S. Trust is also looking at a “limited number” of instances at the company in which fund orders may have been entered or processed after the 4 p.m. close.



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### **How does market timing hurt fund shareholders?**

Typically, mutual funds keep enough cash on hand to meet ordinary redemption activity. If the amount of money bailing out of a fund exceeds the cash plus any new monies being invested, fund management has to liquidate some of its holdings to pay off the departing investors. If a fund company comes to market with a lot of stock to sell for no reason other than meeting redemptions, the market typically will punish the fund by paying lower prices. The result? The fund's net asset value suffers.

### **What should these charges mean to a fund shareholder?**

If the allegations are true, these firms have engaged in an egregious breach of their responsibilities to fund shareholders. They have placed the financial interests of the fund companies and in some cases individual portfolio managers ahead of the interests of their primary constituents, the fund holders. Although many of the companies have agreed to make restitution, it is difficult and may be impossible to determine how much these practices cost investors.

### **What should I do if I own a fund implicated in the scandal?**

The question boils down to a sell or hold decision on the fund. Ultimately, whether you want to seek a safe haven is a personal choice, but you shouldn't make a move, whether the move is to retain the fund or sell it, without calculating all the costs and considering the following:

- Examine the evidence of wrongdoing and unethical behavior. Consider how widespread the activity was and how serious the actions were. Also, review management's response to the wrongdoing, and assess the appropriateness of the response.
- Evaluate the quality of management and corporate governance standards at the fund. You should look at fund expenses, fund communication, the experience, skill and integrity of management, and internal compliance and risk control. Look for funds that strictly adhere to their mandates set forth in their prospectus, have taken comprehensive actions to fair value price the securities in the fund's portfolio (which makes fund arbitrage virtually impossible), have principals who have large sums of their own money in the fund, and charge low fees (which indicates a belief that fundholders are owners, and not consumers).
- Look at the investment performance of the fund both short-term, and more importantly, long-term, on both an absolute basis and a relative basis (compared to other funds with similar investment objectives and risk profiles).
- Carefully examine your tax consequences of making a switch. Investors who hold funds in an IRA can move without facing any tax consequences. There may, however, be transfer fees, deferred sales charges and potentially new sales charges if a financial adviser is involved in making the change. Investors who own funds in a taxable account face those potential charges plus any capital gains they might realize upon selling the funds. If you have a loss in the fund, you could move the money and use the loss to offset other gains. If you have profits in the funds, you will wind up paying capital gains taxes for leaving now. The size of the gains is really what determines the size of the problem.
- Examine the costs associated with making a move. If you are in a broker-sold fund that levies a sales fee, or load, you could be saddled with another sales charge when you buy an alternative load fund. You may have purchased back-end load funds, which would impose a sales charge if you have not held onto the fund for a long enough period of time. Be careful of brokers encouraging you to sell—they may be trying to churn your account and receive an easy commission for themselves. To save money, ask your broker about investing with other no load funds, or with other load funds but at no cost (referred to as a "net asset value" transfer.)



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### **If I sell a mutual fund, what are my other options for investing the money?**

- Invest in another mutual fund (options may be limited if the investment is in a 401(k) or other retirement plan). Make sure that you thoroughly research your investment options to avoid landing in another scandal-plagued situation.
- Select another alternative such as **an Arcataur separately managed account**.

### **How comfortable are you that this lapse is a one-time event rather than a systemic problem?**

Certain asset managers, including Strong and Janus, have had previous regulatory and legal lapses that required restitution. The numbers of fund companies now involved continues to increase, and thus it is beginning to appear as though the problems are more widespread than initially anticipated.

### **What might be other concerns related to holding on to a fund of an asset manager under investigation?**

- In the event that investors begin to withdraw money from a fund, fund managers may be forced to liquidate assets at unfavorable prices to meet cash needed for redemptions. This would negatively affect the performance of the fund. If you remain loyal to a troubled firm, the biggest problem you face is that other fund shareholders will run. Redemptions force fund managers to sell stocks and raise cash, leaving you with a capital gains tax hit, higher expenses and lower return. Additionally, holding cash instead of stocks drags down performance, increasing the likelihood that your heavily redeemed fund will lag its peers.
- Further investigations of trading, management and other practices discovered in the future may impair returns to existing shareholders.

## **Why a Separately Managed Account Continues to be an Attractive Option**

In covering the mutual fund scandal, the popular press is quick to conclude that investors have very few alternatives to mutual funds. **We believe the separately managed accounts offered by Arcataur Capital Management offer a great alternative.**

American investors have been the beneficiaries of an extraordinary change in the investment management industry - the increased availability of separate account management for "retail" accounts. By individually managing their portfolios, investment managers can provide experienced, expert portfolio management complemented by a new level of service. Individual investors can now discover what institutional investors have known for a long time - individually managed accounts offer enhanced investment control and flexibility. Unlike mutual funds, where your assets are pooled with those of other investors, separately managed accounts provide direct ownership of the securities in your portfolio. This structure provides substantial control, allowing Arcataur to customize an investment solution that reflects your individual goals and objectives.

**What are individually managed accounts?** Basically, individually managed accounts offer a step up from a typical mutual fund portfolio solution. They provide you with a customized solution specifically tailored to meet your goals and objectives. Unlike mutual funds, they do not commingle or pool assets. Rather, they provide you with direct ownership of the securities in your portfolio. This is now cost effective as a result of the improvement in technology and transaction costs. A separately managed account can be tailored to meet your individual needs, in terms of such aspects as taxes, retirement planning, risk tolerance and social constraints. The primary benefits include:



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- **Greater control.** The investment strategies implemented using a separately managed account can be as individual as you are. Since you own the underlying securities, we can customize a solution that suits your needs. In a market characterized by greater volatility and tax implications, having a greater degree of control is essential. Furthermore, since accounts are managed separately, the investment manager's strategy cannot be undermined by the cash-raising pressures of a herd as in a mutual fund, nor will investors following long-term buy and hold strategies find themselves thwarted by the cash flow demands of others.
- **Tax efficiency.** With a separately managed portfolio, you have control over when you want to realize capital gains, allowing you to better manage your gains and losses. With mutual funds, it is impossible for you to harvest losses on your timetable. In addition, there is a second major tax benefit of separately managed accounts compared to mutual funds - with managed accounts, there are no inherited capital gains, and you establish your own cost basis.
- **An investment strategy that reflects your personal values.** Specific stocks and/or sectors can be excluded from your portfolio at your request. You may want to pursue a socially responsible investment strategy, or carve out certain sectors and companies from your portfolio holdings. A separately managed account can provide for this.
- **Better able to manage concentrated positions and avoid overlap.** Many investors have substantial holdings in one stock — through company-sponsored retirement programs, stock options and even inadvertently through mutual fund holdings - that can be more effectively managed, held and/or sold off on your timetable and at your choice.
- **Customization.** A separately managed account can allow you to designate sector investing, credit quality minimums, duration parameters, geographic restrictions and individual company parameters.
- **Provides a visible and accountable portfolio view.** Separately managed portfolios are tracked in real time. You will always know which securities you own. You also will know what your account parameters are, and how the account performance and composition are tracking with these parameters. This promotes accountability on the part of your investment manager, and provides you with an up-to-date view of your portfolio, its composition and its performance.
- **Fees.** All mutual funds have operating expenses that are deducted from fund earnings, and usually consist of investment management fees, administrative service fees and distribution (12b-1) expenses. According to The Wall Street Journal, the average stock mutual fund carries an overall expense ratio of 1.59%, and the average bond mutual fund has an expense ratio of 1.10%. Arcataur Capital Management's separately managed accounts carry comparable maximum expense ratios of 0.95% for the Arcataur Large Capitalization Equity Portfolios, 0.60% for the Arcataur Investment Grade Fixed Income Portfolios, and 0.80% for the Arcataur Managed Balance Portfolios. Trading costs would be an additional charge for both mutual funds and separately managed accounts, but keep in mind that Arcataur's trading costs are maintained at low institutional pricing levels available through third party custodians. Please refer to our complete fee schedule set forth as follows:



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Arcataur Capital Management Fee Schedule

<u>Type of Account</u>	<u>Asset Value<sup>1</sup></u>	<u>Annual Expense Ratio</u>	<u>Average Mutual Fund Expense Ratio</u>
Large Cap Equity	First \$1 million	0.95%	1.59%
	Next \$4 million	0.90%	
	Next \$5 million	0.85%	
	Over \$10 million	0.75%	
Investment Grade Fixed Income	First \$1 million	0.60%	1.10%
	Next \$4 million	0.55%	
	Next \$5 million	0.50%	
	Over \$10 million	0.40%	
Managed Balance	First \$1 million	0.80%	
	Next \$4 million	0.75%	
	Next \$5 million	0.70%	
	Over \$10 million	0.60%	

<sup>1</sup> Arcataur Capital Management's stated minimum account size is \$500,000. However, exceptions may be made for smaller accounts.

The greatest benefit of a mutual fund is that it can offer access to institutional quality money managers at lower invested amounts. However, offsetting this advantage are the following drawbacks of mutual fund investing:

- **Excessive Trading.** Excessive trading can reduce returns by 1.5% to 2.0%.
- **Herd Mentality.** Approximately 70% of mutual fund trades are influenced by inflows and outflows. During market declines, mutual fund managers may be forced to sell securities at undesirable prices to raise sufficient cash to meet redemption requests. In contrast, separately managed accounts are not affected by the decisions of other investors who use the same manager.
- **No Individualization.** Mutual funds are a "one size fits all" solution. They offer very little control over your portfolio, and are not custom tailored for your investment needs.
- **Fees and Expenses.** There are four main types of expenses associated with mutual funds. First are continuing administrative, investment management and miscellaneous expenses, which are expressed as an annual ratio as a percent of assets. Second are trading activity costs. These costs detract from performance, but are not spelled out explicitly and are not part of the annual expense ratio. Funds with higher portfolio turnover inevitably have higher trading costs. Third are sales fees and charges, called loads. A typical front end load diverts 5.75% of the initial investment and never gets invested at all. Instead, that 5.75% goes to pay sales commissions. Unless the investor got great investment advice and allocation strategies from whoever sold the fund to them, this sales load is completely wasted. Fourth are taxes. Investors will keep much more of their gains in tax-efficient funds than in funds where the managers make trades without regard to taxes.



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Set forth below is a summary of a comparison of separately managed accounts and mutual funds:

<b>Factor</b>	<b>Separately Managed Accounts</b>	<b>Mutual Funds</b>
<b>Degree of Control</b>	<p>Custom-tailored to meet individual investor needs.</p> <p>Investor can make specific portfolio requests, such as tax-related trading and directed to hold assets. Specific stocks and/or sectors also can be excluded from your portfolio at your request.</p>	<p>Off the rack investment solutions where one size fits all.</p> <p>Not customizable – cannot manage or restrict positions.</p>
<b>Account Minimums</b>	Generally \$500,000 and higher.	Low initial investment required (typically \$1,000).
<b>Tax Management</b>	<p>Investors establish their own cost basis and pay taxes only on the capital gains they realize.</p> <p>Direct ownership of securities allows for personalized tax planning strategies.</p>	<p>Potential for pre-existing capital gains liability.</p> <p>Investors have little control over tax consequences of the fund.</p>
<b>Effect of Redemptions</b>	<p>Not affected by decisions of other investors who use the same manager.</p> <p>Manager’s strategy not undermined by cash-raising pressures of the herd.</p>	<p>Portfolio influenced by other fund holders’ actions.</p> <p>Mutual fund managers may be forced to sell securities at undesirable prices to raise sufficient cash to meet investors’ redemption requests and may trigger capital gains.</p>
<b>Flow of Information</b>	<p>Managed accounts are transparent—investors always know the positions they hold.</p> <p>Monthly/quarterly statements detail each security held, securities’ cost bases, capital gains and losses and dividends and income.</p>	<p>Report holdings semi-annually; frequently out-of-date information.</p> <p>Daily pricing available.</p>
<b>Fees</b>	Usually a single fixed fee based on account asset value, and will not change without notice.	Variable fees, difficult to calculate, fees are deducted from fund assets, and expenses change without notice.
<b>Diversification</b>	Many investors have substantial holdings in one stock. With a separately managed portfolio, you can tailor your investment strategy to avoid further concentration of large holdings.	Within each mutual fund, there are varying degrees of diversification. If you hold several mutual funds, there likely will be overlap in positions, and you may inadvertently be over-concentrated in single stocks.

**Conclusion**

For years the mutual fund industry was touted as providing a "fair playing field" for smaller investors. Clearly, this is no longer the case. Continued expansion of the current probe, combined with additional regulatory oversight, should serve to improve corporate governance in the industry. In light of these allegations, it may take quite a while to restore investor confidence in the industry. Investors must be more discriminating when selecting funds and fund managers. Good corporate ethics, governance and investment performance are not mutually exclusive.

**For further information regarding Arcataur Capital Management's separate account products, please visit our website at [www.arcataur.com](http://www.arcataur.com) or call us directly at 414-225-8200.**