

SCANDALOUS PRACTICES: INVESTMENT INDUSTRY CALLED TO TASK

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Over the past year a number of scandals have hit the investment industry. A disturbingly large number of high profile analysts at leading New York brokerage firms were charged with purposely misleading investors with inflated estimates of the growth potential for mainly high tech stocks. This activity contributed greatly to the boom and consequent bust of this sector, which cost gullible investors literally billions of dollars. It was satisfying to see this behaviour called to task.

In the fourth quarter of 2003 some very disturbing revelations were made about the way certain major US mutual funds were allowing late purchases by preferred customers such as members of the investment committees of large pension funds and hedge funds. The regulations requiring that mutual fund purchase orders must be received before the close of the market is specifically designed to prevent purchasers from having the benefit of hindsight even for a matter of hours. This totally unacceptable behaviour does cost the long-term holders of mutual funds millions of dollars and is completely unacceptable.

Ironically, the amounts involved are insignificant relative to some to other widespread mutual fund sales practices. In Canada, annual management fees of 2.5% and more are not uncommon on even very large funds. We cannot understand why investors stand for giving up such a large portion of the long-term growth of their investments for management — even if it is excellent which often it is not. This level of fee is certainly not necessary for supporting highly paid managers. In fact, a large portion of it goes to support the Fund's marketing efforts. Up front commissions of 5% and annual "maintenance" fees of up to 1% are going back to selling organizations. The highest payment scheme, not long-term performance, appears to be the criterion by which funds are chosen to the recommended lists of many sales organizations.

In the US many leading brokerage firms negotiate large lump sum payments from management companies for putting funds on their approved lists. In mid-January, the US Securities and Exchange Commission announced that it was investigating 20 brokers and mutual fund groups. The SEC feels that this results in a conflict of interest that detracts from investment results.

It is unfortunate that any industry which has so much to offer to investors gets involved in such shoddy activities such as late trading and encouraging short-term trading. In Canada, high fees charged to support fee sharing with brokers and investment planners is, we believe, much more common and costly to fund holders.

Investors should take these revelations as a warning to find out the policies of their financial service providers by asking specific, hard questions and demanding answers. There are managers who stay free of these practices and have good performance records.