ADDING VALUE

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SUMMARY:

This edition of ADDING VALUE addresses the core legislation of our industry. It reviews why the legislation failed, and what is being done to regain the trust of shareholders. It also provides some observations on future industry trends.

Third Quarter Investment Review and Outlook: Investment Company Act of 1940

The guiding force in our profession is the Investment Company Act of 1940. This Act is the primary legislation for the regulation of the U. S. investment management industry. It states: "The national public interest and the interest of investors require that mutual funds be organized, operated, and managed in the best interests of their shareholders, rather than in the interests of advisers, underwriters or others." From the very first page, even an uneducated reader understands the unequivocal message: **THE SHAREHOLDER IS KING.**

In retrospect, the problem with the Act was that the fiduciary duty standard was more implicit, than explicit. In other words, it did not state, thou shall not . . .

- Have late trading;
- Have breakpoint violations;
- Have soft-dollar abuses;
- Have worst execution;
- Have exorbitant fee structures; and so on.

For the first 40-45 years, the Act upheld the interests of the fund owners, and the industry's focus was on prudent funds with long-term strategies and objectives. This proud tradition, however, once overlaid with the longest and strongest bull market in all of human history, deteriorated. Eliot Spitzer opened the Pandora's Box of mutual fund transgressions in 2001, and it seems as though the black clouds of greed, arrogance, and deceit continue to spew forth. While most people in the industry are well-meaning, honest and intelligent, Upton Sinclair remarked: "It is difficult to get a man to understand something when his salary depends on his not understanding it." The intent of this newsletter is to give our clients and readers a preliminary look at the Mutual Fund Reform Act of 2004 and some other vital issues that should attract increasing attention.

The Bull Market of 1982-2000

There are some great books already written on this period in economic history. If you get a chance, you can read Roger Lowenstein's Origins of the Crash, Maggie Mahar's Bull!, or Bill Bernstein's Birth of Plenty. Essentially what you had during this period was remarkable growth of the mutual fund industry. John Bogle, of Vanguard fame, has calculated that in the period from 1953 to 2003, the GDP increased 30x and mutual fund assets increased 1,800x. Even more revealing is his calculation on the economies of scale garnered by this industry of expanding assets.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

In the following chart, he details the percentage change in the unweighted expense ratio from 1965 to 2003 as +86% as follows:

Where are the economies of scale?

	1965	2003	Change
Total equity assets	$ 26b	$ 3,684b	+140x
Avg. expense ratio	0.87%	1.62%	+ 86%
Wtd. expense ratio*	0.51%	0.95%	+ 86%
Fees generated**	$134m	$34,998m	+261x

*Weighted by fund assets.
**Fees generated uses weighted average.

A careful review of this chart, however, shows that the real story is in the ***dollar*** increase in fees generated. As the chart shows, fees expressed in dollars have exploded by 26,000 percent! Basis points may no longer represent a proper standard of measurement, fees expressed in dollars are much more appropriate. One should ask the next logical question: Where did these fees go?

Some expenses that come to mind include:

- Advertising budgets
- Fund manager compensation
- Complicated and elaborate distribution channels
- Salaries of untrained and unqualified spokesmen
- Excessive trading
- Fancy offices

Charlie Munger, of Berkshire Hathaway fame, calls the commandeered billions the "febezzle" – the prefix, of course, derived from the word "fee." You can guess where he is going with the remaining letters. As he so eloquently states in a 2000 speech: "If a foundation, or other investor, wastes x% of assets per year in unnecessary nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the 'febezzlers' think they are virtuously earning income." It still is not clear that this situation is known to most people. However, it is hopeful that a bear market, subdued future returns, mutual-fund scandals, legislation, and angry politicians will force the febezzle to shrink.

Mutual Fund Reform Act of 2004

This bill was introduced by Congress on February 10, 2004, and it is an attempt to make fund governance truly accountable. It adds the "shall nots" to the Investment Act of 1940. Some highlights of its provisions include:

- Ensures independent and empowered boards of directors
- Clarifies the fund directors' foremost fiduciary duty to shareholders
- Institutes Sarbanes-Oxley style provisions for independent accounting and auditing
- Discloses portfolio managers' compensation and stake in the fund
- Standardizes computation and disclosure of fund expenses and transaction costs
- Explains portfolio turnover rates to investors
- Eliminates asset-based distribution fees (Rule 12b-1 fees)
- Unbundles commissions
- Requires enforceable market timing policies and mandatory redemption fees
- Strengthens late trading rules
- Prohibits revenue sharing, directed brokerage, and soft-dollar arrangements

John Bogle states: "While nothing can solve the industry's problems overnight, I view the bill as the gold standard in putting mutual fund shareholders back in the driver's seat, and endorse it in its entirety." While we agree with all the proposed regulatory reform that is currently in process, it still seems to us that this legislation obscures the vital issue: Money management has become an "asset-gathering" business, with an enormous built-in infrastructure, instead of an investment profession. As such, the biggest inducement to change may simply be the market itself. If the capital markets deliver an extended period of subdued returns, investors themselves may begin to question all the issues currently being legislated. Then maybe, the real revolution will occur.

Issues that we have always reviewed as stewards of your assets

To date, through hard work, and a little luck, none of the funds in your portfolios have been directly implicated in any of the mutual fund transgressions, nor have any CFA's been directly involved in the calamitous kinds of shenanigans that have come to light in the mutual fund field. We have always adhered to the implicit standards of the Investment Act of 1940 in that all of our focus has been on creating portfolios that provide the highest return with the least amount of risk and the most prudent level of fees for each individual client situation. To this end, we have looked at:

- Expense ratios
- Turnover rates
- Ownership structures
- No-load funds
- Redemption practices
- Size of assets under management in a particular style
- Tax-efficiency
- Private versus public ownership

Most of the managers of our mutual funds have in place governing principles which we have examined in depth and about which we have queried the managers. None have participated in any market timing schemes. Instead, they have introduced redemption fees for shares held less than 60-90 days to protect long-term shareholders. These policies have always been in place to deter the disruptive, short-term trading activity of market timers and result in more efficient operating environments for long-term investors.

Some highlights of principles that govern the actions of the mutual funds that we invest in include:

- We will not impose loads, holding periods, exit fees or 12b-1 fees on our investment partners.
- We will discourage short-term speculators and market timers from joining us.
- We will treat your investment as if it were our own.
- We will invest for the long term, while always striving to maximize returns and minimize business, financial, purchasing power, regulatory and market risks.
- We will consider closing the fund to new investors if closing would benefit existing shareholders.

Additional observations about the future

It would have been so easy if, as this newsletter started, all investment professionals would have adhered to the guiding principles of the Investment Act of 1940, which was adopted by-the-way after the abuses of the 1930's. It is apparent that the congress and Senate will continue to legislate changes to be enforced by the SEC. Already in our small company, we have adopted a complete set of mandated Policies and Procedures, appointed a Chief Compliance Officer, established a formal Codes of Ethics, requested updated confidential information, revised Form ADV, attended seminars on compliance, etc. Despite all of this activity, we believe that there are some additional issues that have yet to be addressed. These issues include:

Conglomerates now control the fund business: When we started in the business, the industry was dominated by small management companies that were closely held by their principals. These principals were the stewards of the entrusted assets and had their own money invested in the same manner as the clients. During the bull market that began to change, until we now have an industry where public ownership is the dominant organizational structure. Of the 50 largest managers, 43 are publicly owned and only seven private firms remain. Business interests superceded professional interests. Gathering assets became the name of the game. Will legislation ever change the industry's values back to stewards of shareholder assets?
Where will all the new managers come from?: Today, new private investment businesses are formed as hedge funds. The growth in these private companies is phenomenal, with some estimates that there is now $1 trillion under management before leverage in over 9800 funds. If as some pundits remark, these are simply "compensation schemes" what will be the regulatory environment for these practices? Currently, almost all

"new" managers entering the investment industry enter as hedge fund managers. Why not?

401(k) Plans and College Savings Plans: As professionals in this business, we find it very difficult to find information about any deals being made between employers who sponsor retirement plans and mutual-fund management companies. But how is it that employers give one management company exclusive access to thousands of employees? What happens to those employees as they become captive customers of fund families implicated in the mutual-fund abuses? In general, these 401(k) plans may yet prove to have done a great disservice to investors over the defined benefit arrangements of the past, when exorbitant fees and poor management leave many baby-boomers with insufficient funds for retirement.

Performance History of Funds: Like it or not, most investors rely on past performance when making their investment choices. The SEC is adamant that fund returns presented in advertising, in shareholder reports, and in prospectuses are accurate, but that record is often sheer illusion. The rights to the performance belong to the management company; therefore, if a manager accrues a performance history and then leaves the firm, he or she is not permitted to take the performance with them. In fact, the management company keeps the numbers even if not one person is left running that style. Secondly, many funds promote performance when a fund has little money under management, which has far different results when the fund grows to $60 billion.

Assets Under Management and Economies of Scale: Funds have taken in so much money under management, that size has become a hindrance to successful money management. So when you see that a fund has $60 billion under management, it is probably not very effective. In fact, it is taking money from existing clients and giving it to new clients, which is a fiduciary conflict. When a fund keeps its door open to new money flows even though it is impossible to produce **future** performance with such a large asset base, has everything to do with the business of marketing and nothing to do with the profession of investment management.

Fund closings: With money gushing in and regulators on the warpath, mutual funds are closing their doors to new investors like never before. Lipper quotes that through June 30, about 31 funds have closed their doors to new investors in 2004 alone. You should know that most of the funds that have closed are those in your portfolio.

We don't know where this will all go. We are loath to make any forecasts because although we can identify problems, we are unable to determine when changes will occur. We are experiencing a period of secular change; demographics, increased information, heightened awareness of issues and regulatory guidelines, etc. will produce industry changes that are beneficial to the individual shareholder. People are going to have to find a way to assume responsibility for their portfolios. They are going to have to understand fundamental investment strategies, rather than read and take for granted the heavy, "feel good" advertising done with all the money gathered from the extra fees that they themselves have paid. As Paul Simon, once sang: **A man hears what he wants to hear and disregards the rest**. This may no longer be an option.

Sincerely,

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