Independent Financial Advisors

Christopher Kuehne, MS, CFP
Certified Financial Planner
NAPFA-Registered Financial Advisor
Fee-Only Financial Planning
Investment Management Services

TO All clients of Independent Financial Advisors
FROM: Chris Kuehne
RE: Mutual Fund Scandal

Investors are concerned about what Eliot Spitzer, Attorney General of New York, the SEC and other regulators are uncovering about the practices of mutual funds. We have put our trust in funds, as the best way to invest in a cost-effective and diversified fashion. Apparently some fund companies did not live up to that trust.

There appear to be three major areas of infractions:

a. **Market timing,** which most funds say in their prospectuses that they discourage, seems to be allowed for certain large investors, who try to trade on a very short-term basis to take advantage of disparities between the share price of a fund and the value of the underlying securities within the fund. This is possible since fund prices are set officially only once per day, at 4PM. It isn't illegal, be we thought it was discouraged and penalized by mutual fund companies.

b. **Late trading,** which allows certain privileged investors to submit mutual fund trades, let's say at 10PM, and still get the 4PM price that day. The usual practice is that a 10PM trade would get the 4PM price the next day. This practice is illegal and, until recently, it wasn't widely known that it was sanctioned. Certainly I and the other 4,500 Financial Advisors who utilize Schwab Institutional are never allowed to trade late. Such a practice allows the privileged investors to make trades in reaction to market-making news one trading day ahead of other investors; the result is that other investors are hurt slightly in terms of their total return from the fund.

c. **Commission discounts not received** is a problem we don't face, since it involves brokers not honoring discounts on front-end commissions (also called loads) when a mutual fund purchase is above certain dollar amount thresholds. As you know, I purchase only no-load funds on behalf of my clients.

A few of you have asked what I plan to do about this problem. So far, my reaction has been to follow the situation closely but not do anything such as selling funds. The only fund family that we use that has been touched by the investigation is Janus, and I am studying whether or not to replace Janus High Yield fund, which most of you hold. Janus has promised to compensate investors the market timing it allowed Canary, a hedge fund, to conduct, and I still believe the high-yield fund is a good one. Moreover, since the investigation is ongoing, there's a chance we could go from Janus to another high-yield fund that is about to be implicated in the scandal.

The bottom line is that your hard-earned savings are not really at risk in the scandal. According to Stanford University finance Professor Eric Zitzewitz, the typical investor might find late trading and market timing will cost 1% or less in lost returns in a given year. That amounts to about $10 for each $1,000 invested in a fund.

I actually take a rather optimistic view of the scandal. Even though it is now upsetting to see that the industry is not as lily-white as we thought, I'm convinced that the current scrutiny will ultimately result in a stronger mutual fund industry with better, more uniform regulation and possibly even lower costs to investors. Eliot Spitzer is taking advantage of the scandal to advocate that most mutual funds should decrease their annual expense ratio, a possibility we would of course welcome.

If I find that any actions are advisable on Janus or other fund families, I'll let you know right away. Meantime, please give me a call or an email with any of your questions, concerns or reactions.

Sincerely,
Chris Kuehne