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SEVEN QUESTIONS

By IAN MCDONALD



Gary Gensler Sends Message Wall Street Wants Kept Quiet

You can't say Gary Gensler is angling for a cushy job in the mutual-fund business or clap on the back from his twin brother Rob.

Mr. Gensler, that's Gary, and Gregory Baer, Treasury officials in the Clinton Administration, have penned "The Great Mutual Fund Trap," which has a cover and contents that present the fund business as an elaborate shell game where investors pay steep fees to august fund managers and too often get market-lagging returns for their money.

They have a point. Even though many stragglers are routinely merged away, taking their records with them, more than 70% of actively managed U.S. stock funds still trailed the S&P 500 in the 10 years ending Nov. 30 according to Morningstar data.

The sundry fees and sales charges levied by funds are major contributors to that woeful record, the book alleges, along with investors' belief that they can pick stocks or managers that will beat the market over time.

Mr. Gensler is well positioned to critique Wall Street. In addition to his Treasury experience, he's a former Goldman Sachs investment banker and more recently has taken up the fight for clearer financial disclosures by helping Sen. Paul Sarbanes (D., Md.) draft the Sarbanes-Oxley Act. He also has a twin brother Rob, who manages the \$363 million **T. Rowe Price Media & Telecommunications Fund** and [spoke with us](#)¹ back in August.

What are the fund world's traps and how can investors avoid

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Ian McDonald covers the mutual-fund industry, writing the Fund Fiend and Seven Questions columns for the Online Journal. Prior to joining the Journal, Ian was a reporter and columnist with TheStreet.com. Before then, he worked in the fund business for several years. Ian was named to The Journalist and Financial Reporter's list of 30 Top Journalists Under 30 in 2001, and won the New York State Society of CPAs Award for Excellence in Financial Journalism in 2000.

A native of Brewster, Massachusetts, Ian has a BA in English from Bates College.

CURIOUS?

Have a question about mutual funds for Ian? Send him an e-mail at ian.mcdonald@wsj.com¹⁰. We'll post some of the letters, and Ian's responses, on the site.

them? How did Rob react to his brother writing a book that trashes his industry and does Gary own shares of Rob's fund?

We got some answers.

1. Why are mutual funds a trap?

For one, many have the ankle weights of high fees and expenses. When you total them up, they're about 3% of your money year in and year out. There's also a trap where we have this human instinct that tells us we can somehow beat the market or pick the expert who can. We should be able to do that by simply reading those year-end reviews of last year's hot funds that might even be in your fine paper, right? That's a trap. We think that we can look at past returns and pick funds that will continue doing better, but we're usually wrong.

The third trap, which few focus on, is that we think mutual funds are looking out for our interests. Mutual funds are really looking out for their interests. There's been a tremendous focus on corporate governance [of late] but there may well need to be an equally serious focus on mutual-fund governance. The question I'd pose to the mutual fund industry is, 'When was the last time a mutual fund board of directors went out and got someone not affiliated with their company to manage their fund?' Fidelity **Magellan**'s directors hire Fidelity [to run the fund].

There actually was a rare example of that earlier this year, where the board of the Japan Fund [hired](#)² Fidelity to run the fund instead of acquirer Deutsche Bank.

That's a great example, but clearly the exception and a rarity. They should be applauded, but remarkably it didn't make front-page news.

So, the trap is comprised of high costs, expectations that you can pick the winning fund and the fallacy that [fund companies] are looking out for you when they're looking out for their own bottom lines.

2. Fund marketing often leads investors to buy high and selling low. Companies often promote funds on a hot streak that can't last, but investors are chided for chasing performance and not fitting funds together intelligently. Do fund companies need to rethink how they sell funds?

Fund companies do an excellent job for their shareholders [holders of fund companies' stock]. That doesn't mean the investors in their funds. I'm drawing an important distinction there. They've learned, like soap companies, that it's good to market something that's 'new and improved.' They've learned what movie studios have learned, that you market celebrities. They've also learned from toy companies that you should drum up urgency about your product.

It's a type of [shell game in terms of marketing](#)³. They have many funds in their fund family and just like when you're in a casino in Vegas, some hands will come up well and others will be losers. The theory of fund families is that some will be beating the market at any given time, so Fidelity or Putnam will always have some funds doing well and they can advertise those. At any given time there will also

be some not doing well. They'll be quiet about them and those funds might even vanish [through fund mergers] so they don't have to show their bad records anymore.

That's not Darwinism. It's not survival of the fittest. It's just a way fund companies use a roll of the dice to advertise the winners and either be quiet about or close down the losers.

Next year they'll keep doing the same to attract investors. But there will still be the trap of high fees and the fact that past performance doesn't predict future performance. Let's say that again, past performance doesn't predict future performance. Over time only about one in five fund will beat the market over a given five-year period. When you look at those that do however, it doesn't predict that they'll do so over the next five years.

3. The fund industry's trade group, the Investment Company Institute, says fees have been coming down over time. What's your response?

Annual management fees have come down only very modestly. And if you take total fees, including the [sales charges or] loads many people pay, you don't see much of a decline. We profile this a bit in the book looking at a wonderful study comparing management fees for mutual funds and pension funds. Your paper [highlighted it](#)⁴ too, in a smaller article than I thought it deserved.

Two professors, [John Freeman of University of South Carolina and Stewart Brown of Florida State,] found that the largest 10% of pension funds [with average assets of \$1.6 billion] had average advisory fees of 0.2%, while the largest 10% of mutual funds [with average assets of \$9.7 billion] had advisory fees that were 2.5 times those of pension funds. This is just an advisory fee [for managing the portfolio], not the fee for sending out statements and so forth.

So, while the ICI [points to a very modest decline](#)⁵ in mutual-fund fees, its data isn't fully inclusive of loads and other costs. The ICI is an advocacy group for mutual fund companies, not an advocacy group for mutual fund investors. We must remind ourselves of that.

4. In what ways is the media complicit in the fund world's foibles and investor's missteps?

I think we should watch CNBC like we watch ESPN -- for entertainment and information, but not to take action. When you watch ESPN you shouldn't go out on a field and think you can do what players are doing in a football game. Same thing with CNBC, watch it to get some information but don't think it's all tradable. The lessons of Enron are not to trust celebrity CEOs or fund managers or analysts you see on CNBC.

Some in the financial media have said, 'It's a great book and I think half the people on our staff would agree with me, but I don't know if I can write a story about it because it means what we do here isn't relevant.' That's from one magazine [journalist]. One newspaper journalist said, 'Well, I guess I don't disagree, but it's a matter of self-interest. Not your self-interest, but mine. If I wrote about your book, I'm not sure people would have a reason to read the pieces I write.'

The financial media offer an important service, but they are part of Wall Street and what goes on there.

5. You've said the fund industry has been too quiet on post-Enron reforms, why do you think that's the case?

One of the fascinating things of the 2002 political debate post-Enron is how quiet mutual-fund companies and their executives have been. I think it's a tremendous opportunity for them to stand up for investors. I think it's still an opportunity for any one of them to say, 'We're really the fund company that looks out for investors.' They could use their bully pulpit to push for greater reform on Wall St. and greater transparency in financial disclosures.

However, I'm enough of a political realist to understand that it's difficult for any one mutual-fund company to do. The reasons are many, but one is that they're all competing to run corporate America's 401(k) plans. It's also tough to ask for reforms of Wall Street firms [more specifically] because they are either [fund companies'] customers or vendors.

Also, within Washington their approach has been to be a more quiet, behind-the-scenes actor rather than be a public voice. They haven't given a speech at the National Press Club on behalf of investors. They haven't said, 'We're mad about the lack of disclosure and want greater disclosure in corporate America because we represent investors.'

In fact, they've got deep reservations about some of the reform measures being suggested [for funds] including [proxy disclosure](#)⁶.

6. How would you tell investors to avoid the traps you highlight, and should most investors use an adviser?

Just like corporate America is hunkering down a bit, you should do the same. Lower your costs, broaden your [portfolio's] diversification, and [follow] a buy-and-hold strategy. How do you do these things? Through broad market index funds or similar exchange traded funds [or ETFs].

Another aspect is to take advantage of the many ways to invest tax-free. I'd point to 529 plans as an example. You can put up to \$100,000 in a state 529 plan and it's tax-free if you use the proceeds to send someone to college. Use the state of [Utah plan](#)⁷. You can do so if you don't live there and aren't going to send someone to a Utah school. I think it's the best because its costs are just 0.32% expenses or about a third the cost of most other state plans. It's broadly diversified because its three [investment] options are a broad stock index fund from Vanguard, a passively managed bond fund, or a fund that's a mix of indexed stock and bond portfolios.

... As for financial advisers, they can help you think through asset allocation, as well as complex issues like estate planning and insurance. I have one big caveat: pay them by the hour rather than as a percentage of your assets. If a plumber walked into your house and asked for your net worth before writing you a bill, wouldn't you be suspicious? If your doctor said, 'I'll charge you a percentage of your

net worth for this operation,' you'd do it because you need the operation, but it really doesn't make any sense. It also doesn't make sense to use a financial planner to decide how to diversify your equity investments. The best way to do that is to just use a total stock market index fund.

So, I have a mixed message on financial planners. They offer a good, important service but you should pay them by the hour. [The Wall Street Journal's Jonathan Clements [tackled the adviser pay issue](#)⁸ recently.]

7. What was your brother's reaction to the book and do you own shares of his fund?

Rob's been very good-natured about it. When I told him about it he smiled and we've discussed the broad concepts of the book. He's told me he hasn't read it because he'd rather spend time with his kids. And he knows the conclusion we reach is that his industry doesn't provide a product that Americans can really use. I'm a very good brother, but I don't own shares of my brother's fund because I don't believe in active management. We're perfect brothers because we're mirror images of each other. He's been supportive of the book, but hasn't read it. I'm supportive of him, but don't own shares of his fund. We're identical twins, I'm right-handed and he's left-handed.

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