Decision Scenario C
Timing Mutual Funds

Beginning in the fall of 2003, a variety of federal and state authorities have charged many of the leading mutual fund companies and brokerage firms with improperly engaging in or aiding fraudulent trading schemes. Such mutual fund companies as Putnam, Janus, Bank of America, American Express, and Bank One, as well as such well-known brokerage firms as Charles Schwab, Morgan Stanley, and Prudential Securities, have been accused of giving favored clients unfair benefits in buying and selling mutual funds. Most of the allegations involve "market timing" or "late trading" schemes in which favored clients were allowed to buy and sell mutual fund stocks while the financial markets were closed to other buyers.

Mutual funds, as the name suggests, are investment instruments in which a large number of investors pool their money to purchase a wide variety of stocks and bonds. The economies of scale created by pooling resources allow the funds to purchase more stocks than an individual alone could afford. By spreading risk across a wide variety of investments and investors, mutual funds are generally considered safe and attractive investments. In fact, as many as 100 million Americans have almost $7 trillion invested in mutual funds, much of it in the form of individual retirement accounts.

Although investors own the money in the mutual fund, the fund itself is owned by a separate company, owned by separate investors. A fund manager, who works for the fund owner, invests and manages the pool of money. For example, Putnam Investments is the fifth-largest mutual fund company in the United States and is a unit of the insurance company Marsh & McLennan. Thus the shareholders of Marsh & McLennan own Putnam, which is managed by the fund managers to make a profit for those shareholders. Putnam Investments gets its money from individual investors, who assume that fund managers will administer the fund to provide them with safe and profitable returns. Putnam Investments was one of the mutual funds charged by federal and state regulators with fraud for engaging in market timing.

Typically, the price of a mutual fund is set once a day, after the close of financial markets. The price is established by dividing the value of all the mutual fund's stocks by the number of individual investors. "Late trading" occurs when privileged clients are allowed to buy or sell mutual fund shares after the trading day has ended. If information concerning investments occurs after the trading ends, late trades allow these privileged clients to capitalize on that information by buying additional shares destined to increase in value on the basis of good news, or sell shares destined to decrease on the basis of bad news. All other shareholders must wait until the next day when the price of the shares available for them to purchase has already risen, or fallen, with the news. "Market timing" occurs when fund managers allow privileged clients to buy and sell large numbers of shares as close to the market close as possible, thereby improving their ability to predict future share price. Such trades are generally prohibited to all but these well-placed clients because such rapid buying and selling of large numbers of shares to capture small gains adds increased costs and risks to the fund. The privileged clients gain, while most other investors face lower profits and increased risks.

Potential conflicts of interest occur because the mutual fund companies and brokerage firms can make significant profits from frequent trades of large numbers of shares. Mutual fund companies profit from both the amount of money invested with them and by the number of trades executed. In short, large investors who engage in late trading or market timing can generate significant income for the mutual fund companies and brokerage houses. Large investors use this leverage to convince fund managers to allow for late trades and market timing. Thus fund managers are faced with a decision that is in the interests of their firms yet that runs against the best interests of those people who have invested in their funds. The problem is compounded when individual fund managers themselves engage in market timing and late trading with their own personal money.

Then New York State Attorney General Elliot Spitzer was one of many government officials investigating these cases. In September 2003, Spitzer released to the public several documents discovered in his investigation of the Janus mutual funds. In one email, a Janus official admitted that "our stated policy is that we do not tolerate timers. As such, we won't actively seek timers, but when pressed and when we believe allowing