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PERSONAL BUSINESS

Is Your Fund Manager On Your Side?

Some handy ways to figure out whether shareholders' interests come first

Until recently, most investors asked just one thing of their mutual funds: red-hot returns. Now, in the wake of the trading scandals that harmed the shareholders of some funds, investors are also looking for fund management they can trust.

Of course, when it comes to sizing up a fund, trustworthiness isn't nearly as easy to measure as performance or fees. But by examining the behavior of a fund's managers and directors, you can get a sense for how strongly the fund is acting in the shareholders' interest. The Securities & Exchange Commission is pushing good fund-governance practices, too. Among them are new requirements that funds hire compliance officers by Oct. 5 and stop channeling trading commissions to brokers as a reward for promoting the sales of their shares by Dec. 31. In addition, starting next year, companies will have to disclose how they determine a fund manager's pay.

Like corporations, each mutual fund has a board responsible for safeguarding shareholder interests, so it's important to know whether directors have conflicts of interest. For instance, about 22% of directors disclose in fund documents that they are "interested" -- generally meaning they have business or economic ties to an investment adviser, broker, or other firm that provides services to a fund. Those data come from a forthcoming mutual-fund board compensation study by Equilar, a San Mateo (Calif.) compensation-research firm that examined the most recent annual filings, through early August, of 100 of the largest fund families. The SEC recently approved a rule that requires fund boards to appoint a chairman who is independent and to fill 75% or more of the seats with independent directors by early 2006, up from the current requirement of more than 50%.

How can you tell whether a fund is likely to put its shareholders first? Unfortunately, there's no litmus test. Nor is there a guarantee that a fund with strong policies won't mess up. Indeed, despite a reputation for pro-shareholder policies, the advisory firm and manager running the Bridgeway Funds recently agreed to pay almost \$5.2 million to settle SEC charges of overbilling investors in three funds by \$4.4 million when it used the wrong formula to calculate performance-based fees. Shareholders will receive \$4.9 million in restitution and interest, with the remainder covering penalties.

Nonetheless, you can take steps to protect yourself. Start by examining the extent to which those running your fund -- the directors and managers -- are motivated to act in your interests. To assess that, ask your fund for the Statement of Additional Information (SAI) that it's required to file annually with the SEC, or download a copy at sec.gov. (Hint: look for filings with the number "485").

PAY PACKETS

Here you can find out how much the directors are paid. The higher their salaries, the harder they may find it to back proposals -- such as fee reductions -- that help shareholders but hurt the management companies, says Kunal Kapoor, director of fund analysis at Morningstar. Annual compensation for independent directors -- which comes from the funds, not the management firms -- runs from \$4,250 to more than \$800,000, with the median paycheck at \$83,000, according to Equilar. Among the highest-paid independent directors: Dreyfus funds Chairman Joseph

DiMartino -- a past president of the fund company -- who collected \$800,306 in 2003; Putnam Chairman John Hill, who earned \$413,625 in 2003; and three Franklin Templeton directors -- Harris Ashton, Joseph Fortunato, and Gordon Macklin -- who made \$369,700 each in the fiscal year ended Sept. 30, 2003. The fund families with the highest average pay for independent directors are Fidelity, Dreyfus, and Putnam, each at about \$250,000 per director, according to Equilar.

Dreyfus says DiMartino's pay reflects the fact that he oversees "approximately 200 portfolios." Hill says the Putnam directors were paid more than usual over the past year because of a board investigation of market-timing abuses that necessitated holding about three times the routine number of meetings. The company, he adds, is reimbursing the funds for the additional pay. Franklin says that it requires its directors to invest one-third of their pay in Franklin funds to align their interests with those of shareholders.

Fund-management companies, on the other hand, aren't required to disclose how much they pay portfolio managers. But starting next year, the SEC is requiring funds to divulge in the SAI the formulas they use to determine manager compensation, says Julie Allecta, senior partner at law firm Paul Hastings Janofsky & Walker. With that information, you'll be able to judge whether the managers get a better payoff from hitting long-term goals or maximizing short-term performance. If you're a long-term investor yourself, you'll want to have a portfolio manager who, like yourself, is interested in long-term results.

BEHIND ASSET GROWTH

Consider the state street Research Aurora fund, which specializes in small-cap stocks. Like many other fund complexes, State Street rewards its managers based partly on asset growth, according to Morningstar. For shareholders, though, asset growth can be a mixed blessing. To be sure, when assets rise because of investment gains, it's a good thing. But when they grow as new investors pile into a fund, it can become difficult for managers to buy and sell stakes in small companies without negatively affecting stock prices.

In part for this reason, Aurora earns low marks for shareholder friendliness from Morningstar, which recently launched "fiduciary grades" on its premium Web site. (The site charges \$12.95 a month or \$115 a year.) Alyson Lindsey, a spokesperson for State Street, says the firm has periodically closed the Aurora fund to new investors to keep asset growth in check. It now restricts new investment to current shareholders and clients of designated brokers.

You'll also want to know whether managers and directors are investing along with you. By examining funds' regulatory filings, Equilar found that 13.4% of all fund directors have yet to invest a dime of their own money in the funds they oversee. They include longtime directors John Shane at CDCNvest, Elliot Jaffee at Smith Barney, Lonnie Pope at Enterprise, and -- as of Dec. 31 -- Richard Leach at Wells Fargo.

How much investment is enough? Morningstar likes to see directors put away a sum greater than their annual pay. A spokesperson for CDC IXIS, the parent company of CDCNvest, says since the last fund filing, Shane purchased shares valued between \$10,001 and \$50,000. That's below his 2003 annual pay of \$81,950. A spokesperson for Citigroup, parent of Smith Barney, says: "The majority of our independent directors do own shares in the funds they oversee." Wells Fargo declined to comment. An Enterprise spokesperson says the company does not believe directors' ownership "has any bearing on their ability to serve in the best interests of the funds' shareholders."

If you want to find out how much your portfolio manager has invested, you can do so starting next year. As is the case with directors, the data will be published in the SAI in broad ranges -- from "none" to "over \$1 million" (vs. from "none" to "over \$100,000" for directors). Because Morningstar likes to see managers put a substantial portion of their net worth on the line, it asks funds to volunteer this information. Most, but not all, provide the data, Kapoor says.

Another way to assess shareholder friendliness is to look at a fund's past behavior. Morningstar applauds fund companies with below-average fees and clean regulatory records. It frowns on those that fail to close funds before they become bloated.

Having the right policies won't necessarily inoculate a fund. But not having them is a red flag. So rather than make a leap of faith, sit down and review the disclosures. You may very well end up choosing a better fund.

By Anne Tergesen

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