Boston Institute
of Finance

NICSA

THE NATIONAL INVESTMENT COMPANY SERVICE ASSOCIATION

Mutual Fund Industry Handbook

A Comprehensive Guide for Investment Professionals

Lee Gremillion
with assistance from PricewaterhouseCoopers

Foreword by John C. Bogle

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To Kathy, Andrew, and Christine

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Foreword

More than a half-century has now gone by since I opened the December 1949 issue of *Fortune* magazine and discovered the mutual fund industry. An Economics major at Princeton University, I was seated in the reading room of the then-brand-new Firestone Library, considering the choice of a topic for my senior thesis, which was due to be submitted some 16 months later. Determined to write on a subject never before explored in a Princeton thesis (there went Adam Smith, Karl Marx, and Lord Keynes!), I quickly realized that I had found my subject. As it turned out, I had also found a wonderfully rewarding career, the focus of my life-long vocation, and the mission I would pursue to this day: Serving the mutual fund shareholder.

The article that I read all those years ago was entitled "Big Money in Boston." It focused on Massachusetts Investors Trust (MIT), the industry's oldest fund (founded in 1924), its then-largest fund ($280 million in assets), and its lowest-cost fund (an expense ratio that would soon drop to 0.19 percent). MIT's beginnings are described in Chapter 2 ("A Brief History of Mutual Funds in the United States") of the sweeping and comprehensive compendium of the mutual fund industry that you now hold in your hands.

Titled *A Purely American Invention* when it was first published in 2000, the *Mutual Fund Handbook* is a remarkably important work. Sponsored by The National Investment Company Service Association (NICSA) and ably and authoritatively written by PricewaterhouseCoopers' former lead partner Lee Gremillion, it is a book whose time came at the perfect moment. If it had been written a quarter-century earlier in 1975, it would have been regarded as a death knell, for fund industry assets were then a miniscule $34 billion—and shrinking! Who could possibly have foreseen the remarkable sea change that would sweep the industry's assets to $7 trillion as the third millennium began in 2001?

A 56-Year Perspective

As I read this book, I am transfixed, and can't help reaching back in time to my first exposure to the industry 56 years ago. Until I read that 1949 *Fortune* article, I had known absolutely *nothing* about mutual funds. Indeed, I don't even recall having any understanding of stocks and bonds. But after I'd completed my extensive research—my bibliography cited 23 books; 43 articles; three of the classic *Investment Companies* manuals, published annually by Arthur Wiesenberger & Company until 2001—and read the entire 4,217-page report of the U.S. Securities & Exchange Commission that led to the enactment of the Investment Company Act of 1940, I thought I'd gained a pretty solid understanding of the industry.

I chose the title "The Economic Role of the Investment Company"* for my thesis. While it explored many possible roles for the industry, it set forth a simple, overarching principle for mutual funds. In the introduction: "Their prime responsibility must always be to their shareholders." In the conclusion: "The tremendous growth potential of the investment company rests on its ability to serve the needs of both individual and institutional investors . . . to serve them in the most efficient, honest, and economical way possible . . . the principal function of investment companies is the management of their investment portfolios." Today, I continue to hold high these very same ideals.

Following my early study of the industry, I spent the next 23 years at mutual fund pioneer Wellington Management Company, laboring in the vineyards and becoming its chief executive in 1967. Then as now, I was a diligent, determined participant in virtually all aspects of the fund business—administration, operations, marketing, investment management—and by 1974 I had come to believe that I knew *everything* about mutual funds that I needed to know. Today, however, with the sweeping changes that have taken place in the past 30 years, I sometimes wonder if I know *anything* that I need to know to remain an active participant in this wonderful business.

A Cottage Industry Becomes a Giant

In 1949, fund industry assets totaled $2 billion, spread among 91 mutual funds, largely common stock funds. Today, industry assets exceed $8 trillion, and there are 8,000 stock, balanced, bond, and money market funds, with a bewildering variety of strategies and objectives. Furthermore, with all of this growth and diversity, industry operations have become infinitely more complex, and modern information technology has placed abundant information and transaction flexibility in the hands of fund managers and fund shareholders alike. A small cottage industry has become a complex, multifaceted giant.

*In 2001, the thesis was published in its entirety (along with 25 of my speeches) in *John Bogle on Investing: The First 50 Years,* the first volume of the McGraw-Hill series "Great Ideas in Finance."

The *Mutual Fund Industry Handbook* to the rescue! This book has already played a major role in filling the embarrassing gap in my knowledge. Its subject matter is nothing less than *how funds work.* It covers the industry's history (please remember, "those who ignore the past are condemned to repeat it"); industry structure; the investment management "front office" (portfolio supervision) and the "back office" (making the system work); the fund accounting, audit, and legal functions; the transfer agency, now handling 270 *million* shareholder accounts; customer service; distribution methods (including the different challenges faced by the broker, direct, bank, and institutional channels, as well as the similar challenges that *all* channels face in advertising and in retirement investing); the incipient trend toward globalization; and, of special significance, the dramatic changes now taking place in the industry as a result of the revolution in e-business and e-commerce.

I am profoundly impressed by the broad and comprehensive sweep of information and knowledge that this book makes available to industry participants, college and business school students, and anyone else with a serious interest in this industry. But I am even *more* impressed by the fairness and even-handedness it brings to its discussion of many of the controversial issues that face the industry today. Controversy is hardly surprising in an industry that I've often described as characterized by dog-eat-dog competition, and the multiple ways that various fund organizations compete—in distribution channels, in marketing, in advertising, in fund creation, in portfolio policy, in investment strategy—surely characterize any highly competitive industry.

But *cost* competition remains conspicuous by its absence. Remember MIT's 1949 assets of $280 million and its later expense ratio of 0.19 percent? Well, in 2005, despite a 22-fold increase in those assets to $6 *billion,* its expense ratio had *risen* to 1.17 percent, generating a more-than-100-fold increase in fund expenses. While MIT's expense ratio remains *below* the equity fund average of 1.60 percent, neither figure suggests that the staggering economies of scale involved in mutual fund management are being adequately shared—if shared at all—with fund owners. One need not agree with that conclusion in order to wonder whether the fine study of fund expenses provided in this book (based on limited publicly available information) shouldn't be supplemented by an extensive study of the impact of industry costs—not only management fees and expense ratios, but sales charges, portfolio transaction costs, and opportunity cost—on investor returns.

Since I completed my thesis in 1951, investment activity in the fund industry has increased in just about every measurable way. Funds themselves come and go at a much higher rate. While some 14 percent of the funds operating during the 1960s no longer existed when 1970 began, fully 55 percent of the funds of the 1990s were gone at the dawning of 2000. Equity fund portfolio managers (virtually an unknown breed back then, when investment committees ruled the roost) now last on average just five years. Annual portfolio turnover, then about 15 percent, is now near 100 percent. And fund shareholders themselves, joining in this spate of activity, now redeem shares at a 25 percent annual rate, five *times* the five percent rate of 1960. I will not express here the strong opinions that I hold about these trends, but I hope that both those whose careers depend on the fund industry and those whose careers will shape its future will forthrightly consider their implications—specifically, the impact of this frenzied activity on the investment returns of the mutual fund investors whom we are all pledged to serve.

To the author's credit, the final chapters of the *Mutual Fund Industry Handbook* vigorously tackle these and other key issues. They include a fine discussion of industry life cycles, saturation, and alternative products, and jump unhesitantly into three especially contentious issues: First, fees and expenses; second, active management versus passive; and third, the state of "the market" in an industry that is, above all, market-sensitive. Surely the years ahead hold no shortage of challenges for all of us in the mutual fund field.

Years of Challenge

When I wrote the foreword to the previous edition of this book in 2000, I warned that our "soaring equity (fund) trees are unlikely to grow to the sky," and "we'd best be prepared to be tested under duress." It was easy enough to predict that the stock market bubble could not continue, for the record is crystal clear that long-run stock market returns are based on the relatively predictable *investment* fundamentals of earnings and dividends, not on the totally unpredictable *speculative* gyrations in price-earnings multiples. So the 50 percent stock market decline from the high in March 2000 to the low in October 2002, albeit perhaps overdone, largely reflected a return to reality. (With the subsequent market recovery, stock prices are now about 20 percent below their 2000 highs.)

In September 2003, another form of duress reared its ugly head in the mutual fund industry: the revelation of market-timing scandals in which fund managers allowed certain preferred investors, often hedge funds, to trade on the basis of previously determined net asset values, benefiting these traders at the expense of long-term fund investors, and enriching the coffers of the managers. More than a score of large fund managers participated in these unethical schemes, and state and federal regulators promptly jumped into action to attempt to prevent their recurrence. Soon after, other abuses came to light when "pay-to-play" arrangements—direct payments and trading of portfolio stocks—emerged as a *quid pro quo* from fund marketers to reward brokerage firms for their sales efforts. In both cases, fines and penalties have been assessed against the malefactors.

Both the overexuberance of fund marketers to capitalize on the euphoria of the stock bubble and the market timing and distribution scandals were reflections of fund managers placing their own interests first, at the direct expense of fund investors. Too many fund firms seemed incognizant, or even defiant, of the public policy clearly stated in the Investment Company Act of 1940: Mutual funds should be "organized, operated, and managed" in the interest of fund shareholders rather than in the interest of fund managers and distributors. If mutual funds are to truly serve the needs of the scores of millions of families who have entrusted their dollars to them, honoring that policy—in word and deed alike—is essential.

There are yet other subtle changes taking place in the U.S. financial markets. As you read this book I'd like you to think about four implications of the rise of this industry to its preeminent position among our nation's financial institutions:

- First, with People's Capitalism as the new American ethos, what will be the social impact on our political system of the ownership of stocks by the preponderance of our citizenry? With *de facto* control of Corporate America by the public and its stewards, how can the citizenry be *against* big business when, by owning stocks, "we the people" *are* big business?
- Second, as mutual funds become the investment choice of American families, has our nation's legal (and ethical) system provided adequate protection of the rights of investors by their fund trustees? While it's easy to think of today's America as an *ownership* society, it is not. In fact, we have become an *intermediation* society, with investment intermediaries now holding the overwhelming majority of corporate stock. How can we assure that it becomes the *fiduciary* society that is so essential to investor welfare?
- Third, what are the implications of living in an economy that is becoming ever more financial market–dependent? Clearly, substantial investment risk has been transferred from corporations and financial institutions to individuals. With the financial markets inevitably subject to extreme waves of optimism and pessimism, will these swings be translated into greater volatility not only in the markets but in the economy itself?
- Fourth, what role will government play in the financial markets? Even today, as it tries to steer a stable course for our economy, the Federal Reserve focuses on the level of stock prices. But in the long run, stocks cannot be propped up at unsustainable levels by easy monetary policy or

> encouraging words. So as common stocks inevitably enter the political arena, will our political authorities have the courage and the wisdom to let the markets take their own course as, finally, they must?

No matter how these issues are resolved, in the final analysis our job remains to serve our fund shareholders, just as it was the job of our founders when this industry began 80 years ago, and just as it was when I began to write my thesis 56 years ago. *No industry can long endure if it fails to effectively serve its clients.* We now know that it was the booming stock market of 1982–2000—the greatest bull market in all human history—that was responsible for so much of the industry's growth. But that exponential growth concealed serious shortcomings and a failing in this industry's responsibility to provide a fair shake to investors. Today, in the aftermath of the bear market that inevitably followed and the pervasive market timing and pay-to-play scandals in which managers and distributors placed their own interests ahead of the interests of the shareholders they were duty-bound to serve, we are being tested under duress. Addressing this situation is the acid test for any industry. In a book that he wrote nearly a century ago, Supreme-Court-Justice-to-be Louis Brandeis expressed it in these timeless words:

> *In business, the earning of profit is something more than an incident of success. It is an essential condition of success. But while loss spells failure, large profits do not connote success. Success must also be sought in the improvement of products, in a more perfect organization, in eliminating friction as well as waste, and in the establishment of right relations with customers and with the community.*

You'll get the most out of the *Mutual Fund Industry Handbook* if you keep in mind the title of Justice Brandeis' book: *Other People's Money.*

John C. Bogle
Valley Forge, PA

June 8, 2005

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The publication of the *Mutual Fund Handbook* (previously published as *A Purely American Invention: The U.S. Open-End Mutual Fund Industry*) would not have been possible without the generous support of PricewaterhouseCoopers.

William M. Perkins, partner of PricewaterhouseCoopers and a director of NICSA enlisted his colleagues to assist in updating the content of the book to reflect the dramatic changes in the mutual fund industry since the 2001 edition. We thank them for their contribution: Retired PricewaterhouseCoopers partner Bob Rubin, partner Richard Grueter, Emilie Codega, Nicholas D'Angelo, Allen Goldstein, Patricia Guzzetti, Jennifer Horn, Jennifer Morray, Jean Scanlan.

Lee Gremillion guided the process throughout, and we were fortunate to have his commitment to this project.

Through our partnership with Boston Institute of Finance and its CEO Run Pruett, this book continues to be the basis for the very popular and successful on-line course—Certified Mutual Fund Specialist.

We thank Matt Kellen and Kevin Commins of John Wiley & Sons for their guidance and counsel.

All of these collaboration exemplify NICSA's core mission—to educate and inform all the constituents who make the fund industry a key player in our economy.

NICSA
Wellesley Hills
June 2005

chapter 1 | Introduction to the Industry

In 1980, only one in 16 households invested in mutual funds; at the end of 2003, almost one of every two U.S. households is invested in mutual funds. More than a third of mutual fund assets are owned in accounts saving for retirement.

—Investment Company Institute's
2004 Mutual Fund Fact Book[1]

Mutual Funds— Big Business by Any Standard

Open any issue of the *Wall Street Journal*, or the business section of any major newspaper, and you will find several pages of densely packed print labeled "Mutual Funds." These pages may list the names, prices, yields, and other key attributes of over 8,000 funds, each representing an investment pool in which individuals or institutions can participate. At the end of 2003, there were more of these funds than there were common stocks on the New York or American Stock exchanges. Collectively, these 8,000 or so funds represented over $7.4 trillion dollars of assets, about 18 percent of the total financial assets of the U.S. population. At the start of 2004, 22 percent of U.S. retirement funds were invested in mutual funds.[2]

These funds give more than 90 million people the opportunity to participate in the securities markets without having to become money managers themselves. They are professionally managed, pooled investment vehicles. A mutual fund allows individuals (you, me, anyone with some money to invest) and institutions (corporations, foundations, pension funds) to pool smaller amounts of money into a larger amount for investment. Investment management professionals then manage this larger amount to allow

- investment strategies that would not otherwise be feasible (such as buying bonds that only sell in very large denominations);

- achieving economies of scale (such as paying low broker commissions) that are not attainable when investing smaller sums; and
- reduction of risk by holding a diversified basket of securities.

As we will see below, mutual funds offer the investor a number of significant advantages compared to investing in individual securities.

Because of these advantages, mutual funds have gained an increasing share of the nation's financial assets. During 2003, mutual funds received 26 percent of households' purchases of financial assets—that is, households put this money into mutual funds rather than bank savings, individual stocks, or other investments. These mutual funds purchases went into long-term funds. At the end of 2003, mutual funds reached their highest level of household financial assets at 18 percent, increasing from 10 percent ten years earlier. During these ten years, there was a securities markets boom in the late 1990s, and then a securities markets decline in 2001 and 2002. During 2003, the total assets invested in mutual funds grew from $6.4 to $7.4 trillion. The increase in mutual fund assets in 2003 rose from investment gains rather than cash flows because cash flows into long-term funds offset the cash flows from money market funds. Investment gains are dividends that shareholders reinvested in the funds, and the increase in value of the stocks, bonds, and other securities the funds held.

To a large extent, the mutual fund industry is an American phenomenon. While mutual funds or similar investment vehicles exist in other countries, they are nowhere so popular as in the United States, although in recent years more worldwide investors are using funds as their investment of choice. At the end of 2003, the U.S. assets invested in mutual funds represented 57 percent of the worldwide total of open-end, pooled investment funds of nearly $14 trillion. France has the next largest mutual fund industry after the United States, with funds holding the equivalent of more than $1.1 trillion assets. Although the U.S. industry continues to have outstanding growth, increasing assets 34 percent between 1999 and 2003, worldwide total net assets grew 49 percent during the same five years. During the ten years from 1994 to 2003, the U.S industry's growth was 258 percent and the worldwide total net assets grew 236 percent.

The mutual fund industry is a significant component of the U.S. financial services sector and receives significant attention from the U.S Congress, federal regulators, and states who want to protect the interests of U.S. households and their retirement savings. At the end of 2003, approximately $2.7 trillion of retirement savings were invested in mutual funds, representing 22 percent of retirement assets—excluding social security benefits that Americans will need in the future to pay for their retirements. In 2003, it was estimated that the 8,000 funds generated over $80 billion in revenue and provided employment for over a quarter of a million people, with fund management companies, investment advisers, custodial banks, distributors, transfer agents, and other third-party service providers. Collectively, U.S. mutual funds owned about 22 percent of the equity of publicly held U.S. corporations, about 5.1 percent of the debt securities issued by the U.S. Treasury and various federal agencies, and about 18 percent of the bonds issued by municipalities (states, cities, and counties). In the past few years, authors have penned over 100 books advising investors how to use mutual funds to help them meet their financial goals. A number of universities have recently established courses in mutual fund management.

Mutual Fund Defined

Before going any further, a few definitions are needed. All the funds listed in the "Mutual Funds" section of the newspaper fall into one particular category: they are open-end funds. Open-end funds are ones that will always sell new shares to investors wanting to invest money, or redeem shares from investors wanting their money back, at a price dependent on the net asset value (NAV) of the fund. (Well, almost always—there are exceptions, which we will describe as we go along.) In addition, each fund in the paper is registered with the Securities and Exchange Commission (SEC) pursuant to the Securities Act of 1933, and, therefore, is available for sale to the public. By and large, when someone says "mutual fund" in the United States today, this is what he or she is talking about—a registered open-end investment company.

This book focuses on open-end funds. There are other types of funds and pooled investment vehicles, described briefly in the following paragraphs, but none approaches the stature of open-end funds in today's economy.

Closed-end funds were more popular than open-end funds during the early years of the industry. Closed-end funds do not purchase and redeem shares at a price dependent on NAV. Instead, they collect a pool of money, issue shares once to the investors in exchange for their money, and normally plan to neither issue nor redeem these initial shares thereafter. The shares of a closed-end fund trade on the secondary market (such as the New York Stock Exchange), just as the common stock of a corporation does. The market determines the share price one gets when buying or selling the shares, and this price may be different from the net asset value.

Today, closed-end funds have declined in popularity (for reasons discussed in the next chapter), to the point that their assets in 2004 represented just over three percent of those of open-end funds. We will not focus on closed-end funds in this book, except on occasion to contrast them with open-end funds.

Unit investment trusts (UITs) resemble mutual funds, but the portfolio of securities of a UIT is fixed at inception and not actively managed. The sponsor of a UIT assembles a pool of money, purchases a basket of securities, and liquidates securities only in special cases (such as when a bond is called earlier than its maturity date). UITs are set up with a specified life span, after which they are liquidated, and many invest in debt securities. In general, holders of UIT shares purchase them to get a stable investment with a stated life span, although they usually can redeem their shares at any time at the current net asset value. At the end of 2003, Americans had UIT investments of less than $36 billion, a small fraction of the amount held in open end funds.

Variable annuities (VAs) are contracts sold by insurance companies, which are often backed up by mutual fund investments. The investor pays a lump sum or makes periodic payments; the insurance company invests this money in a portfolio of securities, often mutual funds. The value of this invested money goes up or down as the prices of the underlying securities rise or fall. After a specified period of time, often when the purchaser reaches retirement age, the insurer starts paying the investor an annuity. The amount of these annuity payments (or, the lump sum amount the contract holder may elect to take) varies according to the performance of the underlying securities.

The insurance contract allows the investor to defer the tax on the income earned from the investment until the money is withdrawn. This feature of VAs appeals to investors looking for ways to invest for retirement. On the other hand, variable annuities come with a cost—sales charges, administrative charges, and the mutual fund's expenses, or the costs required to manage the underlying investments when a mutual fund is not the investment of choice. The magnitude of these costs varies from one contract to another and from one insurance company to another. As of the end of 2003, Americans had about $866 billion invested in VAs[3] for which the underlying securities were mutual funds.

Hedge funds, another type of pooled vehicle, differ from mutual funds mainly because they are not aimed at the general public, but rather at the sophisticated and large investor. Hedge funds are private pools bound by contracts between the investors and the sponsors of the fund. In late 2004, the SEC, under the Investment Advisers Act, passed a new rule requiring hedge fund advisers to register. Typically, these funds require a minimum investment of $1 million or more, and typically pursue buy (long) and sell (short) investment strategies that may introduce more risk than do mutual funds that normally pursue only buy (long) strategies.

Hedge funds represent just one variation on a much wider theme—the private investment pool. Many investment management organizations will pool assets from among their clients to achieve economies of scale. For example, banks often create collective trust funds into which they put the individual assets of trust customers, instead of attempting to manage each trust account separately. Insurance companies managing investments for other institutions (typically retirement plans), often do much the same thing. While these pools share some attributes with mutual funds, they are not offered to the general public, nor are they bound by the same regulations as are registered funds.

Private investment pools vary endlessly. At the small and simple end of the range lie the investment clubs (like the famous Beardstown Ladies). At the other end we find such entities as limited partnerships, requiring investments of $1 million or more, formed to invest in arcane instruments or special economic sectors (like Long Term Capital Management, a hedge fund). Each has its place in the U.S. financial landscape, but none looms nearly so large in that landscape today as the mutual fund.

Who Invests in Funds, and Why

Who owns these trillions of dollars' worth of mutual funds? Individual U.S. citizens own the lion's share—77 percent at the end of 2003. Institutions of various sorts—bank trust departments, pension plans, corporations—own the remaining 23 percent. The Investment Company Institute (the ICI, described in Chapter 3) has published a profile of the average mutual fund investor in 2003, some of the attributes of which are shown in the following table. As the table suggests, the typical mutual fund investor is solidly entrenched in the American middle class.

The growth in mutual fund assets over the past 20 years has been paralleled by the growth in the number of investors. In 2003, more than one in three American households owned one or more mutual funds. So why do so many Americans keep a large part of their investments in the form of mutual funds? Different investors will have different reasons, but the compelling ones include professional management, easy diversification, liquidity, convenience, a wide range of investment choices, and regulatory protection.

Professional management. Mutual funds provide access to professional investment management for individuals who otherwise could not afford it. Trust departments of banks and private investment counsel firms have long offered professional management, but the minimum threshold for these services is typically $1 million or more in assets. Except in a few special cases, mutual funds require minimum investments in the $1,000 to $5,000 range, making them much more accessible.

Diversification. In general, an investor reduces risk by investing in a larger number of securities, reducing the impact of a decline in value of any one of them. A mutual fund, with its large pool of assets, can economically hold a much larger portfolio of securities than any but the wealthiest individual investor could.

Household Owners of Mutual Funds Demographic and Financial Characteristics, 2003	
Demographic Characteristics	
Median age	48
Percent of households:	
Married or living with a partner	71
Employed full- or part-time	77
Retired	21
Four-year college degree or more	56
Financial Characteristics	
Median household income	$68,700
Median household financial assets	$125,000
Percent of households owning:	
Individual stocks, bonds, or annuities	64
IRAs	69
Defined contribution plan	84

Source: Mutual Funds Shareholders, 2004, Investment Company Institute (www.ici.org)

Funds can hold a wider range of security types than individuals as well. Individual securities of some types cost tens or hundreds of thousands of dollars each to purchase, putting them out of the reach of most individuals, but not of mutual funds. Individual citizens find it difficult or impossible to purchase foreign securities, but can easily buy shares in mutual funds that hold foreign securities.

Liquidity. Mutual funds must determine a net asset value (NAV) every business day, and redeem all shares offered for liquidation that day at that NAV. Shareholders are assured of being able to convert their holdings to cash whenever they want, through a well-defined and fair process (described in Chapter 7).

Convenience. Mutual funds are easy to buy and sell, both directly from fund groups and through intermediaries such as brokers or fund supermarkets. They offer a wide range of attractive features for their shareholders, such as check writing, automatic purchase and redemption programs, and 24-hour access to information.

Choice. An investor today can find a mutual fund to fit any investment goal he or she may have, from conservative to aggressive. In later chapters, we will see some of the types of mutual funds that provide this wide range of choices.

Regulation. U.S. mutual funds are subject to regulation and oversight by the Securities and Exchange Commission (SEC). Each fund must provide each potential investor with a prospectus, a document that discloses its goals, fees and expenses, and investment strategies and risks. Funds must provide periodic reports showing the fund's actual investment performance and financial statements, including its statement of investments at a point in time.

> ***Speaking of Costs: Basis Points***
>
> *A basis point is one one-hundredth of a percent (.0001). Since many fee and cost amounts are fractions of a percent, they are often described in terms of basis points. For example, the .35 of one percent of average assets that Charles Schwab charges funds to belong to its OneSource program is typically described as a "thirty-five basis points fee."*

There's No Free Lunch, However

Of course, the flip side of this coin is that investors pay for all these benefits. In 2003, they paid about two-thirds of one percent of the value of their fund assets for basic management services—investment management, administration, and the like.[4] Some shareholders paid commissions to intermediaries as they purchased shares of the fund. Many funds paid commissions to brokers as they bought and sold securities, commissions that are paid from the shareholder's assets. The specific amount any one shareholder paid depended on the fund (where fees range from about 20 one-hundredths of a percent to almost two percent of assets), and the distribution method (zero for funds that have no sales commissions to several percent for some funds that do involve commissions).

These fee amounts have been a source of controversy for decades. Almost every year brings shareholder litigation against management companies over fees, and arguments back and forth between attackers and defenders of the industry. The courts have largely sided against plaintiffs in these excessive fee complaints, and certain econometric studies have concluded that competition has been effective in controlling fees and others argue otherwise. The ICI has published studies showing that increasing competition in the industry has driven fees down. Industry critics have claimed exactly the opposite. The U.S. General Accounting Office studied the issue in 1999–2000 at congressional request, but failed to come to a conclusion about the propriety of fee levels. In late 2000, the SEC issued the report of its study of mutual fund fees and expenses. While it reached no strong conclusions about the appropriateness of fee levels, it did call for greater fee disclosure and tightening of certain fund governance provisions.

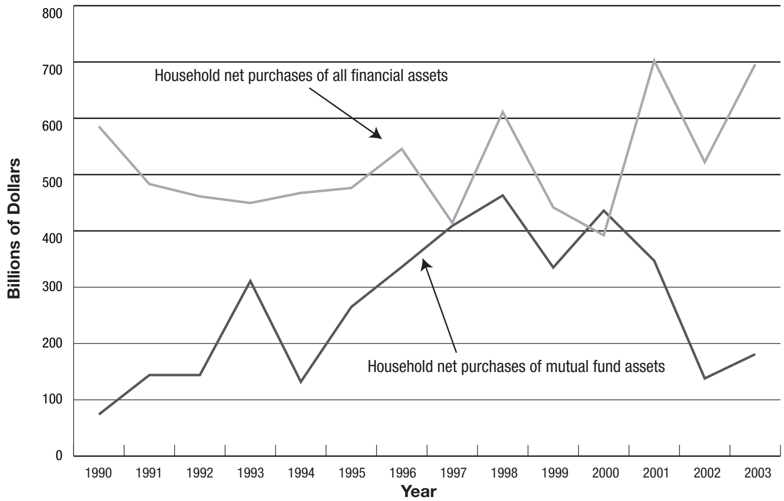
The battle rages on, and will surface in many subsequent chapters of this book. However, it is common sense that the lower a fund's expenses the more

Weighing in on Mutual Fund Fees—Some Comments from Industry Figures	
Strategic Insight (a mutual fund industry research and consulting firm)	"As industry critics continue to call attention to mutual fund fees, an SI study calculates that fund managers receive advisory fee revenues of under $100 annually per average account… [this] leaves $30 or less in profits per average-fund account, net after expense and taxes; hardly an excessive amount."[5]
Jack Dreyfus (an industry pioneer)	"Unless you have made a study of the market and have time to continue to study it, and have confidence in your judgment, it's well worth a half a percent or one percent to put your money in the hands of professionals."[6]
John Bogle (another pioneer)	"…enormous amounts of the expenses paid by fund shareholders are not benefiting those very same shareholders. In effect, high fees are paying for huge profits to fund managers…"[7]

that is left as performance for investors. Likewise it can be argued that if a fund's performance is outstanding, the investor should be willing to pay more for that performance.

In any event, fee amounts obviously have not deterred the majority of American investors, who in recent years have poured money into mutual funds. In particular, they have turned to mutual funds as their preferred way of buying into the stock market. As Figure 1.1 shows, over the past 15 years, U.S. households have become net buyers of mutual funds. In the early 2000s, the decline in the securities markets made net selling universally common for a time. Since 1999, funds have continued to

Figure 1.1 Household net purchases of mutual fund shares and financial assets, 1990–2003.



Source: 2004 Mutual Fund Fact Book, Investment Company Institute (www.ici.org) form a major component of U.S. households' net purchases of financial assets, although not in the dominating fashion that they did during the long bull market.

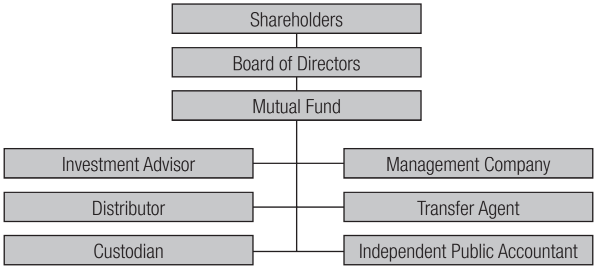
The Structure of a Mutual Fund

Mutual funds have shareholders, directors, assets (cash and securities) and contracts, and not much else. They differ significantly from most business organizations in that they have neither employees nor plant and equipment. (The reasons for this will be explained in the next chapter.) Instead, each fund, as represented by its board of directors, contracts with other organizations to provide the functions it needs. Figure 1.2 shows the ICI's depiction of the structure of a fund and its supporting organizations.

Board of directors. Mutual funds are typically organized as corporations or trusts, and each fund has a board of directors or trustees to oversee the way the business operates and to ensure that corporate policies are followed. A fund's board differs from the normal corporate board of directors in that the Investment Company Act of 1940 requires fund directors to look out for the investor. (The Act, which defines much of the regulatory environment for mutual funds, is discussed in detail in the next chapter.) Specifically, the board must oversee matters where the interests of the fund and its shareholders differ from the interests of its investment adviser or management company. To make this work, during 2004, the SEC amended its rules under the Investment Company Act of 1940 to require at least 75 percent of the board to be unaffiliated with the management company. In January 2004, SEC Chairman Donaldson speaking to fund directors at a Mutual Funds Directors Forum Conference, said,

> *To be truly effective, you must be forceful in requiring your funds and their service providers to establish new standards of integrity. Investors must be*

Figure 1.2 The structure of a mutual fund.



Source: 2004 Mutual Fund Fact Book, Investment Company Institute (www.ici.org)

Mutual Fund Management Companies—A Variety of Forms

- Some management companies are private corporations, owned by a small group of individuals. The most striking example of this is Fidelity Management and Research, which is owned mostly by members of the Johnson family of Boston.
- Some are subsidiaries or components of larger companies, such as Merrill Lynch Investment Managers, a subsidiary within the Merrill Lynch organization.
- A number of managers companies are independent, publicly traded corporations, such as T. Rowe Price (NASDAQ: TROW) and Eaton Vance (NYSE: EV).
- One management company is a singularity: The Vanguard Group, Inc. The Vanguard funds themselves own the management company lock, stock, and barrel. This mutual ownership structure aims at keeping costs to the fund at a bare minimum by eliminating any need for the management company to make a profit.

> *able to see for themselves that fund companies, and fund directors are living up to their fiduciary obligations and the spirit underpinning all of our securities laws.*[8]

Management company. The management company typically performs the administrative functions at the core of a fund complex—a family of related funds, all contracting with the management company for some or all of the services they need. In addition to administration, a management company may provide investment management, distribution, and transfer agent functions. The configurations of management companies—which functions they perform internally and which they turn over to third parties—vary endlessly. Management companies themselves can take any of the many organizational forms available to American businesses.

Throughout the course of our discussions we will see examples of management companies, the way they are organized, and the functions they perform. For most fund families, the management company performs at least the basic administrative services, including overseeing the performance of other companies providing service to the fund and ensuring that the fund complies with federal requirements.

Investment adviser. The investment adviser does the actual picking of securities to buy and sell to maintain an investment portfolio that meets the fund's objectives. The fund contracts with one or more advisory firms to provide this service in return for an investment management fee, usually a percentage of the assets under management.

Distributor. A mutual fund usually distributes its shares through a principal underwriter or distributor, which may be part of the management company, or may be a separately contracted third party. The principal distributor then sells the shares directly to investors, or to investors via other intermediaries, such as brokers or financial advisers. Distributors receive commission payments from shareholders, either as part of transactions or in the form of asset-based fees.

Custodian. The custodian actually holds the inventory of securities that the fund owns. The Investment Company Act of 1940 requires that funds place their holdings in custody as a means of protecting the investors, and most funds today use qualified banks to do this.

Transfer agent. The transfer agent keeps the shareholder records, executes the buy, sell, and other transactions the shareholders request, calculates and disburses dividends, and provides a range of reporting and other services. Many management companies provide complete transfer agent services themselves, others completely outsource these functions to third-party providers, and still others employ a mix—they perform some transfer agent functions internally and outsource others.

Independent auditors. The various acts governing the industry require that financial statements be audited by independent auditors who are registered with the Public Companies Accounting Oversight Board. A mutual fund audit involves procedures to substantiate the existence of the portfolio securities and the security prices that underlie the fund's net asset value. The former Director of the SEC's Division of Investment Management, Paul Roye, speaking to fund directors in January 2004 at a Mutual Fund Directors Forum conference, said that the independent auditors

> *can illuminate weaknesses in controls and identify issues that could result in risk for the fund. Auditors provide expert insight and, importantly, independent insight on a variety of fund accounting and related issues, such as pricing and valuation issues. Thus, you should make sure that your executive sessions and other meetings with fund auditors are meaningful discussions and not perfunctory exercises.*[9]

There are a number of organizations that provide other, more specialized services for mutual funds—printing and mailing, literature fulfillment, escheatment, cash handling, legal services, and so on. All of these organizations—what they do, how much they cost, how they evolved, and what issues and controversies attend them—form the subjects of the chapters that follow.