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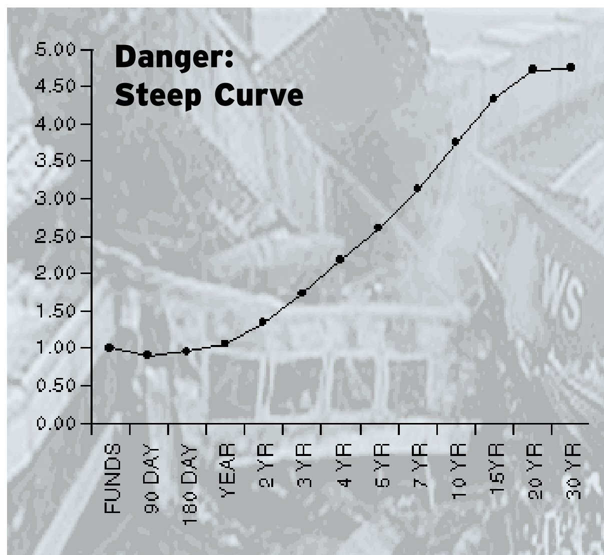
guestperspective

By John P. Hussman, Ph.D.

Picture A Freight Train

Extremely Low Short Rates, Steep Yield Curve And Uncle Holds The Bag…

T.S. Eliot once wrote "Only those who risk going too far can possibly find out how far one can go." It seems that the U.S. financial system is bound and determined to find out.



The major force shaping economic dynamics over the coming decade is likely to be an unwinding of the extreme leverage that individuals, businesses, and the U.S. itself (via its record current account deficit) have accumulated. Every past U.S. economic expansion has begun with a current account surplus, which moved rapidly to a deficit as consumption and investment soared. In contrast, eliminating a massive current account deficit will dampen future growth in domestic consumption and investment for quite a while. Individual and corporate balance sheets are no healthier, of course, and this will make the U.S. economy vulnerable to future debt crises and shifts in the profile of interest rates.

Many of these difficulties are well recognized, if not universally feared. What is not so obvious is the extent to which the U.S. economy and financial markets are betting on the continuation of unusually low short-term interest rates and a steep yield curve. This doesn't necessarily resolve into immediate risks, but it could profoundly affect the path that the economy and financial markets take during the next few years, by making the unwinding of debt much more abrupt.

In response to very low short-term interest rates, many U.S. corporations have swapped their long-term (fixed interest rate) debt into short-term (floating interest rate) debt, to the extent that an increase in short-term rates could substantially raise default risks. Similarly, a growing proportion of homeowners have refinanced their mortgages into adjustable rate structures that are also sensitive to higher short-term yields. Finally, profitability in the banking system is unusually dependent on a steep yield curve, with a widening net interest margin (the difference between long-term rates banks charge borrowers and the lower short-term rates they pay depositors) accounting for all of the strength in bank earnings in recent years.

Of course, if somebody owes short-term interest, somebody else must be earning it. In equilibrium, every security issued is matched by a holder on the other side. For this reason, the ocean of "liquidity on the sidelines" in money market funds is not a pool of money waiting to be invested in stocks or bonds, but is instead a measure of how dependent U.S. borrowers are on short-term debt.

See, if Mickey sells his money market fund to

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Victor Juhasz
Page 5 Illustration

buy stocks, the securities in that money market fund have to be sold to Nicky, whose cash goes to Mickey, who uses that cash to buy stock from Ricky. In the end, Nicky holds the money market securities that Mickey used to hold, Mickey holds the stock that Ricky used to hold, and Ricky holds the cash that Nicky used to hold. In the end, there is just as much "cash on the sidelines" as there was before. Money never goes into or out of the market, merely through it.

So the real question is this: Why is anybody willing to hold this low interest rate paper if the borrowers issuing it are so vulnerable to default risk? That's the secret. The borrowers don't actually issue it directly. Instead, much of the worst credit risk in the U.S. financial system is actually swapped into instruments that end up being partially backed by the U.S. government. These are held by investors precisely because they piggyback on the good faith and credit of Uncle Sam.

"The real question is this: Why is anybody willing to hold this low interest rate paper if the borrowers issuing it are so vulnerable to default risk?"

See, a risk-averse investor might be somewhat reluctant to lend short-term money directly to, say, General Motors. To see how the U.S. government becomes a counterparty to this debt, grab a pen.

First, suppose that Citibank gets money from its depositors at a floating rate, and lends to mortgage borrowers at a fixed 6%. Now GM issues bonds yielding 7%, and enters a swap with Citibank, in which Citibank pays GM 5% fixed in return for a floating rate. (The market for swap transactions of this sort is huge. Technically, both sides agree on a notional principal amount, say, $100 million, and then each side makes payments to the other, one based on a fixed rate times that principal, the other on a floating rate times that sum.) Well, now GM is paying an actual interest rate of floating + 2% (pay 7% to bondholders, get 5% from Citibank, pay Citibank floating). Meanwhile, as compensation for the credit risk it has accepted all around, Citibank earns a fixed 1% margin regardless of interest rate movements (pay depositors floating, get 6% from mortgages, pay 5% to GM, get floating from GM). Neat. And since Citibank is federally insured at the depositor level, and "too big to fail" at the institutional level, Uncle Sam is now a counterparty that effectively shares the risk in the case that GM or homeowners default. Similar transactions serve to swap risky corporate and mortgage borrowing into safe government agency paper issued by Fannie Mae and Freddie Mac.

Now make no mistake, there is little question that bank deposits and agency debt are safely backed by the U.S. government and that this is a good commitment. However, the holders of stock in banks or mortgage companies like **Fannie Mae** and **Freddie Mac** may not be so secure. It's just excruciatingly difficult to perfectly match risky assets and liabilities at extremely high levels of leverage. Ask Long Term Capital. Indeed, were it not for accounting rules that allow Fannie Mae to keep balance sheet losses out of earnings, it would be clearer to investors that last summer's 5-month "duration mismatch" cost Fannie nearly a year of earnings. Similar derivatives-related issues are at the core of Freddie Mac's recent difficulties.

According to the Bank for International Settlements, the U.S. interest rate swap market is about $34 trillion in size, its notional value having nearly doubled in size in the past two years. The reason this figure is so enormous is that there are usually several links in the chain from borrower to investor. A risky borrower may enter a swap with bank A, which then takes an offsetting swap position with bank B (earning a bit of the credit spread as its compensation), and so on, with a cheerful money market investor at the end of the chain holding a safe, government backed security, oblivious to the chain of counterparty risk in between.

Hussman Research and Insight Disclosures
Specific positions and investment strategies taken by the Hussman Strategic Growth Fund are presented in the annual and semi-annual reports. The investment strategy of the Fund is detailed in the Prospectus and Statement of Additional Information (SAI). Investors should rely solely on these materials when evaluating the investments of the Fund. These documents are available at www.hussman.net.

Picture a freight train.

Aside from the risk that any particular link in this chain might be weak (know thy counterparty), the U.S. financial system has gone one step further. In order to hedge against the risk of defaults, banks frequently lay credit risk off by entering "credit default swaps" with other banks or insurance companies. These swaps essentially act as insurance policies for credit risk.

Once again, however, the iron law of equilibrium is that every risk swapped away by someone is held by someone else. According to Bloomberg, over half of the world's trading in the credit swaps market is concentrated among five banks: **J.P. Morgan** (26%), **Citigroup** (10%), **UBS Warburg** (9%), **Bank of America** (7%) and **Deutsche Bank** (7%). As **Warren Buffett** has noted, "Large amounts of risk, particularly credit risk, have been concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another. The trouble of one could quickly infect the others."

Picture a freight train.

In short, the U.S. financial system is in a delicate balance. On the issuer side, a great many borrowers have linked their debt obligations to short-term interest rates. This is tolerated by the financial system because the debt has been swapped out through financial intermediaries, so investors get to hold relatively safe instruments like bank deposits and Fannie Mae securities. This mountain of debt in the U.S. financial system—tied to short-term interest rates—is ultimately and perhaps somewhat inadvertently backed by the U.S. government.

On the investor side, Asian governments intent on holding their currencies down relative to the U.S. dollar have purchased a great deal of U.S. government and agency debt—effectively "buying dollars." Individual investors have also been willing to hold low-yielding money market instruments because of profound weakness of the U.S. stock market and restrained inflation. A reduction of demand for short-term debt, either by foreign governments or by U.S. investors, could have very undesirable consequences.

All of which is why the U.S. is now extremely dependent on short-term interest rates remaining low indefinitely. In addition to the direct effect of increasing debt-servicing costs of fragile borrowers at all levels of the economy, an increase in short-term interest rates would tend to raise "monetary velocity," resulting in an abrupt and unexpected increase in inflation. As a rule, rising short-term interest rates have historically been self-reinforcing because they trigger the delayed inflationary impact of the prior monetary easing.

"My broker says don't panic, I'm still young enough to recoup my losses."

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While the prospects for rapid and sustained economic growth remain questionable, there is increasing evidence that the U.S. economy may enjoy a surprising burst of strength in the second half of this year. Given the potential pressure on short-term market interest rates (regardless of whether the Fed follows suit), a short burst of strength in the U.S. economy may ironically be the last thing that the U.S. economy needs.

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John Hussman is Chairman of Hussman Econometric Advisers, the investment adviser of the Hussman Investment Trust, and portfolio manager of the Hussman Strategic Growth Fund and Hussman Strategic Total Return Fund. John's Hussman Investment Research & Insight is published periodically by the Fund Manager, Hussman Econometrics Advisors.*

***Full Disclosure:**
Kate Welling owns a modest number of shares in the Hussman Strategic Growth Fund and from time to time has held positions in Vanguard's Windsor and money funds.

listening**in**

Stewardship Apostle

What Fund Industry Needs, Says Vanguard's Jack Bogle, Is Some Old-Time Religion

*That **John C. Bogle**, the founder and former CEO of the **Vanguard Group** speaks his mind–and is a fervent believer in index funds– comes as a surprise to no one in Wall Street. But that Jack, who now sports the title of President of Vanguard's Bogle Financial Research Center, has chosen to spend his "golden years" hopping from speaking platform to speaking platform, Congressional Hearing Rooms most definitely included, to excoriate his industry, corporate managements and the Street for enriching and entrenching themselves while treating investors shabbily in the extreme,is–face it–a mite unsettling. Rocking the boat just isn't good form. Yet there's Jack, forcefully advocating things like making mutual funds prominently disclose not only performance stats and proxy votes, but expense ratios, sales charges, portfolio transaction costs and other expenses –in terms their investors can understand and on a regular basis. Not to mention a federal statute spelling out a fund management's fiduciary duty to its shareholders. I drove down to the outskirts of Philly last week, to hear firsthand, what's on Jack's mind. Hint: Plenty.*
KMW

Even a casual perusal of your recent speeches on the Vanguard website makes it clear you're on something of a crusade, Jack–
I don't know that I'd call it that. But we've created quite a mess in the corporate and financial worlds over the last few years, and I've been pointing out some important–and largely unrecognized– themes that I think go a long way toward explaining how we got into this position, and suggesting ways out. But our problems are complicated, and I don't claim to have all the answers. They don't all stem just from criminal elements. It wasn't just a few bad apples. It wasn't just the accountants. Or stock options. It wasn't just the short-term fixation of the markets. Or the mania. It wasn't just the failure of directors to do their duties and the failure of owners to exercise their responsibilities. It wasn't even just greedy managements. It was kind of all those things, coalescing together.

We've been through a financial perfect storm?
As I heard a wise man say not long ago, when you have strong managers, weak directors, cooperative accountants and passive owners, don't be surprised when the looting begins. We had some of that, and we had a lot of stuff that was not technically looting, but certainly was a betrayal of trust. And I think a lot the blame can be laid on a transformation–or pathological mutation, it's been called–in the nature of capitalism in this country since the end of WWII, from owners' capitalism to managers' capitalism. The former was based on a dedication to serving the interests of the corporation's owners, maximizing the return on their capital investment. But a new system slowly developed in which the corporation came to be run to profit its managers, in complicity if not conspiracy with accountants and the managers of other companies. How could it happen? In my view, because the markets–aided and abetted by the mutual fund industry–had so diffused corporate ownership that no responsible owner exists. And the said truth is that this is not only morally unacceptable, but also a corruption of the very notion of capitalism.

Phew. But why blame mutual funds? Isn't it really the institutionalization of the market that's at fault?
Probably. But the fund industry grew enormously over that time–and played a critical role as its focus gradually shifted–from management to marketing, from stewardship to salesmanship, and–just as in the case of corporate America–from owners' capitalism to managers' capitalism. At this point, the mutual fund business is an industry without even a pretense of price competition–unless you want to argue that the competition in the mutual fund industry is to *raise* prices, which I would not argue with!

Isn't that bound to change, if investment returns stay more modest than we've been accustomed to for quite a while?
Well, there are two elements to that. It is amazing how much the world has changed and how everybody is now talking about costs. Not a lot of people are *doing* anything about them–like the proverbial weather–but even the academics now realize that getting costs out of the equation is our No. 1 job in the industry. Anyone who doesn't–put it this way: If you look back 30 years, you'll see that half of the funds that existed back then are gone now. And that was in a stable mutual fund industry.

Not to mention, a bull market.
But at least half of today's mutual funds will be gone in 10 years.

You give them that long?
This industry acts very slowly when its own economic interests are at stake. Price competition will come, but investors will have to be the driving force behind it. Brokerage firms, for example, have no interest in lowering their charges. They're marketing information. That great Wall Street selling machine depends on selling–and salesmen depend on commissions. That has always been the case and it is still the case today. That is not necessarily bad although there is a tremendous amount of abuse in the system. But as investors figure it out, it will change. One reason that the Investment Company Institute's cost numbers are down so much is not–like the ICI is telling you–because the industry is competing, but because investors perceive lower cost funds are better and the ICI cost data is sales-weighted.

How so?
Visualize this: In Year 1 there is a fund that has $100 million in sales volume and a 2% expense ratio. But the day that year ends, all investors wake up and buy index funds. They buy $100 million in the index funds at .18. The ICI would describe that as a 90% cost reduction in the mutual fund industry. But real price competition is not defined by the actions of consumers. It is defined by the action of producers.

It *should* be.
It is, in any economic textbook. Competition will eventually come. But it will come at a glacial pace because there is always somebody out there who beat the index last year. Actually, in any year, about 1 out of three managers do it, and over 5 years it is probably one out of 5 and over 10 years it is probably one out of 7 or 8, if you take into account survivor bias. But there is always somebody, so there is always a salesman. This is still very much a business that requires human interface–and that face that is interfacing with you is going to get paid. Besides, we are all Americans. We think we are going to win the competition no matter what the evidence says.

***Someone* has to. Now, I know John Neff and Peter Lynch–and I know I'm not them. But philosophically not even trying is profoundly defeatist. Not only that, but indexing only "works" under special circumstances: When most investors *aren't* doing it–and in bull markets.**
Do you always put your philosophical problems ahead of your financial future?

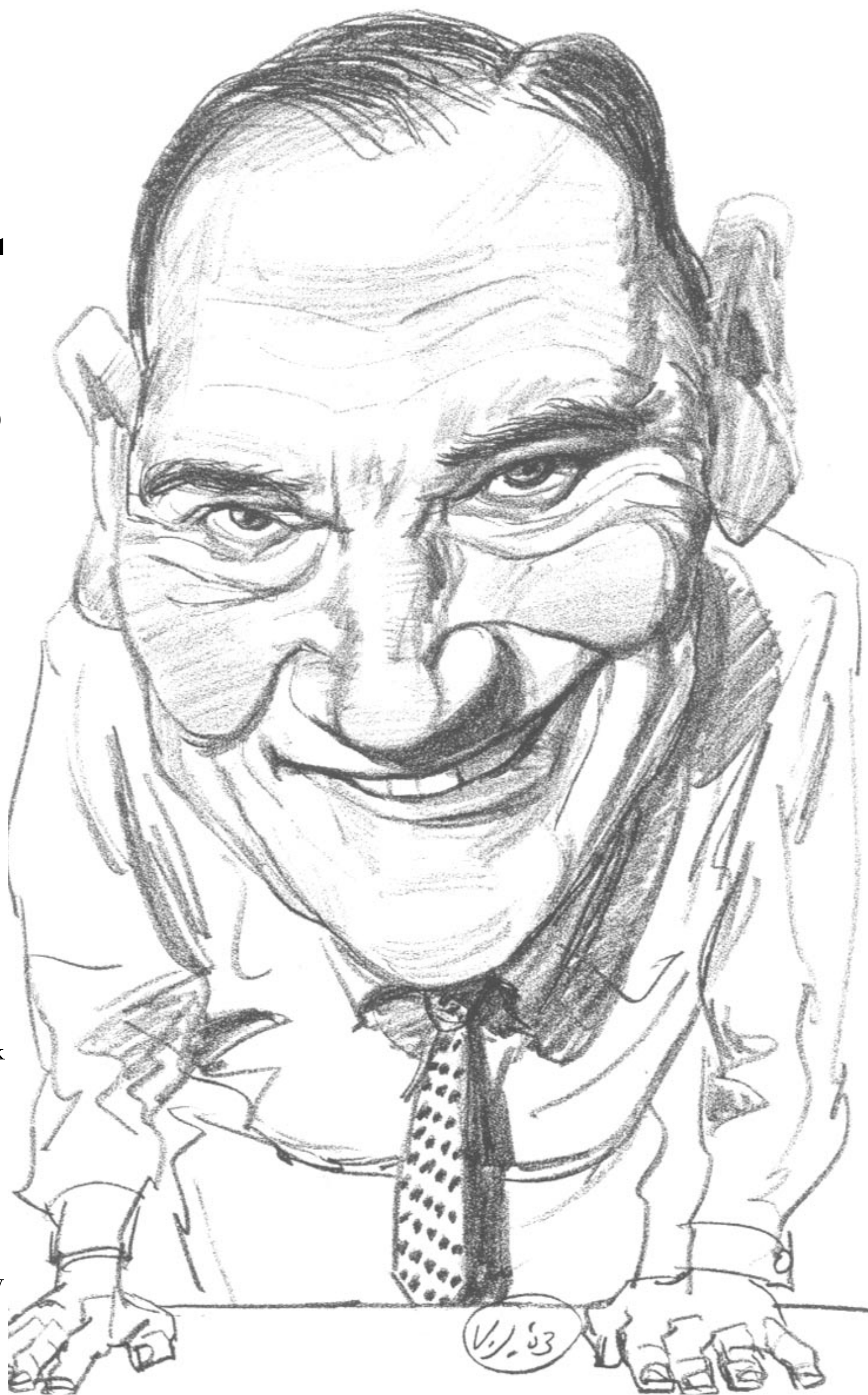
All too often. But why are you so sure I can't find other John Neffs, even if I can't perform his magic myself?
As much as I love John Neff, if you look at his **Windsor Fund** record, you will find that counting three or four extraordinary years, he just about equals the index *after taxes*. Portfolio turnover is a big drag, even with Vanguard's cost structure which is very unusual and unusually low–and which was a big benefit to John. He would be the first to tell you that. And when you take taxes out, it is not easy. Now, **Legg Mason Value Trust's Bill Miller** is a wonderful manager. He has been for 12 years. Does anybody really think he is going to be for the *next* 12? Well, probably everybody. But *I* don't know. It is going to be a bigger fund. He may decide to retire. A couple of facts: The average mutual fund investor owns approximately 4 equity funds. The average mutual fund manager lasts for 5 years. That means in 10 years, you have 8 managers. In 20 years, you have got 16 managers. In 30 years, 24 managers have taken roughly 3% a year out of your return. You are going to probably pick those managers based on their past performance, another big mistake. So the probability that the average fund investor is going to beat an unmanaged index over 30 years is zero.

But there aren't only average investors and fund managers. Some are better than average—just like some are worse. Besides, the popular indexes *aren't* unmanaged.
Really, the indexes aren't managed in any sense we'd talk about. The mathematics aren't complicated. Why would anybody take a gamble like this: You have a 5% chance of beating the market by a tiny amount, certainly not by a large amount. But the odds are overpowering that you are going to lose–half of the people are going to earn less than half as much money as the index produces, 45% are going to make somewhat less than the index.

Wait a minute. The indexes *aren't* managed? Their components are massaged all the time.
Stocks go in and out of the indexes, yes. But based on the University of Chicago data, we know what the return of the stock market has been since 1928. The S&P has actually done a little better, which is a statistical aberration because they picked up a little performance in 1933 and '34. But the correlation is .97. It is a myth that the S&P 500, which is of course 80% of the market anyway, is not going to give you the market's return. How could the other 20% be *that* different? And it *does* in fact give you the market return. And the most powerful part of stock price returns are based on what the market does. You can't really get that much differentiation. So yes, I am a dyed-in-the-wool indexer.

The problem is, you've attracted too much company.
You mean, what happens if everybody indexes? Well, if everybody indexes, we have no financial markets because there is no trading.

Exactly. Something akin to that played no small part in the bursting of the stock market bubble in early 2000. It wasn't just the index funds that were indexing, but virtually every professional investor was "closet indexing." Eventually, we hit a tipping point, and the market couldn't keep levitating.
I am going to say two things: 1) A lot of my intuition tells me that you are exactly right. There *was* a lot of "closet indexing"– although there was no real uniformity in what that



"The fact is, mutual funds need a change of heart —no pun intended."

meant. But just look at how brokers make recommendations now. They don't say buy and sell they say overweight, underweight. They are closet indexers. And that does make indexing bigger. But 2), that said, you have to ask yourself what that closet indexing meant to the market. Because if the index is the S&P 500, you could argue that the S&P 500 was actually driven way above the return of the market and then sold way below it in the ensuing crash. *But that did not happen.* The S&P tracked the total stock market or the rest of the stock market very closely on the way up–and very closely on the way down. Which implies to me that closet indexing *didn't* play the role you're talking about.

That's just it. The S&P *wasn't* ground zero of the mania. That was in the Nasdaq—and in the tech sector of the S&P. Which *were* blown way above trend, and then blown to bits. And that's where the closet indexers concentrated.
I just don't see that in the data on how the funds performed.

Clearly, I'm not going to convince you not to index. Let's get back to what ails the fund industry. Why hasn't competition from the likes of Vanguard already forced rivals to bring their costs down?
There are a lot of people who argue that Vanguard's cost structure, merely by its existence, has kept costs from going up further. I am going to guess that is true–but the industry's costs should be much lower. You have an average unweighted equity fund expense ratio of 1.6%. The weighted average is 1.2%. The average turnover cost I use is about 0.8% and [Aronson + Johnson + Ortiz LP's] **Ted Aronson** uses a number that is probably double that, but I think that I am right and he is wrong.

Ted respectfully disagrees, I'm quite sure—
In my view, a cost is anything that comes out of an investor's pocket and so detracts from the market return. But I don't buy the idea of opportunity costs on the trading side. I don't buy delay costs.

Ted can show how they detract from a portfolio's investment returns every which way.
Yes, but what I do is look at costs *to the system*. If I buy 100,000 shares of, say, Intel and pay $21 a share, instead of $20, because of a delay, well, somebody else sold it for $21 instead of $20. In other words, it is a closed system. I am trying to look at the costs that the system extracts. Ted's methodology is perfectly intelligible and correct *for a fund*, but I am looking at out-of pocket costs for all mutual fund investors. It takes money to administer 401-Ks, money to buy and sell stocks. It takes money to print statements, all those kinds of things. A lot of firms charge extra fees on accounts below a certain size. Sales charges aren't included in any of the performance data you see. Where opportunity costs come in, in my view, is in an equity fund that doesn't have a 100% of its assets in the market.

Maybe in a bull market—but certainly not in a bear. Then again, you're definitely not a market timer, as your response to Peter Bernstein [w@w, June 27] made plain—
Definitely not. If you accept that over a long period stocks will do, say, 4% better than cash, and yet you're keeping 5% in cash, that's 20 basis points subtracted from your total return, right there. Anyway, when you put it all together, 3% is not a bad estimate of mutual fund costs. That is what the data show. Since 1984, there's been a 2.9% difference between total stock market return and the return of the average equity fund. The average fund investor, because of timing and selection penalties, has actually done much worse. Costing himself another 5% by some calculations.

Even that didn't matter terribly when the average investor was getting a fat double-digit return. But things are very different in a subdued return environment.
3% out of 15% is 16%, and 3% out of 6% is 50%. It doesn't take a genius. And that is especially obvious the money market fund field, where costs and returns are simply opposite sides of the same coin. They are a pristine example of everything I have just told you about in the stock market. Investors lag the market by the amount of the system costs every day. When investors finally see that, they will eventually have to think about what's happening in their equity funds, too. In fact, it is high time we had a government-sponsored economic study that "follows the money" in the mutual fund industry. The Investment Company Act of 1940 says absolutely nothing like, "You are able to charge what the traffic will bear." Nor does it say that what the competition is charging is a good guide for a fair cost for mutual funds. The Investment Company Act of 1940 says unequivocally, right in the preamble, that the interests of mutual fund *shareholders* must be placed *ahead* of the interests of mutual fund managers and distributors. What it says specifically is that mutual funds must be organized, operated and managed in the interests of shareholders rather than in the interests of managers and distributors. But there is not a human being in America today who believes that is the way this industry is being run.

I am glad *you* said that. Next you're going to be talking about quaint notions like fiduciary duty.
As I said, this business of *stewardship* has been turned into a business of salesmanship.

A transformation, your tone leaves no doubt, you were happy *not* to be in the vanguard of.
I can take some consolation in the fact that the Vanguard Group's market share has increased for 20 years in a row. Without big sales charges, without doing the face-to-face to the ultimate buyer. We have succeeded in driving almost every major firm out of the no-load mutual fund business. Think about that. **Scudder** is gone. **Dreyfus** is half-gone or three-quarters gone. **Fidelity** is emphasizing advisor funds that they sell through brokers. They have actually taken the loads off a couple of their big funds, like Magellan, but they're not selling any, so that's not much of a difference. Costs are going to come down for a whole lot of reasons. But especially because the reality is that directors have to live up to their responsibilities. I am trying to get Congress, which is looking into this right now, to say there is not enough disclosure to each investor of how much he is paying for each fund each year. To say that fund board chairmen should be *independent* directors. That independent directors should probably be provided with staff to discharge their duties. Imagine the foolishness of having the chairman of the management company negotiating management fees with the chairman of the fund, *when they're the same person*. As **Warren Buffett** says, negotiating with oneself seldom produces a barroom brawl. We haven't had any barroom brawls in this industry.
I am a big believer in those ideas, which the industry is obviously fighting. They don't seem to be fighting too much my suggestion that we take the independent component of the board up to two-thirds. I haven't gotten a lot into disclosures of soft-dollar arrangements, but of course they should be disclosed and payments to dealers for sales should be disclosed, too. But we don't do those things at Vanguard, so I have not really gotten into that fray. But nobody else in the industry wants to talk about survivorship bias. Nobody wants to talk about incubator bias–even though two fund groups already have gotten fined by the SEC for rolling over IPOs, which they were allotted because of the buying power of their big funds, into start-ups. I wouldn't want to say that was a tribute to high ethical standards in this industry.

No. But it was an easy way to generate highly marketable performance numbers.
You got it. Putting stewardship under salesmanship or salesmanship over stewardship.

Has the mutual fund industry peaked? Look at the enormous growth

of hedge funds and alternative investment vehicles–

Well, when the record is written, I don't think hedge funds, or separately managed accounts, will produce returns any better–and probably worse, given their costs–than the average index fund. It is *hard* to beat the market.

That is how the hedge funds justify their enormous fees. By claiming they can–and do.

Funny, I read somewhere that around 700 of them went out of business last year. But let's get back to mutual funds. We definitely want to get rid of this Gordian knot that gives the managers such control over the funds. I also want to establish a federal statute of fiduciary duty, clearly stating that directors have a fiduciary duty to place the interests of shareholders ahead of the interests of managers, directors, officers and distributors of the fund. That is what the act implies now. But a federal fiduciary statute would be a big step forward. There hasn't been a lot of response from the committee members, I admit. But I would hope the SEC would play a much more active role in all this. The fact is that mutual funds need a change of heart–no pun intended.

Heart? What heart?

Here I'm reaching all the way back to an article that appeared in *Fortune Magazine* way back in December, 1949, on trusteeship, in mutual funds–and which inspired me to write my senior thesis at Princeton on the industry. Fund trustees were groups of investment professionals, by and large, back then. The funds were run by those committees, not by individual managers. Very often, the managers of the funds had nothing to do with the funds' distribution. Separate companies were set up to handle the distribution, and made their money on a sales charge, a nice little business. Portfolio turnover was around 16% a year–for a very long time. In other words, portfolios turned over about every six years. It didn't get over 16% until 1965. Now it averages something like 110%–meaning the typical holding period is 11 months. The difference is stunning, especially in its implications for costs borne by investors. Back then, you had trustees interfacing with independent directors. Now the same thing supposedly happens–except that the directors aren't independent in many cases. The funds are no longer run by private little companies whose owners feel duty-bound to restrain their greed. In 1951, the average expense ratio for the 25 largest funds, with aggregate assets of but $2.2 billion, was only 0.64%. What a difference five decades makes! In 2001, the average expense ratio for the equity funds managed by the 25 largest fund complexes has risen 134% to 1.5%, despite the fact that their assets have soared 845-fold, to $1.86 trillion. The dollar amount of direct fund expenses borne by shareholders of all equity funds has risen from an estimated $15 million in 1950 to something like $35 billion in 2002. Despite the truly staggering economies of scale in mutual fund management, fund investors have not only not shared in these economies. They have been victims of far higher costs.

Why? Other than fraud, waste, greed and stupidity, that is?

I believe that the most powerful force behind the change was that mutual fund management emerged in the post-war era as one of the nation's most profitable businesses. Entrepreneurs could make big money managing mutual funds. Just a few years after that Fortune article appeared, the whole dynamic of the fund industry changed. Up until 1958, a trustee could make a tidy profit by managing money, but could not capitalize that profit by selling shares of the management company to outside investors. The SEC held that the sale of a management company represented payment for the sale of a fiduciary office, an illegal appropriation of fund assets. If such sales were allowed, the SEC feared, it would lead to "trafficking" in advisory contracts, leading to a gross abuse of the trust of fund shareholders.

Gee, you mean *the SEC* was prescient?

A California management company challenged the SEC's position and won in court. After that came a rush of IPOs as management companies were quickly brought to market. But that was just the beginning. Giant banks and insurance companies bought up even privately held management companies, paying lofty premiums averaging 10 times book value to get into the burgeoning business. "Trafficking" wasn't far off the mark; there have been at least 40 acquisitions during the past decade. Today, only six of the 50 largest fund managers are privately-held, in addition to mutually-owned Vanguard. Only seven are publicly held. The rest are owned by giant U.S. and foreign financial conglomerates. Clearly, when a giant corporation buys a business it expects to earn a hurdle rate on its investment. The upshot is that as you get the economic ownership attenuated out to the shareholders of Deutsche Bank, just to pick an example, the independent fund directors aren't going to feel the same responsibility towards shareholders, it seems to me. I also think the structure of mutual funds will have to be streamlined, though it won't happen rapidly. Isn't it peculiar that these $100 billion fund complexes need another company to run them? Think about that. At that kind of asset level you can run the company yourself. That is what Vanguard does. I don't mean to aggrandize Vanguard's interests but what we call "The Vanguard experiment," was to see how a mutual structure and governance would do in the crucible of competition. I believe that the jury is in. It works in favor of investors and that is ultimately what investing is all about. Letting people have a more secure financial future. My point is that fund investors lose a lot of money not just because of their own foolishness and greed but because we–the industry–create things like "information age" funds to lure in the money and advertise them like crazy. I'm the kind of guy who dug out the March 2000 issue of *Money* magazine recently, to look at all the fund returns in the ads. There were 44 mutual funds advertising their returns for the preceding year in that issue –and the average return advertised was 85.6%. The industry was saying, "Come and get these new age funds." Of course, the industry is going to object, "We didn't say that at all."

That was clearly the message. If not the words used. But are you arguing for some sort of restraint on free speech or commerce? Remember, you couldn't *give away* boring old value funds, for instance, at that point.

Let me answer this way: Is it possible to believe that those 496 funds were organized in the interests of investors rather than in the interests of managers?

Not on your life.

What's wrong with expecting a certain amount of discipline from fiduciaries? Just think about what has happened to a manager who sold those funds. His face is red. He has hurt his business in the long run.

But which is the chicken and which is the egg? It seems that not just mutual funds, but investors of every stripe, as well as most companies are all afflicted with ADD [attention deficit disorder].

There is no question that is the problem of the age. A short-term focus is at the root of many of the governance problems, for example. We hear this called a rent-a-stock industry–and it is. Renting and owning are two very different things. If you own a stock you care about how the company is governed. If you're just renting short-term performance, you couldn't care less how a company is governed. This fund industry, with its short-term focus, bears huge responsibility for both the bubble and it aftermath. We have gotten almost no blame for it at all–but we should have. We've hurt a lot of investors very badly and hurt a lot of other people, employees of corporations, by allowing ill-considered mergers to be approved, by approving excessive approve mergers, we improved excessive compensation to managers. Fact is, while a fund that owns stocks has little choice but to regard proper corporate governance as of surpassing long-term importance, a fund that rents stocks could hardly care less.

Thanks, Jack.

newsbites

Remember The Alamo?

LTCM Wasn't Nearly That Long Ago, But Clearly Has Been Forgotten

"Simply put, leverage empowers the investor with a method of delivering higher returns with no increase in risk."

That's a verbatim quote, from the monthly performance report of a currently hot hedge fund group.

No kidding.

Is this a credit bubble or what?

"E" Is For Effort, Or Enterprising Hedgie...

Emblem From Enron Headquarters Now To Glow Above Boston

An enterprising hedgie I know amuses himself these days by bidding on Bubblemania tchatchkes on Ebay. So naturally, the posting below was just too much for him to resist. When the auction failed because the seller's reserve wasn't met, my intrepid friend pursued, and closed, the deal in private. (At what price, only he and his shrink know for sure.)

His plan has Enron's E soon lighting Boston's sky from a window high atop 101 Federal Street...There's only one catch: Our friend's staff is having a devil of a time trying to figure out how to make this neon bear's trophy shine through the office tower's high-tech coated windows... **KMW**

ebay **ENRON- "E"- Logo from one of the entrances**

Note: *This is a Reserve Auction in which the reserve price was not met. Therefore, there is no transaction between the seller and the high bidder...*

Description: This is an auction for one of the ENRON E's that used to be outside of the ENRON building. The E is made from solid stainless steel and weighs over 300 pounds. It has a very unique lighting system in that there are red, green, and blue lights that glow from inside making it attractive at night. According to the company that originally fabricated the neon lighting, the Enron executives were very detail oriented and desired real stainless steel with imported glass for the neon lighting. The glass was imported from Italy and only a few glass benders can fabricate that type of glass. This company is only one of two that can fabricate imported glass in Texas. The imported glass in the E is extremely expensive and the manufacturer requires a very large minimum order to create the custom colors they ordered. This E is 48"x48"x15" in dimension. This is a great conversation piece and looks awesome when the lights are turned on!

Current bid	**US $11,100.00 (reserve not met)**	**Starting bid**	**US $999.00**
Quantity	**1**	**# of bids**	**27**
Time left	**Auction has ended.**	**Location**	**Houston, Tx**
		Country/Region	**US/Houston**
Started	**May-29-03 18:19:36 PDT**	**Ends**	**Jun-05-03 18:19:36 PDT**

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