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Off the Shelf

Some Mutual Fund Numbers Look Great, but for Whom?

By [HARRY HURT III](#)

THE public stock markets are in the throes of one of the biggest and most egregious financial scandals in modern history, according to Louis Lowenstein. The scandal has little to do with highly publicized abuses like market timing or insider trading. It is not directly related to the current credit and subprime mortgage crises.

Instead, it involves the \$10 trillion in life savings that 90 million individual investors in the United States have entrusted to mutual funds.

This unprecedented scandal is documented in succinct but gory detail by Mr. Lowenstein in *The Investor's Dilemma: How Mutual Funds Are Betraying Your Trust and What to Do About It* (Wiley, \$29.95). Mr. Lowenstein is a lawyer, a former business executive and a professor emeritus of finance and law at Columbia Law School. Like [Warren E. Buffett](#), he is a proud disciple of the "value investing" principles outlined by Columbia professors Benjamin Graham and David L. Dodd in 1934.

Mr. Lowenstein is also a heck of an investigative reporter, as well as an astute financial adviser.

Here's the nut of the mutual funds industry scandal, as summarized by Mr. Lowenstein: "There is a profound conflict of interest built into the industry's structure, one that grows out of the fact that the management companies are independently owned, separate from the funds themselves, and managers profit by maximizing the funds under management because their fees are based on assets, not performance."

As a result, the vast majority of mutual funds are far more interested in taking money from investors than in making money for them, according to Mr. Lowenstein.

From 1980 to 2004, the assets of stock funds increased 90 times, from \$45 billion to \$4 trillion. During that same period, fees paid by investors and collected by fund managers via fund management companies soared from \$288 million to \$37 billion. What's more, the fund managers received their fees regardless

of whether the prices of the stocks they selected went up or down.

Not surprisingly, mutual funds continue to multiply like rabbits. By the beginning of 2007, there were about 4,800 mutual funds with \$6 trillion invested in stocks and \$3 trillion more invested in bonds and money market funds.

“The remarkable growth is a reflection, no doubt, of pervasive anxiety about corporate pension plans and Social Security, a sense that people had better take care of themselves or they could be left out in the cold in their so-called golden years,” Mr. Lowenstein observes.

But alas, the performance of the vast majority of mutual funds ranges from dismal to atrocious, especially in comparison to the highly profitable performance of the management companies that own them. The record of [T. Rowe Price](#), which is widely regarded as a respectable mutual fund family, is one of Mr. Lowenstein’s many graphic cases in point.

From 2001 to 2005, T. Rowe’s mutual fund assets under management soared 70 percent to \$270 billion; the profit of the management company that owned the funds more than doubled. But most of the investors in T. Rowe’s five leading large-cap growth funds were treading water. During the five-year period ended Dec. 31, 2005, two of the funds gained 1.26 percent and 1.38 percent, barely outperforming the 0.54 percent return of the Standard & Poor’s 500-stock index. The other three T. Rowe funds posted negative returns, ranging from minus 0.26 percent to minus 2.06 percent.

Mr. Lowenstein cites several structural reasons for the failure of mutual funds to serve the best interests of their investors.

One reason is that most mutual fund managers do not, as Mr. Lowenstein puts it, “eat their own cooking.” From 2003 to 2006, for example, T. Rowe’s chief investment officer amassed ownership or control of stock in the management company worth over \$75 million. But his total personal investment in T. Rowe’s mutual funds was only \$1 million.

Mr. Lowenstein contends that most mutual funds intentionally set low performance standards for themselves. Their goal, he says, is not to beat the S. & P. 500 average or the average of a particular industry sector, but simply to “track,” or approximate, those averages so that their managers “don’t look bad.”

The mutual fund industry offers 11,000 different asset classes, ranging from high-tech to old economy stocks that are sold to investors “like soap.” But rather than dealing directly with the public, mutual funds amass up to 90 percent of their money through retail brokerage firms, which, in turn, enjoy “pay to play” revenue-sharing arrangements. In 2005, for example, the Edward Jones brokerage firm collected a whopping \$172 million from a favored seven mutual fund groups to which it had referred its retail clients.

Mr. Lowenstein acknowledges that indexing a stock portfolio can have its virtues. He notes that a mutual funds analyst at [Morningstar](#) recently described T. Rowe Price funds as the type “you would feel good about your granny investing in,” though Mr. Lowenstein hastens to add, “Maybe your grandma, but not mine.”

Mr. Lowenstein balances his critique of rapacious mutual funds with an analysis of two relatively new funds, Wintergreen and Fairholme, that buck the prevailing trends.

THE Wintergreen and Fairholme business models mirror the Graham-Dodd philosophy of focusing on a few carefully selected stocks rather than diversifying in the name of safety, which is typically a euphemism for lazy research, Mr. Lowenstein says. Where the average mutual fund held 160 stocks, Wintergreen held 41 stocks and Fairholme held just 18 when the book was written. The annual returns of both funds were above 16 percent.

Mr. Lowenstein discloses that he owns stakes in the Wintergreen and the Fairholme funds. Given his trashing of most of their competitors, he may be faulted for not specifying the exact amounts of what he describes as his “modest positions.”

But at the risk of mixing metaphors, it seems clear that Mr. Lowenstein puts his money where his mouth is, and that the type of investing he praises is the kind of cooking that the general public deserves to be eating as well.

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