MUTUAL FUND INDUSTRY PRACTICES AND THEIR EFFECT ON INDIVIDUAL INVESTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

MARCH 12, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–11

U.S. GOVERNMENT PRINTING OFFICE

87–798 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
DOUG BEREUTER, Nebraska
RICHARD H. BAKER, Louisiana
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chairman*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
DOUG OSE, California
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
PATRICK J. TOOMEY, Pennsylvania
CHRISTOPHER SHAYS, Connecticut
JOHN B. SHADEGG, Arizona
VITO FOSELLA, New York
GARY G. MILLER, California
MELISSA A. HART, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
TIM MURPHY, Pennsylvania
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
RAHM EMANUEL, Illinois
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama

BERNARD SANDERS, Vermont

Robert U. Foster, III, Staff Director

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD H. BAKER, Louisiana, *Chairman*

DOUG OSE, California, *Vice Chairman*
CHRISTOPHER SHAYS, Connecticut
PAUL E. GILLMOR, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
EDWARD R. ROYCE, California
DONALD A. MANZULLO, Illinois
SUE W. KELLY, New York
ROBERT W. NEY, Ohio
JOHN B. SHADEGG, Arizona
JIM RYUN, Kansas
VITO FOSSELLA, New York
JUDY BIGGERT, Illinois
MARK GREEN, Wisconsin
GARY G. MILLER, California
PATRICK J. TOOMEY, Pennsylvania
SHELLEY MOORE CAPITO, West Virginia
MELISSA A. HART, Pennsylvania
MARK R. KENNEDY, Minnesota
PATRICK J. TIBERI, Ohio
GINNY BROWN-WAITE, Florida
KATHERINE HARRIS, Florida
RICK RENZI, Arizona

PAUL E. KANJORSKI, Pennsylvania
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
JAY INSLEE, Washington
DENNIS MOORE, Kansas
CHARLES A. GONZALEZ, Texas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
KEN LUCAS, Kentucky
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
MIKE ROSS, Arkansas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
RAHM EMANUEL, Illinois
DAVID SCOTT, Georgia

CONTENTS

	Page
Hearing held on:	
March 12, 2003	1
Appendix:	
March 12, 2003	59

WITNESSES

WEDNESDAY, MARCH 12, 2003

Bogle, John C., Founder, The Vanguard Group	7
Bradley, Harold S., Senior Vice President, American Century Investments	13
Gensler, Hon. Gary, Co-author *The Great Mutual Fund Trap,* former Under Secretary for Domestic Finance, Department of the Treasury	18
Haaga, Paul Jr., Executive Vice President, Capital Research and Management Company	16
Montgomery, John, Founder and President, Bridgeway Funds	11
Riepe, James S., Chairman, T. Rowe Price Associates, Inc.	20
Wagner, Wayne H., Chairman Plexus Group, Inc.	10

APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	60
Clay, Hon. Wm. Lacy	62
Emanuel, Hon. Rahm	63
Gillmor, Hon. Paul E.	65
Hinojosa, Hon. Rubén	67
Kanjorski, Hon. Paul E.	68
Ney, Hon. Robert W.	70
Bogle, John C. (with attachments)	72
Bradley, Harold (with attachments)	134
Gensler, Hon. Gary	155
Haaga, Paul G. Jr., (with attachments)	168
Montgomery, John	193
Wagner, Wayne H. (with attachments)	202

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Fidelity Investments, prepared statement, March 12, 2003	210
United States General Accounting Office, prepared statement, March 12, 2003	216

MUTUAL FUND INDUSTRY PRACTICES AND THEIR EFFECT ON INDIVIDUAL INVESTORS

Wednesday, March 12, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND,
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:07 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Gillmor, Castle, Royce, Manzullo, Oxley, Kelly, Ney, Fossella, Biggert, Kennedy, Tiberi, Harris, Kanjorski, Sherman, Meeks, Inslee, Frank, Lucas of Kentucky, Ross, Clay, Baca, Matheson, Lynch and Scott.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Subcommittee on Capital Markets to order, and welcome those who are here in attendance today.

Today, the subcommittee will examine mutual fund industry practices and the potential effects on individual investors. This hearing is a next step in the committee's continuing efforts to protect America's investors and help in the restoration of public confidence in the performance of the capital markets. This effort began some time ago in the last Congress, with hearings in this subcommittee on the conduct of securities analysts and a series of others, culminating in the passage of the Sarbanes-Oxley legislation. The statute once adopted addressed not only analysts' conduct, but strengthened oversight and the responsibilities of accountants, attorneys and corporate officers. It was a very important beginning.

Last month, we examined the collection and investor restitution efforts by the SEC. I am personally anxiously awaiting the outcome of the global settlement, hoping that it will make significant provision for investor restitution. The committee will continue this work. For example, it is my hope in the near term to visit the credit rating agencies and determine how their performance fared during the disappointing market periods.

These actions are not without justification. Ninety-five million Americans are now investors in mutual funds, with many depending on long-term performance for their retirement. The point needs to be made clearly. The responsible performance of the markets and the equitable treatment of all investors is essential for the economic vitality of the country. This committee, and I hope this Congress, will take all appropriate steps to restore efficient performance and ensure fair functioning of the capital market allocations.

Today, we turn our attention to the mutual funds, a sector of the market which during the 1990s experienced unprecedented growth. We should examine whether investors really get what they pay for, and determine whether investors know what fees and costs they are paying, and then examine how the current regulatory system either succeeds or fails in investor protection. It is not, at least with my current understanding, clear to me that all is well. The recent GAO report, which was by the way initiated by request of this committee many months ago, has reached a conclusion only yesterday that fees are up. More troubling, investors are paying higher fees while suffering from troubling fund performances.

According to the information reviewed in the last few days, in the last 15 years the S&P index has outperformed almost 60 percent of the diversified equity funds. Another trend in the industry which is alarming is the turnover rates in portfolios. Currently, the average portfolio turnover for a fund is 110 percent, with average fund holding periods of 11 months. Obviously, these are not investments made for the long haul. This continual churning increases cost to the investor and potentially generates additional tax liabilities. This short-term, roll-them-in and roll-them-out strategy, as I call it, certainly does not enhance the building of corporate wealth or shareholder return, but appears to generate significant cash flow in fees for somebody.

As troubling as the facts appear today, really they are not that easy to get at. So I am, just like everyone else, hoping to learn today about how to better understand how the market functions. This lack of transparency certainly leaves the average investor without an ability to determine what action is in his own best interest.

Current disclosure in the prospectus that shows fees as a percentage of assets, which is based on a hypothetical dollar amount, may be somewhat instructional. But I am very hopeful that the SEC will soon move forward on an enhanced disclosure requirement and also give final approval to the pending proxy voting disclosure rule. I think such changes will provide the initial and necessary steps to strengthen the position of individuals and certainly help build confidence in market performance. But know from my perspective that these two steps are really very rudimentary. They are only small steps down what is, I think, going to be a long road.

I hope we can turn to the industry leaders to assist in this effort. At the end of the day, everyone from the director of a large fund to the smallest investor will benefit from a market structure which is transparent, efficient and fair. We must have a platform in which investors are willing to return to the market with their dollars. Our economy and our nation, will benefit from such enhancements. I, for one, will not conclude my efforts until we have attained that goal.

Mr. Kanjorski, do you have an opening statement?

Mr. KANJORSKI. Mr. Chairman, thank you for the opportunity to offer my initial thoughts about mutual funds before we hear from our witnesses. I want each of them, and you, to know that I approach today's hearing and future discussions on mutual fund issues with an open mind.

As we begin our examination of mutual funds in the 108th Congress, I feel it is important to review some of the basic facts about this dynamic industry. According to the Securities and Exchange Commission, at the end of fiscal year 2002 mutual funds managed $6.1 trillion dollars in investments, significantly more than the $3.7 trillion deposited at commercial banks. Additionally, the SEC calculated that 93 million investors living in 54 million households owned mutual funds. The mutual fund industry has also evolved dramatically in the last several decades. The number of mutual funds has grown from 564 in 1980 to nearly 8,300 today. In addition, the assets in mutual funds portfolios totaled just $56 billion in 1978. By 1990, this figure increased to $1.1 trillion, and by the turn of the century mutual fund assets had expanded another sixfold.

Today, mutual funds also represent about 20 percent of our nation's equities market. Without question, we can therefore conclude that mutual funds constitute a major sector of our nation's economy.

As the mutual fund industry has grown, it has worked to bring the benefits of securities ownership to millions of hard-working Americans. Many securities experts have noted that the typical investor would find it expensive and difficult to construct a portfolio as diverse as that of a mutual fund. I wholeheartedly agree. Mutual funds have clearly provided an economical way for middle-class Americans to obtain the same kind of professional management and investment diversification that was previously available only to large-scale institutions and wealthy investors. In short, mutual funds have worked to democratize investing.

Despite this tremendous success, securities experts continue to examine how we can improve the performance of the mutual fund industry and advance the interests of U.S. investors. Some recent public policy debates in this area have focused on disclosing proxy votes to mutual fund shareholders, modifying industry oversight through the creation of self-regulatory organizations, and increasing the frequency of mutual fund holdings disclosures. Although each of these issues is important, today we will generally focus our examinations on the cost of mutual fund ownership—an issue that many consider is the most consequential.

As you know, Mr. Chairman, I have made investor protection one of my top priorities for work on this committee. Understanding the cost of operating a mutual fund and learning how such expenditures affect investing is, in my view, therefore very important. These fees and loads will, after all, have a significant effect on investors' returns. A recent story in USA Today, for example, determined that for government securities mutual funds, the group with the lowest expense ratios averaged a 43 percent gain over five years, while those with the highest expense ratios grew by 34 percent during the same time frame. Small differences in annual fees will ultimately result in major differences in long-term returns.

During our deliberations today, I expect we will hear many conflicting views on the issue of mutual fund fees. Some of our witnesses will cite studies showing that these expenses have increased in recent years, while other panelists will refer to analyses demonstrating a gradual decrease in such fees. Although each side in

this debate will seek to use statistics to its advantage, our job should be to learn more about the industry today so that we can work to improve public policy in the future.

For my part, I hope that these experts will answer a number of questions that I have about mutual fund fees. I would like to determine whether investors have obtained the benefits of economies of scale as the size and scope of the mutual industry has grown. I also want to learn more about the calculation of 12(b)(1) fees, the use of soft dollar arrangements, and the effects of portfolio transaction expenses.

In closing, Mr. Chairman, I look forward to hearing from our expert witnesses on these important issues. Mutual funds have successfully worked to help middle-income American families to save for an early retirement, higher education and a new home. We need to ensure that this success continues. I therefore look forward to working with you to examine these and other matters related to the mutual fund industry in the weeks and months ahead.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 68 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Chairman Oxley?

Mr. OXLEY. Thank you, Chairman Baker, for holding this important and timely hearing. This morning, we will discuss the state of the mutual fund business. Our inquiry is simple: Are investors getting a fair shake? At last count, there were 95 million mutual fund investors in the United States. For most Americans, mutual funds are the primary vehicle for accessing the capital markets and building wealth. The rapid growth in fund ownership over the past 20 years is unquestionably a positive development. Mutual funds provide the opportunity to invest small sums of money in return for a diversified investment in stocks, bonds, and other securities. Selecting a suitable fund can be a challenge for many investors. Some funds buy large capitalization stocks; others buy small or mid-caps. Some buy foreign companies or corporate or municipal bonds. Still other funds invest entirely in one sector of the economy. There are multiples classes of shares, different investment styles and so on. Add to this the fact that there are now almost 5,000 stock mutual funds.

All these funds are competing for investor dollars. While there is clearly competition in the fund industry, some question whether it is working the way it does in other industries. That is to say, are costs going down for investors? Recent data indicate that the answer is no. Fees and expenses in fact are going up, and this despite the efficiencies created by these enormous economies of scale. While investors have become sensitive to certain fees like sales loads, other fees are either hidden or opaque, escaping the attention of even savvy fund investors. This precludes them from comparison shopping—a strong market influence that would encourage fee-based competition and would likely bring down costs.

What are investors getting in return for these increasing costs? The evidence is troubling. Noted financial commentator Jim Glassman has said, what is truly remarkable is that hundreds of funds do worse than the rules of chance would seem to allow. He adds

that the low-cost Vanguard 500 index fund has beaten 76 percent of its managed fund peers over the past 10 years, according to Morningstar. Even worse, the NASD and the SEC have recently discovered widespread evidence that fund investors are not even receiving the discounts on sales loads that funds promised in their prospectuses. While preliminary reports indicate this failure to provide break-point discounts does not appear to be the result of fraudulent behavior, one commentator is reported as attributing the problem to laziness or sloppiness. That is simply unacceptable. I am pleased that the regulators are acting quickly, and I urge them and fund directors to take steps immediately to repair this breakdown and to make investors whole.

Along with rising fees that are often hidden or not easily understood, and chronic under-performance, this committee intends to examine the role of mutual funds in corporate governance. Last year, Congress passed the Sarbanes-Oxley Act in an effort to help rebuild investor confidence in public companies. New and mostly sensible regulations have been enacted for accountants, corporate executives and directors, investment bankers, research analysts, and attorneys. Until very recently, though, mutual funds have not been the focus of regulators and lawmakers, despite the fact that funds own about 20 percent of U.S. equities. The voting power represented by these securities carriers carries great potential to influence U.S. corporate governance. Whether mutual funds have used their powerful position to do so is an important question that merits attention.

Another important issue to this committee concerns the role of independent fund directors. Are they looking out for the best interests of shareholders in the fund, as is their fiduciary duty? At least one prominent investor emphatically says no. In his recent letter to Berkshire Hathaway shareholders, Warren Buffett said that fund directors had an absolutely pathetic record, particularly with regard to removing under-performing portfolio managers and lowering fees charged to investors. Some have asked, where were directors during the frenzied creation of a multitude of tech funds during the bubble of the 1990s that left so many investors holding the bag? An article in yesterdays Wall Street Journal observed that during the tech bubble, stewardship often gave way to salesmanship. Borrowing a phrase from one of our distinguished witnesses here today, Vanguard founder, Jack Bogle.

In recent months, the SEC has acted on a number of important mutual fund initiatives, often in the face of fierce industry opposition, I might add. Last December, the commission issued a proposed rule that would enhance portfolio disclosure and help clarify fund fees. The commission also recently required funds to disclose both their proxy voting policies and procedures and their actual proxy votes. These are good steps, but more needs to be done. I have the utmost confidence that we can count on Chairman Donaldson to continue Harvey Pitt's fine work on behalf of fund investors.

Mr. Chairman, I look forward to hearing the testimony of this distinguished panel, and I yield back the balance of my time.

Chairman BAKER. Thank you, Mr. Chairman, for your statement and your participation today.

[The prepared statement of Hon. Michael G. Oxley can be found on page 60 in the appendix.]

Mr. Scott?

Mr. SCOTT. Thank you very much, Chairman Baker. I want to thank you and the ranking member, Mr. Kanjorski, for holding this hearing today regarding the mutual funds industry. I also want to thank this distinguished panel of witnesses today for their testimony.

Given that more than half of all households in the United States now hold shares in mutual funds, any discussion today will have an enormous impact on millions of investors and billions of dollars. I firmly believe that the individual investor is empowered when given the tools to compare varying investment funds. Hopefully, this hearing will help us understand whether mutual funds investors are receiving fair value in return for the fees that they pay.

There are some serious issues and some troubling questions that the American people certainly want answers to. For example, how can mutual funds empower individual investors to make the best decision about their money today? Some funds are able to get away with overly high fees because investors do not understand how fees can reduce their returns. We need to find answers and make recommendations to clearly explain the potential cost of fees to investors up front.

Another troubling issue is sloppy recordkeeping at brokerage firms. What cost is that for mutual fund customers? There is a cost that is estimated at more than $600,000 in overcharges in one year alone. How can we get the mutual fund industry to ensure that they have the capacity to charge customers the right amount? These are questions I think that the American people certainly want answers to, and I would hope with our deliberations today that we can get some of those answers.

Again, I look forward to this very important discussion. Mr. Chairman, I yield back the balance of my time.

Chairman BAKER. Thank you, Mr. Scott.

Mrs. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

For many years, the public looked at the stock market as a sophisticated, obscure type of crap shoot. When mutual funds came into existence, the mutuals gave some investors the sense that there was stability somehow, and that in unity they would make out better. And they invested, and that was a good thing. Those were the vehicles that brought a lot of investors into the market. But recently, the public has been painting the mutual funds with the same kind of distrust that they are painting corporations and the stock market. I think that they are looking at things like hyperactive turnover. They are looking at sales techniques that are producing increases in fees.

Personally, I think that if we can get some transparency into some of these things, it will help investors make intelligent decisions and it will bring people back into the market. So I applaud you, Mr. Chairman, for having this hearing. I look forward to the witnesses' testimony today.

Chairman BAKER. Thank you, Mrs. Kelly.

Mr. Castle, do you have a statement? Ms. Biggert? Does any other Member have an opening statement? Ms. Harris?

Ms. HARRIS. Thank you, Mr. Chairman.

I wish to express my appreciation for this panel today and for the panel's testimony that is going to contribute greatly, I am certain, to helping us understand and secure investor confidence in the mutual fund industry.

Mutual funds have become a vital tool that millions of Americans rely upon to ensure the safety of their investments in U.S. capital markets. In fact, nearly half of all U.S. households hold a stake in some type of mutual funds. Reflecting on that dramatic shift in recent decades towards investment alternatives, mutual fund industry assets raised dramatically from $56 billion in 1978 to $6.4 trillion in 2002.

So as our nation confronts an array of daunting challenges to restore and safeguard the economic security of every American, that has to stay at the top of our priorities. We cannot achieve this goal without examining the basic practices of the mutual fund industry and the affect upon individual investors. So in particular, we must verify the legitimacy of the various charges that the industry levies, guaranteeing their relation to the substantial overhead costs that mutual funds encounter. Moreover, we must determine what action, if any, is necessary to guarantee an adequate level of disclosure and transparency so investors can make informed choices.

I look forward to your testimony this morning. Thank you.

Chairman BAKER. Thank you, Ms. Harris.

I have been informed that we might expect a series of votes about 11 o'clock. Certainly, any other member would be recognized for a statement if you choose to make it, but let me request you to do it briefly so we can give our panelists an opportunity before the committee's work is interrupted.

Mr. Ney?

Mr. NEY. I am going to submit for the record.

Chairman BAKER. Thank you, Mr. Ney.

[The prepared statement of Hon. Robert W. Ney can be found on page 70 in the appendix.]

All other Members' statements will be submitted for the record.

Without any other requests, I would move now to our witnesses this morning, and call first Mr. John C. Bogle, Founder of the Vanguard Group. Welcome, Mr. Bogle.

STATEMENT OF JOHN C. BOGLE, FOUNDER, THE VANGUARD GROUP

Mr. BOGLE. Thank you very much, Chairman Baker, and good morning. Thank you, Chairman Oxley. Thank you, Ranking Member Kanjorski and thank you Members of the committee for coming out.

I hope that my long experience in the mutual fund industry will be of some help to you in considering the issues that lie before you today.

Vanguard operates under a mutual structure in which our management company is owned by the shareholders of our mutual funds and operates on an at-cost basis. This is a unique form of shareholder-oriented organization and has enabled us to emerge as

the lowest cost provider of services in our field. As you see in the chart, the expenses of the average Vanguard fund today come to just 26 hundredths of 1 percent of assets, a reduction of 65 percent since we began in 1974, while the expense ratio of the average mutual fund was 1.36 percent last year, up almost 50 percent in that period.

Does this difference matter? Our cost advantage of 1.10 percentage points applied to our fund assets, presently at $550 billion, now results in annual savings for our fund shareholders of $6 billion. Lower costs mean higher returns, for what investors must earn and do earn is whatever returns the financial markets are generous enough to provide, minus the cost of financial intermediation. It is not very complicated. The returns therefore earned by mutual funds as a group inevitably equal the market returns, less the costs funds incur, most obviously in money market funds.

Over the past five years, the money market funds with the lowest costs earned a gross return of 4.8 percent, costs of 0.37 percent, net yield a little over 4.4 percent. The highest cost funds earned 4.7 percent—not very different from the lowest cost group—deducted cost of more than 1.7 percentage points and provided a net yield of just 2.9 percent. Result? Just by owning the lowest cost group, fund investors could have increased their income by 51 percent, without any increase in risk whatsoever.

While less obvious, the same relationship prevails in equity mutual funds. Over the 10 years ended June 30, the risk-adjusted annual return for the lowest cost quartile of equity funds was 13.8 percent—three full percentage points higher than the highest-cost quartile. This relationship, as you see in the chart, appears to be universal, prevailing in each one of the nine Morningstar so-called ″style″ boxes—large-cap growth funds, small-cap value funds and so on. Great consistency of advantage around the 3 percentage point level by each of the nine style boxes.

In the long run, Mr. Chairman and members of the committee, costs make the difference between investment failure and investment success. Over the past two decades, and even after the recent decline, the stock market provided an annual return of 13.1 percent compared to a 10.0 percent return reported by the average equity fund. For the full period, therefore, $10,000 invested in the market itself grew by $105,000, while the same $10,000 invested in the average equity fund grew by $57,000—just half as much. That 3.1 percentage point difference is largely a reflection of the costs that investors incur. So yes, costs matter.

In the interest of time, I am going to skip chart five and go to looking at costs in dollars rather than expense ratio terms. That is a very important thing the committee ought to consider. In 2000, for example, the actual cost of providing portfolio management services for all of Vanguard's money market funds, as shown in chart number six, came to $15 million. That is our known cost. Yet in another firm's money market funds with the same $65 billion in assets, the funds paid the investment manager for investment management services only, $257 million. It is high time we looked into these issues and had a government-sponsored economic study that follows the money in the mutual fund industry.

That such a fee was approved by that fund's directors suggests a monumental shortfall in the shareholder protections sought by the Investment Company Act of 1940, which clearly states that funds should be operated and managed in the interests of their shareholders, rather than the interest of their investment advisers, and subjected to adequate independent scrutiny.

What is the case? Well, fund directors have two important responsibilities: obtaining the best possible manager and negotiating for the lowest possible fee. Yet their record has been absolutely pathetic. They follow a zombie-like process that makes a mockery of stewardship. Able but greedy managers have overreached and tried to dip too deeply into the shareholders' pockets and the directors have failed to slap their hands. Independent directors over more than six decades have failed miserably. I would not have the temerity, Mr. Chairman, to use those words, so they are all a direct quotation from Warren Buffett in his recent annual report.

One reason for the failure of directors is that the head of the fund's management company is typically the chairman of the fund's board as well. As Mr. Buffett has observed, negotiating with oneself seldom produces a barroom brawl. So we need to require that the fund chairman be an independent director. Would it matter? Let me give you one example. That is the way we operate at Vanguard, and since we began in 1974, the fee rates that our Wellington Fund has negotiated at arms length with its external investment adviser, Wellington Management, have been reduced six times. Last year's management fee in this $22 billion fund was 0.04 percent—four one-hundredths of one percent of assets or $8.5 million. Without those reductions over the years, that fee would have otherwise been $92.2 million. Active fee negotiations therefore saved the fund's shareholders $85 million for that one fund, and enabled the fund to catapult its returns over 90 percent of its balanced fund peers. Yes, again, costs matter.

We need to awaken investors to the critical importance of lower costs. We need information that encompasses all of the costs of fund ownership, presented forthrightly in fund prospectuses and annual reports, and we need to show each shareholder the dollar costs that he or she is incurring in their statements.

At the same time, we have got to empower independent directors to live up to the standards of the law of the land and protect the interest of the fund shareholders that they are honor-bound to represent.

Thank you, Mr. Chairman.

[The prepared statement of John C. Bogle can be found on page 72 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Bogle, for your appearance and your testimony.

I failed to say it at the outset, but all witnesses' formal statements will be incorporated into the official record, and to the extent possible, if you can keep your prepared remarks to five minutes, it would be helpful in getting to our question and answer period. We appreciate your courtesy in being here.

Our next witness is Mr. Wayne H. Wagner, Chairman of the Plexus Group, Inc. Welcome, Mr. Wagner.

STATEMENT OF WAYNE H. WAGNER, CHAIRMAN, PLEXUS GROUP, INC.

Mr. WAGNER. Thank you, Mr. Chairman and Committee Members.

I want to talk about the transaction costs associated with the management of mutual funds here. Several points—Are these costs significant? How should they be evaluated? Should they be disclosed to fund participants? And are the markets—a little farther afield—are the markets optimally organized to keep these costs low?

Bottom line, as Jack has said, costs hurt performance here. They immediately reduce investor assets. They do not stay in the portfolio to continue to perform. They impede the ability to capture the benefit of research. They reduce liquidity and interfere with capital formation. Congress and the SEC have repeatedly attacked these issues here to make these better in general here.

To me, it is impossible to argue that uninformed investors are better investors. More information is better, as Congressman Scott said. It is empowering for investors to know the correct information here. As long as that information is not misleading, of course, and when we are talking about transaction costs, in particular, that can be a little bit problematic here.

How important are these transaction costs? Very. I believe they account for the difference as to why active managers have such difficulty in maintaining performance to Mr. Bogle's fund here. We have measured those on a regular basis for 17 years. We measure them for 2002 as 1.5 percent, one-way transaction costs. Multiply that by a buy and sell, multiply that by 110 percent turnover, and you can see we are talking about a great deal of money.

I personally believe that these are the largest costs which are borne by investors over time. Now, that may sound like a very large number to you, and it is surprisingly large. To the retail investor, the market looks like a vending machine. You put your coins in, you push the button, and out comes your selection. That is not true for institutional trading. It is not true for mutual funds trading.

Could I have my first slide please? Thank you. We took a look at our universal, which represents about 25 percent of exchange volume. We divided it into five groups, where each of the groups was sorted on the size of the trade. So the first line on there is the smallest trades. There are three groups omitted, and the last line is the largest trades that were put out by mutual funds in their investing process. Each of these is of equal importance to investors because each of them represents the same amount of dollars being invested.

The top group is the smallest trades, and they are really not that different from the retail market here. They are the vast bulk of every trade, representing 11 out of every 12, averaging 2000 shares, $53,000 in principal and less than half of 1 percent of the daily volume. They cost about a quarter of 1 percent, but they are only one-fifth of the trading.

Concentrate for a moment on the largest trades here. This is only one out of every 400 trades, yet it makes the same impact on the performance of the funds here. They average two million shares

apiece, $77 million in principal, and over half a day's volume. They cost in excess of 1 percent here.

Clearly, the vending machine analogy does not work for these large trades. These are not trading events. They are a trading process that links the portfolio manager and his decisions to the trader, to the broker, and to the exchange. They are really orchestrated into the market, and because of their size they may take many days to complete. This stretched-out process leads to delay in opportunity costs.

If I may have the other slide please? We have measured these on a regular basis. This iceberg shows that not only the costs are very obvious, the commission on the top of the iceberg is very obvious and we all see what that is. The impact cost is the cost of hitting in the marketplace. The delay in opportunity costs down below stem from this orchestration process where it is difficult to get the size through the marketplace.

To our mind, this total cost is what investors need to know, because you cannot ignore that 75 to 80 percent of the cost, which is coming out of performance, and yet is really not available in something simple like the commissions here.

Saying that, revealing the commission is sufficient to reflect the cost, I do think is not enough. It is only 10 percent of the cost. It sends the wrong message that costs are trivial, and that costs are comprised of broker payments, rather than a measure of overall management effectiveness here.

Investors need to know basically which firms are efficient; which ones are doing a good job of using their resources here. This was the conclusion of the AIMR trade management guidelines. I have a thousand copies coming. I will send copies for the committee here. It defines best execution as the trading process firms apply to maximize the value of client portfolios. Rather than focus on costs in isolation, the definition focuses on a cost-to-benefit ratio of trading. May I suggest that this is a useful definition for the committee to keep in mind.

With that in mind, I have overrun my time and I will cede the mike.

[The prepared statement of Wayne H. Wagner can be found on page 202 in the appendix.]

Chairman BAKER. Thank you, Mr. Wagner. We appreciate your participation today.

Our next witness is Mr. John Montgomery, Founder and President of Bridgeway Funds. Welcome, Mr. Montgomery.

STATEMENT OF JOHN MONTGOMERY, FOUNDER AND PRESIDENT, BRIDGEWAY FUNDS

Mr. MONTGOMERY. Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, from a recent news article, I quote, "Mutual funds exist in a culture that thrives on hype and withholds important information in a cutthroat business that regularly misleads investors."

While I hardly think that this reflects the environment at Bridgeway Funds, and while I believe that the mutual fund industry is on the cleaner end of the spectrum in the investment community, major criticism is well-deserved. As an industry, we must do

better if we are to serve the long-term needs of this country's smallest investors.

After the most extended bear market since before World War II, investors are starting to look under the hood of their mutual funds, and they do not like some of what they see, especially some of what they do not see and cannot find. Access to key information is crucial to fair competition on which our free enterprise system is based.

To be sure, progress has been made with the plain English prospectus, simple and standardized fee tables, better standards of performance evaluation, disclosure of the effect of taxes on returns, and much more detailed information available through the Internet. Soon, we will have disclosure of proxy voting and more frequent disclosure of mutual fund holdings.

My written testimony outlines better disclosure in 13 areas, but I would like to comment now on just four of these: soft-dollar commissions, standardized industry operating information, manager salaries, and board decisions on management contract approvals.

First, disclosure of soft-dollar commissions. Apart from the affiliated brokerage and directed brokerage, the practice of soft-dollar commissions is one of the worst examples of undisclosed conflicts of interest in the mutual fund industry. The term ″soft-dollar commissions″ refers to an agreement between a broker and investment adviser by which the broker supplies a variety of products or services from research to software, hardware, data or other services, in return for a certain volume of business to the broker. The problem with this legal arrangement is that the adviser receives the immediate benefit, while the shareholder pays. There is inadequate incentive for the adviser to keep soft-dollar commissions low.

A confirmation of this situation is the response of vendors when we tell them that Bridgeway will be paying with our own hard dollars. One salesman, a software salesman, looked at me incredulously and asked, why on earth would you pay with your own money when you could pay for it in soft dollars? The problem with soft dollars, then, is that they are really hard dollars. They just belong to somebody else. As a fellow Texan said, if you see a snake, just kill it; do not appoint a committee on snakes.

[Laughter.]

This would be one snake we should not disclose. We should just kill.

Second, standardized industry operating information. When I worked in the urban mass transit industry, there was uniform data on system expenses, passengers and other very helpful operating data, with enough detail to establish some best industry practices. Twenty years later, there is no similar, easily accessible database for the mutual fund industry. Some information is in the SEC-EDGAR system, but it is not down-loadable, expense categories are not standardized, and it is terribly time-intensive to access information across fund families. While this level of detail is not generally sought by individual investors, use and analysis by academia, authors such as Mr. Gensler, media, consultants and fund boards of directors could greatly spur industry competition and effi-

ciency. The federal government is in the best position to take the lead on this disclosure.

Third, disclosure of manager salaries. When we invest in individual companies, we have the right to know the compensation of the company leaders. When we invest in mutual funds, we are in the dark. To the best of my knowledge, Bridgeway is the only mutual fund company that voluntarily discloses portfolio manager pay in its statement of additional information. Compensation level, and especially structure, do affect portfolio manager incentives and fund decisions. Our industry's refusal to disclose it contributes to the aura of withholding important information and misleading shareholders, that some shareholders perceive in the current environment. This disclosure would be easy and costless.

Finally, number four—board disclosure. Over the years, I have examined the record of some of the consistently worst-performing mutual funds and wondered, "where are their boards of directors?" Unlike the boards of privately held firms, nonprofit organizations and even publicly traded companies with multiple constituencies, a mutual fund board exists only to protect shareholder interests. Studying the worst-performing funds over the last five years, for example, I identified some funds that were poor performers for some years before. Their average costs exceeded the entire average historical return on the stock market. How can these funds hope to make any return for their shareholders? Why doesn't somebody put them out of their misery?

Each year, the independent members of the fund's board must actively consider a number of factors before approving a management contract. Why not disclose to shareholders the basis for their decision? Here is an even more radical, but serious idea: Require fund boards to consider alternative bids for service when both fund under-performance versus a market benchmark, and fund expenses, exceed extreme levels.

In conclusion, if mutual funds are going to address increasing public distrust in the environment of a bear market and if we are going to continue to play a major role in giving access to the wealth of this nation through the fund structure, we are going to have to earn it. We need to pursue the interests of shareholders relentlessly, and we need to ensure that adequate information is available for shareholders and their advisers to make informed decisions.

Finally, I want to thank the committee for the opportunity to testify this morning.

[The prepared statement of John Montgomery can be found on page 193 in the appendix.]

Chairman BAKER. Thank you, Mr. Montgomery.

Our next witness is Mr. Harold S. Bradley, Senior Vice President, American Century Investments. Welcome, sir.

STATEMENT OF HAROLD S. BRADLEY, SENIOR VICE PRESIDENT, AMERICAN CENTURY INVESTMENTS

Mr. BRADLEY. Thank you. Chairman Oxley, Chairman Baker, Ranking Member Kanjorski, and all the Members of the Subcommittee, I appreciate the opportunity to be here today and talk. Some of my remarks, limited to soft-dollars, mostly, and the use of

commission dollars by investors, have been taken by my colleague to the right of me. So what I would like to do is walk through how it looks, but to say first that I am proud to be associated with the fund industry and its strong record as an effectively regulated and affordable place for investors. I have been a trader and a portfolio manager and virtually all of my investments are in a mutual fund, none of which are index funds. The three-year bear market has been hard on all of us. Me, too.

I represent American Century Investment Management. Along with our industry, we are now looking in the mirror to see what things we might do better. We have a long record of working with the staff at the SEC of advocating more transparency regarding market structure and trading practices, specifically in the area of soft-dollar disclosures. We think Congress should work to understand how its law, section 28(e) of the 1975 amendments to the Securities Exchange Act actually encourages investment managers, through expansive interpretation by the SEC, to use commissions paid by investors as a source of unreported income to pay unreported expenses of the managers. I would like to try and explain.

This is a picture of the typical five-cent-a-share commission paid by the typical investor. That rate is negotiated by the investment manager. The blue bar represents our best guess, based on our experience, of what commissions pay for in execution-only services, based on fees charged by electronic venues, such as Archipelago or Instinct. The red bar on top represents what is called paying up, or the value of soft dollars in the commission's pot. It includes things like broker research, fund expenses, access to IPOs, and in some cases normal and customary business expenses, as in the expansive definition now allowed by the SEC.

I am guessing when I estimate the size of these practices. Some have called these largely undocumented practices the frequent flyer program of the money management industry. Both the number of miles, which equates to trading volume, and the premium prices paid create cash-back rebates, or the free travel equivalent for the investment manager. We need to better understand the tangible benefit for the investors. I am told there is far less documentation of soft dollar use and utility since the 1997 SEC soft dollar sweep in this area. Furthermore, I am told by our accountants that our auditors have told us that if soft dollar deals were documented, it would likely trigger accounting treatment on the investment adviser's books. We do need some notion of fair value assessment here.

I will restrict my remarks specifically to third-party payment of soft dollars and to the use of soft dollars to obtain IPOs. Chart two, is a picture that shows the long-term average commission rate paid by investment managers on behalf of investors. It goes back 12 years. You can see on the top line, the average commission rate paid by managers per share traded that there has been little movement in a decade. It looks a little bit like a flat line on a cardiac patient. It does not move because of the embedded economics—it is not in the investment managers economic interest to negotiate lower rates. In other industry surveys, the average commission rate remains above five cents per share traded. Meanwhile travel—trading volume—is the chart that is increasing six-fold during the past decade. The current situation is not unlike fixed commissions that

existed prior to 1975. The value of the unreported and mostly uncategorized or un-catalogued ″research″ services obtained by money managers, provides strong incentive to keep per-share charges high.

Chart three. This is a busy chart that requires study. It takes a simplistic example and shows the strong positive effect of soft dollars on an investment manager's profits. They are a powerful form of economic incentive. Furthermore, since fund boards can only benchmark a fund's negotiated rates against industry averages, there is little competition. If you are paying a lot of soft dollars, you just do not want to be too far under the industry average or too far above.

I think that there is a list of about 1,200 vendors in your attachment, called third-party vendors, where commissions can be used to pay for services through the commissions stream—1,200. If you look at them, they include telephone companies. It includes hardware vendors like Dell Computer, quote vendors, the New York Stock Exchange. I would think that most investors believe the management fee they say should be sufficient to pay for stock quotes—a basic requirement to be in the business. We think there is a problem, and it is a transparency problem. We think specifically that commissions should be negotiated and disclosed as a percent of principal, as it is done in markets across the world. This will create more competition and transparency, and meaningful measurement of trading costs.

Fund managers should identify and disclose the execution only rate for each broker they use, to make explicit the perceived value of services provided. The little blue bar on that first slide, that is the real execution rate. We must make explicit money manager use of commissions to pay third parties for goods and services available to the public for cash, like my Wall Street Journal.

Now, of course, these things that are paid for cash like the Wall Street Journal, if in fact these were explicit contractual commitments on paper as agreements for soft dollars, they would show up as expense items already. They are just not ″real″ today because they are not recorded.

We also think Congress should look at considering a new law or rulemaking that removes the structural incentives based on commission flows that have contributed, we believe, to the IPO pricing and allocation scandals. We also believe that underwriters should publish the size and identity of the 50 largest IPO allocations so that our investors can be assured when they are told that by paying more, we get access to those IPO allocations, that we really do. There is no transparency there. We need transparency and we need accountability in these poorly understood areas.

I really do believe that if we start to make progress a little bit at a time, we will more quickly restore investor confidence across all of our markets.

Thank you very much.

[The prepared statement of Harold S. Bradley can be found on page 134 in the appendix.]

Chairman BAKER. Thank you, Mr. Bradley.

Our next participant is Mr. Paul Haaga, Jr., Executive Vice President, Capital Research and Management Company. Welcome, Mr. Haaga.

STATEMENT OF PAUL HAAGA, JR., EXECUTIVE VICE PRESIDENT, CAPITAL RESEARCH AND MANAGEMENT COMPANY

Mr. HAAGA. Thank you, Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, Members of the Subcommittee, I am pleased to be here.

I am Chairman of the Investment Company Institute's Board of Governors, and I am a member of the executive committee, and I am here testifying on behalf of the institute. My own firm is the investment adviser to the American Fund, which manages $350 billion on behalf of about 12 million mutual fund investors. We are the third largest mutual fund family in the United States and the largest that sells exclusively through financial intermediaries.

I appreciate the opportunity to continue to work with Chairman Oxley, who first chaired a hearing on the fund industry in 1998, as well as Chairman Baker and their staffs, as the committee examines additional ways to bolster investor confidence in our financial markets. With half of all Americans owning mutual funds, fund companies can play a key role in helping millions of middle-American investors to gain confidence in long-term investing. Following today's hearing, the ICI and the fund industry look forward to addressing any questions or concerns members of the committee may have as we continue to reinforce our commitment to meeting the needs of the 95 million fund investors.

You have asked how the fund industry is serving individual Americans who invest in our funds. We believe the answer is very clear. At a particularly difficult and challenging time in the history of our financial markets, we are serving 95 million investors very well. We provide useful information, multiple investment options, and valuable services to our shareholders, and at much lower cost than ever before. We believe the cost of mutual funds and the services they provide to investors are lower than any other alternative financial services used by investors.

I was at a press briefing this morning, and I was asked the question, do you think that the hearings today will destroy confidence in mutual funds? My answer would be a resounding no. I think they will increase confidence in mutual funds. We welcome them. We welcome regulation and we think investor confidence will increase as they know that people are watching. So thank you again for having this hearing.

We view strict federal regulation as an asset, not a liability. Under the SEC's watchful eye and the effective oversight of our independent directors, mutual funds have remained free of major scandal for more than 60 years. We do not think that it is an accident that historically mutual funds have enjoyed unusually high levels of trust and support from fund investors.

The hearing occurs as we approach the 37th month of one of the worst bear markets in modern history. Our memory of costly accounting scandals and corporate abuses is also still vivid. Most individual investors holding stocks and stock mutual funds have lost money over the last few years. Some have also lost confidence.

While stock mutual funds are not the cause of the scandals or abuses, our responsibility to serve and protect the millions of individual investors makes it imperative that we work to devise and support solutions.

For this reason, we strongly supported the Sarbanes-Oxley Act and many other reforms to our financial reporting and oversight system, and in fact many of the corporate governance reforms that were in the Sarbanes-Oxley Act and the follow-up regulations came directly from mutual fund's longstanding practices.

Let me turn to the issue of mutual fund fees. It is frequently reported that the average stock mutual fund charges fees at an annual rate of about 1.6 percent of assets. By itself, that statistic is essentially true. But by itself, that statistic is also very misleading. Although the average stock mutual fund charges 1.6 percent in fees, an overwhelming majority of stock mutual fund investors pay far less. At the end of 2001, the average investors stock mutual fund had annual fees of .99 percent, just under 1 percent. As illustrated in the chart we brought with us, 79 percent of all mutual fund accounts are in lower-cost stock funds. These lower costs hold 87 percent of all stock fund assets.

At first, it may not seem apparent that the average investor could pay less than the average fund charges. But consider a business that has two cars for sale—one for $20,000 and the other for $40,000. The average selling price of the cars is obviously $30,000. But if 80 people buy the less expensive car, and only 20 choose the more expensive car, the typical buyer clearly does not pay the average price charged by the seller. The typical buyer pays $24,000. This is 20 percent less than the $30,000 average price charged by the seller.

Now, what do cars cost, I ask? Industry critics would say $30,000, and they would point the finger at the cars that cost $40,000. We would say they cost $24,000, and so would the GAO and the SEC in their studies, which are asset-weighted, because that is what the majority or the average of what shareholders are paying. If you walk down the street and find somebody who owns a car, the likelihood is that they will tell you that their car cost $20,000, because that is what they paid.

The committee also expressed interest in the trend in mutual fund fees and expenses. Since 1998, major fee studies have been completed by the ICI, the General Accounting Office and the Securities Exchange Commission. My written testimony points out that these studies share many common attributes and conclusions. Perhaps the single most important conclusion is the finding that as mutual funds grow, their fees generally decline, with the sharpest reductions apparent at the funds that grew the most. The ICI study found that 74 percent of the 497 funds that they reviewed lowered their fees as they grew. The average reduction amounted to 28 percent. The GAO study of 46 large funds found that 85 percent reduced their fee levels and the average reduction was 20 percent. The SEC study found that 76 of the 100 funds they looked at had contracts that automatically reduced fee levels. They also found that stock funds that had grown to exceed $1 billion in assets had fee levels substantially lower than smaller funds. In fact,

the SEC found specifically that as fund assets increased, the operating expense ratio declined.

We are pleased that all three studies on this subject—the ICI, the GAO and the SEC—recognized that cost savings from mutual fund asset growth can only be realized by individual funds, not by industries.

It is equally important to understand that mutual fund fees schedules cannot be increased without three separate actions being taken. First, the fund's board must approve the increase. Second, the board's independent directors must separately approve the increase. And third, the fund's shareholders must vote to approve it.

This positive news hardly means that our job is complete. This is especially true in the wake of the corporate scandals and abuses that have been revealed over the last 18 months. The challenge of educating investors about diversification, asset allocation, various types of risk and the impact of fees and taxes, the need for realistic expectations and a long-term focus is our constant responsibility and an essential element in reinforcing confidence in our markets.

Thank you very much for helping us to ensure that we will do that.

[The prepared statement of Paul Haaga, Jr., can be found on page 168 in the appendix.]

Chairman BAKER. Thank you, Mr. Haaga.

Our next witness is Mr. Gary Gensler, no stranger to the committee as former Under Secretary for Domestic Finance, Department of the Treasury, and the author of The Great Mutual Fund Trap. Welcome.

STATEMENT OF GARY GENSLER, CO-AUTHOR, "THE GREAT MUTUAL FUND TRAP," FORMER UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. GENSLER. Thank you, Chairman Baker, Chairman Oxley, Ranking Member Kanjorski. Thank you for having me here today. It is a great honor to be back with you. It looks like there are more seats, though, here in the front since I was last here.

Needless to say, as the author of The Great Mutual Fund Trap, I applaud this committee's willingness to look at the mutual fund industry closely. There are great statistics that have been named, but in each of your congressional districts there are 125,000 households that own mutual funds. Middle income, generally married, median age 46—sounds like I might be a pollster, but I am not—but 125,000 households in each of your districts. It counts to middle-income Americans what this committee is talking about here today.

By any objective measure, however, mutual funds have been failing millions of those investors, or hundreds of thousands in each of your districts. That is understandable given $70 billion of annual costs—$70 billion—not small amounts of money. In any other industry, we would take a close look at that, and I think Congress would, and I am glad you are today.

Investors can expect costs totaling about 3 percent of their money each year for investing in mutual funds. I actually agree with the testimony to my right. It is about 1 percent a year on average for the management fee. Where is the other 2 percent, you might ask?

Well, it also comes in what is called sales loads. About half of mutual funds are sold today with a commission up front or at the back end, which is 4 percent. Given our American nature of turning things over so often, which is once every two and a half or three years, that adds about 1 percent to 1.5 percent more cost.

Then there is the undisclosed cost, and those are dramatic. Portfolio trading costs add about .05 percent of your money a year, because these portfolios turn over on average pretty quickly. I would use the median, and they on a median turn over once every 15 months. That is pretty fast trading, and that fast trading runs up short-term capital gains taxes—good for the budget deficit, good for Treasury where I once served, but not good for Americans. Better to go back to a buy and hold strategy. Short-term capital gains taxes when markets are at least modestly going up add 1 to 2 percent of your money every year.

Take out 3 percent of your money each year, what happens after 40 years of savings? You give up 42 percent of your savings. We wonder about savings in America, and the retirement of the baby boom generation, and the mutual fund industry has done a tremendous job, but can do better if costs are lower.

I would also note that many Americans complain about their $1.50 ATM charges, because they see it. It is direct. Mutual fund charges, it is a wonderful thing—we do not see it. It is just taken out and we do not have to write a check like we do to our plumber or our mortgages.

What happens to the average? As you heard Mr. Bogle's averages, I will not repeat them, but over the last 10 years, Morningstar reports the average diversified fund is behind by 2.2 percent the S&P. But that does not count all the funds that went out of business. About 5 percent of funds go out of business every year. Add them, you are about 3.5 percent behind, similar to the cost structure, as we have just noted.

Many Americans think, well, if I just buy yesterday's hot fund, I will be able to do well in the future. The mutual fund industry has figured out to advertise yesterday's hot fund in all those January and February Money magazines, and Smart Money magazine advertisements of the hot fund of yesterday. But yesterday's hot fund usually does not do well in the future—just a little bit better than random chads.

You have heard a lot about fund directors. Whose fund is it anyway? It is the investors' fund, and the Investment Company Act of 1940 set up a structure whereby investors actually have a board of directors control that fund, and can fire the fund manager—at least in theory, that is. In practice, when does it ever happen? In fact, fund governance leads to the problem you have heard about today—soft dollars. While I too am recommending that you ban soft dollars, I am not suggesting that you once again take up McCain-Feingold. This is not that type of soft dollars.

These soft dollars are saying that fund companies, which are distinct from funds, make profits, because the fund companies ask Wall Street to pick up their expenses and then charge them through higher commissions, as was earlier shown, that nickel a share, the higher commissions, directly to the fund companies. In fact, many fund companies who get the benefit and have higher

profits, direct commissions to Wall Street's biggest houses. I would say ban soft dollars. I think there is no room for it, no excuses for it.

The other recommendations that I outline in the testimony, I would say start with the belief that Americans really have a choice. I wrote a book for Americans to choose. If Americans wish to choose the high-cost funds, that is their choice. But I think transparency would add something. While I say six recommendations in the testimony, let me just highlight a few.

One is to disclose portfolio trading costs. A hard job to do, but important costs. Two, I think survivorship buys, as tough as it is—all those funds that go out of business—it would be helpful if fund companies put on their Web sites the ones that went out of business and report their averages including the failed funds. It would be sort of like asking about those reality TV shows and forgetting about all the ones that are kicked off the island. I think we need to know a little bit about those as well. Thirdly, I think disclosure with regard to all the revenue sharing arrangements, all the conflicts that are inherent in the market, would do us well. That is with brokers, as well as with corporations around 401(k) plans.

I too think that the SEC and Congress should consider taking a close look as to why funds do not go out and try to hire new fund managers. Seven thousand funds in America, and can we name one that in 2002 fired their fund company? Can we name one that went out to competitive bid? That is 7,000 companies. Would not we think that there would be five, ten, fifty of them that might have, if fund directors actually were fulfilling their fiduciary responsibilities?

Lastly, as you consider new 401(k) legislation, I know that many in Congress think that there is a need for investment advisers to be giving advice—that, too, raises new conflicts of interest. As you grapple with that, you might want to consider I would suggest adding that all 401(k)s and 403(b)s have at least an alternative which Congress has for federal workers—an index fund to add to the choice of investors so that if they get this new investment advice, at least they have one low-cost alternative in their portfolio.

I thank you for considering my thoughts.

[The prepared statement of Gary Gensler can be found on page 155 in the appendix.]

Chairman BAKER. Thank you for your participation, Mr. Gensler. We are glad to have you here.

Our next witness is James S. Riepe, Chairman, T. Rowe Price Associates.

Just by way of announcement, we do have a series of votes on the floor. It would be my intent after Mr. Riepe concludes his remarks that the committee would recess for about 15 minutes to go make the votes and come back.

Mr. Riepe?

STATEMENT OF JAMES S. RIEPE, CHAIRMAN, T. ROWE PRICE ASSOCIATES, INC.

Mr. RIEPE. Thank you, Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, and all the other Members of the Subcommittee.

T. Rowe Price is a Baltimore-based investment management firm. We manage over $140 billion of assets. About $90 billion of that is in mutual funds, and we have been at it for about 70 years. Personally, I have been in the fund management business for about 34 years, and I am happy to be here with you all today to talk about this important subject.

Before I start, I want to note that as you conduct your review of the fund industry, it is important to remember that stock funds, although they get all the headlines—particularly after three years of a severe bear market, represent less than one half of the mutual fund industry assets, about 41 percent specifically. The balance are in fixed income funds and money market funds. Even when we look at just the equity fund portion of the industry, less than one-fifth of those assets are in aggressive growth funds—again the ones that get the most headlines. So that means when we look at the mutual fund industry assets, only about 6 to 7 percent of the entire industry is in this aggressive end, which enjoyed the upward volatility of the late 1990s and now suffered the downward volatility of the last three years. I think just putting that in context, that this is much more than just a growth stock business. It also means that the vast majority of investors have benefited from mutual funds in a very substantial way, when one considers all the other kinds of funds in which they are invested.

Individual investors do not typically trust all their assets to just one fund or even one manager. The average T. Rowe Price investor, for example, owns at least three of our funds, and they also own funds offered by two or three other managers as well. So clearly, investors understand the idea that diversification is important, not only diversification among funds and within funds, but among managers as well.

That has come across in the defined-contribution side of the business. Again using our example, our typical 401(k) investor has seven different investment accounts and about 50 percent of the assets are in equities, and then some more in company stock, and then fixed income options. So as a result, the 401(k) investor has done relatively well in terms of his or her risk-adjusted performance during this recent down period, and did well during the later years of the bull market as well.

Our panel has covered a range of subjects today, and I just want to touch on a few of them. Several issues we are a bit uncertain about, and others we view with some certainty. With respect to disclosure, I do not know if mandating more disclosure is the answer. I think we need to work harder in determining what disclosure is illuminating to the investor and what disclosure is obfuscating. As an industry, we are committed to educating investors, and I think the evidence is very clear that we have done that, both collectively and as individual firms. We have done it quite frankly, because it is in our self-interest to have investors who understand their investment.

But disclosure for the sake of disclosure is not good. I would use the example of owners manuals. Studies show that people do not read owners manuals. One of their problems is that the first 10 pages tend to be filled with disclaimers and warnings, and then the book is too thick. If we do the same to mutual funds, then we are

going to turn away the average mutual fund investor. So we need good, useful, focused disclosure; we do not need simply more disclosure.

When we get into the world of trading cost evaluations, you can tell from listening to a couple of the comments here, it is incredibly complex, and very difficult to measure. There are multiple ways to measure transaction costs, but there is no consensus on which is best. And all the measurement models are at their base speculative. I think we can be comforted in the fund industry that however such costs are measured, we know that the fund investor's return is net of all costs. I think that is very, very important.

Some things we do know. The fundamental qualities of mutual funds—diversification, professional management, relatively low cost—have proven their merit during this bear market. Being able to gain access to a diversified portfolio is critically important for investors. When they invest individually in individual stocks, they do not have such diversification. Morningstar and all the critics have pointed out the value of fund investments from a diversification perspective.

Mutual funds also provide better and much more useful and more transparent disclosure than any other financial product we service. As Mr. Gensler suggested, the disclosure always could be better in mutual funds. But let's compare mutual funds to other financial services. If I buy a certificate of deposit at my bank, they tell me I am going to get 3 percent. They do not tell me that they are going to lend that money out at 8 percent, use 400 basis points to cover their expenses, and keep 100 basis points of profit. That is the reason, ironically, that you could not have hearings on the expenses of those products in the way you can have hearings on mutual funds. Because funds spell out all the expenses that investors incur, and they spell out the bottom line, which is the net return the investor receives after these expenses.

I think, too, there is an impression being left that mutual fund investors panic easily, that they are skittish, et cetera. One has to look under the aggregate redemption numbers, to find that most fund investors are long-term investors. There are certainly those investors who follow trends. There are investors who think they can out-guess the market. They are not the majority. They are not even in many cases a significant minority, but they trade often enough that they affect the overall redemption numbers. So I think it is misleading, frankly, to look at aggregate numbers and try and draw conclusion about 95 million investors. Mutual fund investors are intelligent when they make their investments, and they hold their investments longer than aggregate redemption ratios might indicate.

Unlike many other financial relationships, and in contrast to Mr. Bogle's suggestion, the interests of fund companies and mutual fund investors are, in my view, very well aligned. Investors and fund managers, they want good performance. We all want good performance. That is how we thrive. That is how as mangers we thrive and prosper. We want good service. We have to have good service to be competitive and we are an incredibly competitive industry. We also need to provide helpful guidance. Investors select us on the

basis of the kind of guidance and intelligent advice we can give them. And they want all of that at a reasonable cost.

As to the suggestion that almost no one beats ″the index,″ nearly 80 percent of T. Rowe Price equity funds beat the competitor Lipper Group and the S&P 500 over the last five years. Almost two-thirds have beaten the market index over the last 10 years. So the fact is, there are many funds out there that have been successful in beating the indices. There are many investors who would rather bet on health care or on financial services, or on technology, than buy an index fund that is going to provide them with the overall market performance.

Having said that, T. Rowe Price manages billions of dollars of index funds, along with our actively managed products. This is not about religion. This is a matter of choice. Selection depends on an investor's objectives and how he or she believes they can best achieve them. Index funds are out there for all those investors who want them.

Let me just say very quickly a word on governance. Sarbanes-Oxley adopted governance practices that have existed for mutual funds for many, many years. So we feel the corporate world is coming closer to where we are now, and not vice versa. Fund investors do not invest in boards of directors. They invest in a fund manager—a company they know, a company they have read about, a company they have talked to their friends about, a company they have read in Morningstar or Lipper or Money magazine. They do not expect directors whom they do not know, and who do not necessarily have an investment expertise, to decide to replace the manager they have picked. What they do expect those directors to do is to monitor the funds's results and make sure the managers act in a prudent way. If there are funds that they believe have not performed up to reasonable standard, they should urge the management to make appropriate changes. But the idea that independent directors should start replacing managers and putting out to bid contracts, when the investor has already made the decision to invest with that company, I think is neither appropriate nor expected.

In closing, when you ask about the effects that funds have had on investors, the answer is that the mutual fund as an investment vehicle for individual investors has been arguably the most successful financial service in the 20th century.

Chairman BAKER. Mr. Riepe, I hate to interrupt you, but we are down to two minutes left on this vote, and members are going to have to excuse themselves. We will pick up your train of thought when we get back in probably 15 or 20 minutes.

Mr. RIEPE. Great. Thank you.

[RECESS]

Chairman BAKER. If I can ask everyone to take seats, we will reconvene our hearing.

Before we took our recess, Mr. Riepe was concluding his remarks. Members will be returning momentarily. I expedited my trip. So Mr. Riepe, if you would, please?

Mr. RIEPE. I appreciate the opportunity, and I will just give you my closing remarks, Mr. Chairman.

When you ask about the effects funds have had on investors, the answer is that the mutual fund—as an investment vehicle for individual investors—has been arguably the most successful financial service of the 20th Century. It has succeeded because investors see value in it as an investment vehicle. Funds have provided tens of millions of investors with diversified and professionally managed access to stock, bond and money market securities invested around the globe in every way, shape and form that investors could want. Mutual funds have succeeded without incurring major scandals or frauds during their long history—a statement that not many industries could make, and certainly not any other financial services.

That success, in my view, is attributable to a number of factors, including the intensive regulatory scheme under which funds operate. But most important to their success is the transparency which our panel has talked about and which is inherent in funds. And that transparency has been critical in creating trust between tens of millions of investors and the managers responsible for investing their hard-earned dollars in these funds. It is a trust that all of us in the business know could be lost very easily if we do not continue to earn it every single day.

What you see is what you get in a mutual fund. The net return on a fund is just that, return net of all the expenses—whether they are in fact, the measurable ones or the more difficult ones to measure. Our fund is measured every single day. The results are posted in the paper, and are seen by everyone. The evidence clearly indicates that investors value this combination of transparency, diversification, and professional management—all at a relatively low cost.

Thanks very much for the opportunity to express my views. I appreciate it.

Chairman BAKER. Thank you, Mr. Riepe. We also appreciate your participation here today.

I will start off with questions to you, Mr. Haaga, and you, Mr. Riepe, centered around a comment which you made about performance of funds generally as contrasted with the S&P. When we passed Sarbanes-Oxley, we had what I called—and this is a congressional term—a coloring book requirement which posted the individual stocks that an analyst would cover against his upgrades, downgrades and price targets. That is required to be prepared by the firm for whom he is employed on an annual basis so that a shareholder interested in that analyst's performance can look back at that coloring book illustration and understand how his recommendations fared against the actual performance. That leads me to conclude this, that current disclosure requirements are not necessarily crystal clear. They are not opaque. They are somewhere in the translucent range, in order to help facilitate an individual investor's understanding of fund performance. Also with the disclaimer, past performance is not an indication of future, blah, blah, blah.

Would either of you object to a requirement on an annual basis to have a disclosure of individual funds' performance as cast against either the Wilshire, the S&P—you pick out the standard index against the fund, so you could make a judgment of that sort

from the graph, without having to dig through numbers and post it yourself. Is that an unreasonable request?

Mr. HAAGA. Actually, we already have it. There is an SEC requirement that our annual reports include our results in comparison, and of course net of fees, in comparison with a recognized stock index of our choice—Wilshire, S&P—

Chairman BAKER. But is there an industry standard that everybody does it against the Wilshire?

Mr. HAAGA. All the funds do not seek to mimic the Wilshire. There are many balanced funds, funds with—

Chairman BAKER. Well, do we require multiple—

Mr. HAAGA. Nearly all of them use the S&P—nearly all the large, broad-based equity funds use it. We also can in those disclosures compare against the Lipper averages, the averages of other funds, and many funds do. So they will say, we were up X amount; the Lipper average for our type of fund was up Y amount, and the S&P was up Z amount. I think bringing it down to a single comparative number would probably be misleading for some of the funds. There really is a vast range of funds and there is a vast range of what they do. Having said that, there are only three or four recognized indexes that we use. So we are almost there.

Chairman BAKER Do either of you think there is any additional disclosure standard required from your perspective at this time, based on what you have heard from other folks this morning?

Mr. RIEPE. With respect to performance?

Chairman BAKER. Fees, performance—you pick. We have about five or six different topics that others have elicited comment on. But generally from the read of your remarks, and do not let me mischaracterize it, you feel generally the industry on balance is performing well, and that investors have access to the information they need to make informed judgments. If that is your position, then do you think any additional standards or disclosures are required, based on what you have heard this morning?

Mr. HAAGA. Yes, and in fact we have got that in writing, because there are two SEC proposals out there. One is a requirement that any mutual fund advertising or anything you see in the paper include a cross-reference directing the shareholder to go to the prospectus to find the fees and expenses. That has not been there in the past, and we support that. The other is an additional fee table. There is, as you know, and several have mentioned, there is a fee table in the prospectus that takes all the fees and combines them and puts them in a standardized dollar amount. The SEC has proposed that that be extended to the shareholder reports, and that in the shareholder reports, unlike the fee table in the prospectus, the actual investment results of the fund be used against a standardized dollar amount to give the total. We support that as well, so there are two additional changes we would like to see.

Chairman BAKER. And my last point, because I am going to run out of time.

Yes, quickly.

Mr. RIEPE. Mr. Chairman, I think the problem is not additional disclosure, as much as it is getting people—it is my owners manual analysis. It is getting people to look at what is there, and having

a better understanding of what the characteristics of that particular investment are.

Chairman BAKER. I liken it to the privacy disclosure statement by financial institutions. By the time you read it, you do not know what bank you are doing business with, much less what your rights are.

Mr. RIEPE. And after the first couple, you just throw the envelope right out.

Chairman BAKER. And what you are looking for is something that says, if you give it to us, we are not going to do anything bad with it, but lawyers will not let you do that. But there ought to be some good faith disclosure which I do not think, frankly—I do not any longer invest in mutual funds or have any holdings in the stock market for a lot of reasons—but I have looked at my son's.

I have got to tell you—I know I am a Congressman and that puts me on the low end of the food chain—but I could not make much out of his mutual fund statement to tell him really where he was. That is what is troubling. I do not think people can, despite good faith effort and a lot of expert counsel, on their own take their information and determine what their actual costs are, not to allege that the costs are inappropriate or that you are not getting good service for the fees you pay. Those are different issues. Right now, I think the question is, can the average investor understand where he is with his piece of paper and the holdings he has? T. Rowe Price is a great firm, does a good job, makes money for people. I have no complaint. But there are a lot of funds out there that do not exactly have your model, and that is the troubling part.

I know I am over my time, but I am at least going to get Mr. Bogle and Mr. Wagner in, because the representations made on the other side are that your calculations of costs are not exactly on target, and that somebody here is not—from my view of the representations at the table, there are two pretty clear distinct representations about fees and charges. I am leaning toward writing my own letter. I have not had a chance to talk to Mr. Kanjorski to see if he would sign onto it, but at least from my own initiative, and we will ask other members if they choose to do so, to sign onto a letter to the SEC outlining the points made here today, and asking them for professional guidance in sorting this out, and maybe reporting back to the committee in some length of time to give us a real insight into the issues raised.

If you were in our position, give me some good investment advice. Where do we go to get this resolved in an impartial courtroom?

Mr. BOGLE. I think going to the SEC or an independent consulting firm to look into the cost issue is a perfectly good thing to do, a perfectly intelligent thing to do. I would definitely tend to lean toward the SEC. They have a very good staff. Although I have had a lot of trouble trying over the years to get the SEC to do an economic study of this industry that is really on thing that ought to be central to the work of your committee. We need to follow the money in the mutual fund industry. Not only these ratios, which we have probably bored you to tears with, but the total dollars involved. This is an immensely profitable industry. Mutual fund

managers get paid not only through their expense ratios, but through their use of brokerage commissions for their own benefit.

Chairman BAKER. Let me hit that point. I am really way over, but let's just take simple examples. Let's assume it is a $100 million fund; I am the investor; you are the portfolio manager and you are getting instructions from your director to do certain things. Let's assume, based on last year's performance, the fund is down 25 percent from the date on which I signed in. But you also assume we have had our 110 percent turnover rate that has been elicited earlier in the comments, and let's just use the average that they have used, the .99 percent transaction cost. Is there a way for you as a portfolio manager in the current scheme of things, even when the fund is down, to generate a profit for you or the directors from the turnover in those fees?

Mr. BOGLE. Can you as the portfolio manager or the management company make a profit on turnover when markets are down?

Chairman BAKER. Based on the generation of the fees that you are talking about. Where does the fee money go, even in a down market? When you are rolling over my stocks at the rate of 110 percent, and assume the stock valuation has gone down from the time I got in, but there has been a lot of turnover, a lot of transaction costs, and it is not going to research and market data. Where does that money go? You are saying, follow the money, tell me where it is going.

Mr. BOGLE. Okay. Let me just give you a simple example. Take a $10 billion fund and the market drops—

Chairman BAKER. I like your definition of ″simple.″ Yes, go ahead.

Mr. BOGLE. Well, I want to make sure the numbers come out in a decent way. I will start with it simple. Let's assume the market goes down 20 percent. The fund is now $8 billion. Annualizing that number, the total management fee at 1 percent would drop from $100 million to $80 million. The manager at the beginning of the year is making about $50 million. The pre-tax profit margins in this business have been, at least at the high market levels, very close to 50 percent. So his profit is going to go down from $50 million of that $100 million of revenues, to—I have got to make sure I have got my decimal points right—from $50 million to $40 million. He will be making $40 million, assuming his costs, which are the other $50 million of the original $100 million remain unchanged. So he makes less money, but it is still 40 million even though the shareholders have lost $2 billion—

Chairman BAKER. That is my point. Is that I as the investor have lost equity in my fund because of the market under-performance, but the fellow with whom I am doing business is only going to make $40 million as opposed to $50 million. My heart goes out to him.

Mr. BOGLE. Yes, mine does, too, sir.

Chairman BAKER. I do not think we have focused on that enough this morning. I have got to quit, because I am way over my time.

Mr. Lucas?

Mr. LUCAS OF KENTUCKY. Thank you, Mr. Chairman.

I come at this from a couple of angles—32 years in the financial planning business, so I was a supplier of these services and also

a consumer. But I think one of the things, and I think it is healthy to have this hearing, and I think that there can be some good come out of it. I would just hope that we as a committee do not overreact to this, because it has been my experience that people who have stayed in functional allocation and in great diversification in mutual funds have been far better off. I think you need to look at the end result. Would the consumer be better off if he or she were involved in function allocation and spread all around the board? Would they be better off in the end paying these fees? The net bottom line is, in my view, the vast majority of consumers who were involved in functional allocation funds have far more in their 401(k)s and profit-sharing plans and individual portfolios today than some of those people who thought they knew all the answers and were in individual stocks.

So I do not think we should, although I think it is important, as the Chairman said, to be able to know and understand this, the information is there for those who want to ferret it out. I think that competition works that one fund wants to be more open and more competitive than any other. I think those factors are there as well.

So I really do not have a question, other than I very much am an advocate of this functional allocation. As I would tell my clients through the years, we may not hit any home runs for you, but we are also not going to strike out. Worst case, maybe we will do some singles and doubles, once in a while a triple maybe, in baseball parlance, but I think we have to look at the performance of the funds as measured against the marketplace. I know as a consumer who has a considerable amount of my net worth in the market, even though it is way down, it is much less down than people who are investing in individual stocks.

So I would just say, let's do not throw the baby out with the bath water here, and let's not overreact. I am for more disclosure as well, but there are two sides to this coin.

Thank you.

Mr. BOGLE. May I comment, Mr. Chairman?

Chairman BAKER. Certainly.

Mr. BOGLE. I would just like to say, we have talked a lot about the return of the average fund in these markets. We have talked very little about the return of the average fund investor. This industry, Mr. Congressman, has moved a long way from being an industry selling diversified stock funds, to selling specialty funds. In the recent bubble, technology funds were very big. Internet funds were very big. Telecommunications funds and aggressive growth funds owning those stocks actually, believe it or not, sir, took in $500 billion in the couple of years going up to the market peak, while fund investors were taking $40 billion out of value funds at just the wrong time. Investors had 75 percent of their money in stock funds at the peak, and in round numbers just 50 percent in stock funds now that the market is down—again too much risk at just the wrong time.

So if we look at the returns of the average investor, not the average mutual fund, we see something very different. A study in one of my exhibits that is in your report shows that in the last 20 years, one of the great bull markets of all time, even after the decline, the stock market went up at a 13 percent rate. You saw that

a little bit earlier. The average mutual fund went up 10 percent, primarily because of that 3 percent are points of costs. But the average fund investor, as far as the data we can find tells, and it is going to be very good data, but not precise, made 2 percent annually in that 20-year bull market. The average investor in equity mutual funds earned 2 percent. That means if you started at the beginning with a dollar and owned the market, you ended up with a profit of $10.70. Starting in the beginning with an equity mutual fund on average, you ended up with $5.70—just about half as much. And if you earned that 2 percent that the average fund investor appears to have received, you ended up with a 50 cent profit. That just is not good enough. That is not one of the great success stories of the 20th century. It may not be a scandal, but I think it is close to one.

Chairman BAKER. Let me offer time to the other side here. Mr. Haaga did you want to make a comment?

Mr. HAAGA. I sure did. I will not refute all those numbers, but I will just say I do not agree with them. I guess if we were giving people 50 cents over 10 years, I do not know how we got to be $6.3 trillion in assets.

I wanted to thank Mr. Lucas for his comments, and buttress them with some figures from Morningstar that really show the value of diversification. Twenty percent of the stocks in their database—that is 6,500 stocks they cover—20 percent of them lost 60 percent or more in value in the year 2002. One-tenth of 1 percent of all equity mutual funds lost that much. So I think that shows the value of diversification.

One other thing I would like to just set straight. The 110 percent turnover rate, I do not know where that came from. We would like to check. It may be another one of those statistics that is an average that is not what anybody is doing. Our turnover numbers are way below that, but they are higher than they used to be. When I asked our portfolio counselors how come there is more turnover—our turnover is in the 20 to 30 percent range, but it is up from below 20 percent—their answer is that the market is so much more volatile.

I was reading in Business Week, that said how two out of every five days on the NASDAQ, the market moves by 2 percent or more, and one out of every five days I think it is the S&P moves by 2 percent or more. Those numbers were unheard of. There is just volatility. There were no 2 percent days in the past. I think that is what is happening. I do not want to defend 110 percent turnover number, because I do not agree with it, and we do not have that kind of turnover, but I think we need to know what the real number is and we need to have it in context.

Mr. GENSLER. As I do find that Paul and I might differ on policy, we tend to agree on numbers. Turnover in the industry is reported by Morningstar from their database. The median is 76 percent. The average is over 100 percent because there are some funds that I do not even know, have 6,000, 7,000 turnover that skew an average. Large diversified funds are probably closer to 60 percent turnover. That is still selling all their stocks every one and a half years. I do share your view that financial planners have a great service to Americans in asset allocation. All the studies that I have looked

at show that about 80 percent of American returns come from how you allocate your assets. Do you buy stocks or bonds, and hopefully if you diversify. If you are, as Mr. Bogle said, picking just a sector fund, a technology fund, well then you are in for a wild ride.

Chairman BAKER. Mr. Lucas yields back all of his time.

[Laughter.]

Chairman BAKER. Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman. It has been a most enlightening hearing and we appreciate all of your participation.

Mr. Riepe, you indicated at the end of your statement that in your business what you see is what you get. That would seem to indicate that the average mutual fund participant and owner really understands and has all the information available to him in understandable form. Is that really true? Do you think that your customers really do have all of that information in front of them in understandable form?

Mr. RIEPE. I think, Congressman Oxley, that you perhaps were not in the room when I answered Chairman Baker's comment before, but those are two quite different things—having all the information one needs, and understanding it. I believe that investors get all the information they need to make an intelligent decision about a fund. The challenge for us is to get those investors to spend the time looking for that information, if you will. Understanding it is the bigger challenge. Finding it is not the big challenge.

Mr. OXLEY. Do you think the SEC is on the right track, then, with their proposal to take the proverbial $10,000 account and try to put some numbers to it?

Mr. RIEPE. I will tell you two things on that. One, we as an industry have supported that. Personally, I honestly have some reservations about it because my experience over three decades with investors is that they understand things they can compare. Returns on mutual funds, returns on investments are expressed in percentages. That is why the expense ratio has always been the most simple and easily understood way to express a cost. So if I am going to earn 10 percent in this fund and it is going to cost me 1 percent, I can understand that. If you tell me every quarter that it cost me $322 last quarter, and this quarter it is $275, I do not know how to compare that. I do not know whether I put more money in, I did not put more money in, my asset value went up, my asset value went down. I cannot compare it to another fund as easily as I can in simple percentages. So I hope we will not lose the percentages.

Mr. OXLEY. If that is the case, let me ask you then, the GAO study indicated an 11 percent increase in that ratio. Those are relatively easy numbers to understand. Mr. Bogle, do you have any comments on that? You heard Mr. Riepe say that the more accurate definition would be the expense ratio, and yet—

Mr. RIEPE. I did not say accurate. They are both accurate.

Mr. OXLEY. They are both accurate?

Mr. RIEPE. They are both accurate. The question is understandable; which will be more useful to an investor?

Mr. OXLEY. All right. Is it useful to an investor, Mr. Bogle, to understand based on the GAO report that expense ratio has gone up 11 percent?

Mr. BOGLE. Yes, it is useful, and we ought to show investors the dollar amount of their costs. I do not think we should ever think of these things as mutually exclusive. In my testimony, I recommend that each mutual fund shareholder statement at year end, an annual statement, include a footnote, printed in the statement, showing that the annual expense ratio of this fund is 1.4 percent, say, and where he says the year-end value is $11,000, just let that little computer multiply 1.4 percent times $11,000, and say on that basis your cost would be $154 or whatever it comes out to. I do not see any harm in that. You still have the expense ratio, and at least the person can look at his direct mutual fund costs, previously hidden, and compare them with his electric bill or his rent or anything else he wants to compare them. He has the right to ignore it.

Mr. OXLEY. Or with other mutual funds, too, in terms of cost.

Mr. BOGLE. Absolutely.

Mr. OXLEY. Mr. Haaga, is that a good idea?

Mr. HAAGA. No, that is just the problem. He cannot compare it with other mutual funds. He can only compare it with his rent, if it is a non-standardized number. That is what we are talking about. We are all interested in including all the costs, reducing them both to a percentage and to a dollar amount. The argument is only whether you should use a standardized dollar amount or the actual dollar amount that the person paid. The comparison you were looking for at the end of your remarks, which is with other funds, can only be made if you use a standardized amount, not the actual amount that Jack Bogle is talking about.

You can translate that. If you really want to know that, you could translate that yourself, but you would have to remember if you have made purchases during the period, you have to adjust for that. So we think it is much better to look at standardized amounts, not actual individual amounts. It is all about comparison.

Mr. BOGLE. It does not take a mathematical genius to apply the standardized expense ratio to the amount the investor has in the fund and show the dollar amount of costs he would expect. I do not see how that can even be controversial.

Mr. OXLEY. Mr. Haaga, when you sent out the investor account balance, that is net after fees, right?

Mr. HAAGA. Yes, it is.

Mr. OXLEY. You are able to calculate how much to take out of my account at that point, to determine the fees and the net, but can it also tell me how much in dollars it took out of my account?

Mr. HAAGA. We actually do not take it out of the account. The fees are paid by the fund itself, rather than by the shareholder. So we are not calculating that at the shareholder level, nor are we deducting them from shareholder accounts. So when the shareholder gets a statement, that is the net amount they own, which is the net amount the fund earned after the fund paid fees.

Chairman BAKER. Would the gentleman yield?

Mr. OXLEY. Yes.

Chairman BAKER. I just wanted to ask, if somebody else is paying the fee, where do they get the money from in the first place?

Mr. OXLEY. Yes. Those fees are obviously coming out of somewhere.

Mr. GENSLER. It really is a wonderful system they have, is it not? It really is. It works well.

[Laughter.]

Mr. HAAGA. The fund is paying the fee, and the investor's account, the investor's earnings, the value of the investor's shares are net of that. But the fund does pay the fee.

Chairman BAKER. Mr. Chairman, if I may interrupt again, let me understand. I put money up. You manage it for me. In the course of managing that account, you are going to tell me I have this percent of fees that deduct from my net check. Before you get to that check, you have operating expenses that the fund assumes on my behalf. But that offset of operating expenses comes off the top of the distribution that comes back to the investor. Even though it is not allocable to me individually, it is allocable to the fund.

Mr. HAAGA. That is precisely what we are disclosing.

Chairman BAKER. Okay. I have got it. I yield back.

Mr. OXLEY. Mr. Montgomery, do you have any comments in that regard?

Mr. MONTGOMERY. I guess I am in favor of some kind of disclosure. I do agree with Mr. Haaga that the timing of purchases and sales of a fund complicate it, unless you have this footnote that Mr. Bogle refers to at the bottom of the statement that says, assuming you held your fund for the entire quarter, let's say, without any purchases and sales, it would be this. If you made that assumption, then it is very easy to calculate and I do not see why we cannot do it. If, however, you want to be accurate, if you are telling shareholders that this is the actual fee that you paid from your fund ownership, then you do have to account for purchases and sales. It gets very complicated. Bridgeway actually used to do this level of account disclosure for returns. One of the criticisms of our industry is that, yes, this is the return of the fund, but how has my investment since I made it actually performed? That is what I want to know.

So when we created our first account statement eight and a half years ago, we actually told investors what that was. It is a much more complicated calculation if you include the effects of redemptions and purchases. So I am somewhere in between what you have heard today. But if you make the simplifying assumptions, it is a dollar amount, then people can compare it with the ATM fees that Mr. Gensler talks about.

Mr. OXLEY. Let Mr. Gensler respond. He looks a little skeptical to me.

Mr. GENSLER. The nature of the mutual fund industry is to promote profits for mutual fund companies. Many of them are public companies. The nature of Las Vegas is to promote profits for the casino. I would make a note, and I find myself probably agreeing with Mr. Riepe, who by the way is my twin brother's boss.

[Laughter.]

Mr. OXLEY. He brought the wrong twin.

[Laughter.]

Mr. GENSLER. But I would note that if there is some genetic flaw, then he must have it, too.

[Laughter.]

Mr. GENSLER. Somewhat like Vegas, we Americans do not really pick our funds on cost. So if we put more disclosure out there, there is probably still going to be 85 or 90 percent of Americans investing in actively traded mutual funds. It is relying on experts. It is a sense of the buzz. It is a sense of in my work-a-day life, maybe I, too, can get an excess return. There are a lot of good things mutual funds do as well—the service, the diversification that has been referred to. So I am a little skeptical that added disclosures will help a lot. I think there are some areas that disclosure should be considered. I think, to comment on Chairman Baker's point earlier, just like with analysts and Wall Street firms, it would be helpful to know what the whole fund family has done, even including all those dead funds. As Mr. Riepe has said, many people pick by the fund family—by Fidelity or T. Rowe Price. It would be helpful to see how that whole fund does, and just put it on the Web site. Let the financial planners know that information is on a Web site. It does not have to go out in some thick owner's manual.

I do think at the core there is an issue about governance in the mutual fund business, and all of these fund directors sort of passively going along with the status quo. In many funds, that is all right—probably the funds represented at this table. But we all know with 7,000 or 8,000 funds out there, there are a lot of really poor performers and high churn, high turnover and high fee funds, and if none of them ever change their managers—well now somebody in the press or somebody will find one that did—but so few do. It seems something is out of balance to me in that regard.

Mr. OXLEY. Well, let me just complete this. That really gets at the core of the whole issue. Why in the world would an investor stay with an under-performing fund that you just described, unless they had no idea what was going on? Why would they do that time after time, when they have the ability to take their money and run, or to vote with their feet and go with somebody else?

Mr. GENSLER. At the core, I think it is human nature. I think I could quote various studies, and in this case not financial studies, but the psychology of finance, that often we Americans hang with our losers. We sell our winners and hang with our losers, and all sorts of studies have shown this. It is a little like the deer caught in the headlights.

Mr. OXLEY. I could understand that with individual stocks. It is hard for me to believe in a mutual fund concept, which is just the opposite of individual stocks. You are buying a marketplace of stocks. It is almost like staying in a bad marriage, I guess.

Mr. GENSLER. It is. Fortunately, I have a good marriage. But it is like picking stocks. A lot of Americans will stay with a bad mutual fund, hopefully not represented at this table, and just stay and not open the monthly or quarterly statements.

Mr. HAAGA. Mr. Oxley, I have a good marriage, too, by the way.

[Laughter.]

Mr. OXLEY. This was not meant to be a quiz. This is not Phil Donohue or even Jerry Springer, for that matter.

Mr. HAAGA. Since he said it, my wife is on the Web cast and I thought I'd better say it.

[Laughter.]

The truth is, the shareholders do move. We have talked about the lowest cost funds getting the most assets. There is kind of a circle of causality there. And we have also talked about the lowest cost funds performing the best. Those are all related consequences because the funds that do perform better get more people, and then as the GAO and SEC said, they reduce their fees. So they all cycle together. I do not want to leave it on the record that shareholders do not move when their funds do poorly. They move and they move quickly.

I also do not want to leave it on the record that they do not go for the lower expense funds. I think as our slides show, there has been a million man march in the direction of the low cost funds. I think one of the reasons for that is because they perform better. Another reason for that is because they are lower cost and the people understand it. So I just wanted to add that. Thanks.

Mr. RIEPE. I would also add a specific example. We have a growth fund that under-performed both the market index as well as its competitive group in 1997, 1998, and 1999. It then out-performed those same benchmarks in 2000, 2001 and 2002, and for the six-year period it is in the top decile of all other funds, and beat the market index as well as the competitors. So it is in the top 10 percent. But that tells you that people are not always confident they know when they should move, and too often they move at the wrong time. Human nature is such that people tend to give up at the bottom, and they tend not to have the courage to go into something at the bottom. I think that is the reason that we, and it was alluded to earlier, went out of our way both as an industry and individually to try and highlight during that bubble to investors the risks of moving into the top performing stocks. But you cannot overcome human nature and greed. They are powerful influences on people's behavior.

Mr. OXLEY. My time has expired. I yield back.

Chairman BAKER. Just barely, Mr. Chairman.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

The comment was made that some have bad marriages. My question is, should the government be involved in selecting spouses?

[Laughter.]

Is not that what we are talking about here? I guess I am interested in, one, I think the mutual fund industry represents risk. It invests in risk. By definition, there are going to be successes and there are going to be failures. I am more interested to know from the panel, maybe particularly Mr. Bogle and Mr. Gensler, is there any fraud or abuse that you see in the mutual fund industry that we should be attending to? Or are we just talking about poor judgment and boards of director that are not necessarily actively involved in what someone thinks is a standard of selecting new managers or new advisers? I am curious whether you see actual fraud or abuse out here, to the extent that it warrants government intrusion.

Mr. BOGLE. Well, I am not sure we need additional government intrusion, but let me answer categorically yes, there is fraud, and yes there is abuse. Let me give you a couple of examples of fraud by large managers with a great deal of power in the IPO market

because they are clients of the brokers. They take those initial public offerings that they get because they pay large brokerage commissions to those firms. They direct all those IPOs into a new small fund, and the fund goes up, say, 100 percent in a year, or even 100 percent in a month, and they advertise that and put it out to the public. That is what I would call fraud. I am not sure anybody else would call it that, but I would call it categorically fraud.

Mr. KANJORSKI. You mean they get the advantage of the IPO because they are handling a larger fund, and then that is sort of a backward payoff?

Mr. BOGLE. They put the IPO's in the smaller fund where it has a huge impact, and they do it over and over again.

Mr. KANJORSKI. Should not it go into the same fund that created the incentive?

Mr. BOGLE. It is a curious thing. Of course, it is the large fund's buying power that gets this free ride—a term that will probably vanish after this great bubble—but of course it should go there from the economic standpoint. But I am sure that the manager argues that the big fund is a very conservative blue chip fund, and I have this little speculative fund over here, so I will put it there. That is a specious argument, because the real idea is to pump up that return to the fund, and then sell it to the unsuspecting public. We have two documented cases where the SEC has taken them to conclusion. Without the SEC having criminal powers, the managers were fined. So this is right there in the record.

We have something else very close to that kind of fraud or over reaching. If you open up the March, 2000 issue of Money magazine, right at the market high, there were 44 mutual funds that advertised their past returns. The public did not know about these funds, so we advertised them and sold them to investors. We created the funds. The average return for the previous year of those 44 funds that were advertised in Money magazine, the average annual return was 85.6 percent. Our ads are saying, come and get your 85.6 percent. Oh, sure, there is a hedge clause saying past performance may not be repeated in the future. They should have said "will not" in this case, but it is in tiny type, barely readable. We know that high returns are what attract the public. Those ads, as it happens, produced business, and that is fraud or abuse.

Other abuses is this pandering to the public taste by fund managers, bringing out 496 new Internet funds, technology funds, and aggressive growth funds in the midst of the bubble. I do not know that anybody in the investment departments of the fund firms wanted to do that, but I know the people in the marketing departments did. I have been in this business for a long time. I know what causes what. The great firm of Merrill Lynch brought out two such funds at the peak of the market. They sold $2.2 billion of these funds to their customers. One was an Internet strategies fund. One was a Focus-20 fund. Both funds went down about 95 percent in the market decline, and so did customers' money. One fund has been put out of business so its record will no longer be visible. Is that an abuse? Yes, sir. I would argue that is a serious abuse.

Mr. KANJORSKI. Of course, the NASDAQ itself went down 75 percent, Mr. Bogle. Is 20 percent a greater loss than that?

Mr. BOGLE. You know, if you had started—it is a very good question—if you had started, out of your marketing opportunism, a NASDAQ fund when the index was at 5,048, and you said, well of course the index went down 75 percent, and so did the index fund. But, if you want to do that, and people did, the reason you are doing it is not to help people invest better. It is to bring money into the business. This business, as everybody has observed, has become an asset-gathering business, more than an investment management business. Just read what people that are doing all these mergers of management companies and acquisitions of management companies are saying. The first thing they say is, here is the asset-gathering capacity of the firm. I have never seen a word in one of those investment banker's reports that say anything about mutual fund performance.

Mr. KANJORSKI. Should the government then get into the business of maybe regulating how they advertise?

Mr. GENSLER. Mr. Kanjorski, the government is in the business. Sixty-three years ago Congress addressed itself to the inherent conflict in the Investment Company Act of 1940. Subsequently, the SEC has promulgated numerous rules and Congress has come back. I think this hearing is just part of the ever-going sort of finding the appropriate balance.

On the issue that Mr. Bogle raised, yes those very things occurred, where large fund companies start up with what is called incubator funds and by the roulette wheel some of them will do well and some of them will do poorly. The one's that do well, you advertise. Sometimes they try to help the roulette wheel by putting in hot IPOs. Now, the SEC has addressed that with some final rules on IPOs. We could debate whether it has worked, but they have addressed that.

To your question, I grappled with it. I wrote a book for investors. I did not write a book for Congress. I did not even envision that there would be such hearings. But when I was asked to testify, I sort of thought, Congress has grappled with this for 60 years and the SEC has grappled with it. By and large, I think there should be individual choice, freedom of American choice. This industry, like other industries, has the right to advertise its products. But I think on the margin, some additional disclosures could be helpful and warranted, and on the margin some addressing to governance, particularly around these soft dollars where I do not think that is fraud. I think it is well known. It has been going on for 10 or 15 years, but it seems out of kilter with what the funds really ought to be doing.

Mr. KANJORSKI. Can that be handled by the present regulations in the SEC, or do we need additional statutory authority?

Mr. GENSLER. That is a very thoughtful question, one that I have not thoroughly researched. It may well be that the SEC has authority to address that, and if they did, I would hope that they would, but it may well be the Congress giving them a little added nudge along the way would help as well.

Mr. BRADLEY. Can I speak to that one?

Mr. KANJORSKI. Yes.

Mr. BRADLEY. As I understand, if 28(e) was originally interpreted by the SEC in a far more limited fashion. Managers could not pay

for services otherwise and customarily available for cash to the public. The SEC has broadened that through interpretive releases over time. There has been no rulemaking. My concern would be, maybe it is time for rulemaking to say what exactly constitutes paying up, and what exactly is the value of those goods and services to investors.

Mr. KANJORSKI. Tighten it up.

Mr. BOGLE. I would like to add one other thing, sir, if I may. I think the government is going to have to look into, number one, a more express statutory standard of fiduciary duty for fund directors. Number two, is building up even further the independent majority of the board, for the present independent director structure clearly have let investors down. And number three, as I mentioned in my testimony, is to have the chairman of the board, not the same person as the chairman of the management company. The Investment Company Act of 1940 was right when it said that investment companies are affected by a national public interest, and all this talk about what buyers do and what buyers choose is fine, but our law says, more is required. It says, in effect, that mutual funds are not toothpaste and mutual funds are not soap, and mutual funds are not beer. They are people's retirement savings, children's college education savings. It is not just a consumer issue, it is a legal and governance issue that requires the boards of directors of mutual funds to see that funds are operated primarily in the interest of shareholders, and not in the interest of managers. I believe that balance has been badly distorted. The system that the law established isn't working.

Mr. KANJORSKI. So that is something statutorily that we could do.

Mr. BOGLE. Yes, sir.

Mr. KANJORSKI. The other thing that I am worried about in terms of the evidence is no manager has been fired among 7,000 or 8,000 funds—that does raise a question. But it is sort of our shining example of independence. I am just worried about how many people we are going to put in charge of watching over the board of directors, and then who is going to watch over the watcher of the board of directors and how far can we go. Is not this structure sort of the same structure, and there are independent board members. Their job is to have a fiduciary relationship. If they violate that fiduciary relationship, are not they subject to class action lawsuits?

Mr. BOGLE. We have had class action lawsuits and they have been notoriously a failure for reasons that I think are in many respects too bad, because the courts have judged the level of one funds' fees by the level of other funds' fees. So if you look at a management company with, say, a 1.5 percent fee, and the range of fees is 1 to 2 percent, the court says, in effect, " we are not going to interfere with that." As far as it goes, that is okay, but it is almost the same issue as executive compensation that has gotten so out of hand in this country. If everybody is doing it, then I can do it too. But that is a new standard, and not the standard established by the 1940 Act. The standard of the 1940 Act is fairness to shareholders. Yet even as fees go up, plaintiffs have not been successful.

Mr. KANJORSKI. Mr. Bogle, I tend to agree with that, but then does not it go contrary to our system? I mean, if we are going to have the SEC approving salaries and activities, where does it end? I mean, if I needed brain surgery, I would not advertise as to who can give me the cheapest brain surgery. I would want to hire the best brain surgeon in the country. I assume that these funds are interested in growing and attracting more investment money. So is not the natural market incentive there to have the best managers and the best advisers in the country?

Mr. BOGLE. Yes, sir, and that is a wonderful question. There are, say, 500 different management firms and 10,000 mutual funds, each of which is trying to be the best. But, it is inevitable, given the mathematics of the marketplace, that before costs are deducted, they are all average. When they trade stocks, they trade with one another. I will use the entire institutional community, not just the mutual fund industry because most firms are doing both. So they are all average before costs, but after cost, they are all losers to the market itself. Beating the market, is, must be, and always will be, a loser's game.

So what happens in this industry? Well, we will have managers who look very good in the short term. The top 20 managers in the two years coming up to the boom, the peak of the boom, were the bottom 20 managers in the two years that followed, metaphorically speaking. Actually, they were not exactly the bottom 20, but they were in the bottom 50 out of 5,000 funds. They looked like good managers, but they were just speculators. So we have a system that is shaped the wrong way—an opportunistic system.

Mr. KANJORSKI. How do we correct that?

Mr. BOGLE. Yes, that is a very good question. We need education. Investors should know that the first rule of investing is uncertainty. That the second rule of investing is gross return minus cost equals net return. The third rule of investing is, for God's sake, do not put all your money in the stock market unless you are 20 years old and it is your first $100 in a 401(k) plan, in which case it is fine. We need more education like that. But above all, we need a structure in which the people govern the fund, the directors, the fiduciaries, the stewards of the fund—are called to task to live up to their responsibilities.

Mr. KANJORSKI. The funds that you show in your chart—the Wellington Fund—you own your adviser group, so that is part of the fund itself?

Mr. BOGLE. No, let me explain that for a moment. Vanguard is a mutual company owned by our shareholders. It is a unique structure in the industry. We manage about 75 percent of our money inside Vanguard. The index funds and our bond and money market funds are pretty much all managed at Vanguard on an at-cost basis. That was the main example. For the remaining approximately 25 percent of our assets, we use external investment advisers. We use Wellington Management, for one. Actually, I think we use about 18 different outside advisers. We go out and negotiate fees with those advisers. Believe me, if you are legitimately negotiating, you can get a fee of four basis points if the fund is large enough—and admittedly Wellington Fund is large enough—just four one-hundredths of one percent. Our Ginnie Mae fund, which

I did not comment on earlier, pays a fee on that is only nine-tenths of a basis point. It is fractional, while other Ginnie Mae funds pay 50 basis points, 100 basis points—sometimes 100 times as much or more. In the Ginne Mae case, it is very much of a commodity fund, so we were of course the best performing Ginnie Mae fund over time. We cannot do it otherwise. We cannot beat the Ginnie Mae index, but we can beat almost everybody else just because of one low cost. There is where our extra return comes from. We have got to educate investors about the importance of cost in shaping what they earn.

Mr. KANJORSKI. Why is it that through either the mutual funds themselves or the association or a cooperative formed under that group, why can't you buy seats and trade yourself and set your own cost? Would not that save a great deal, rather than going through the established brokerage business?

Mr. BOGLE. Well, we do not. I am not sure I fully understand the question, but at Vanguard we do not do any business with affiliated.

Mr. KANJORSKI. How do you make your purchases on the exchange?

Mr. BOGLE. First of all, index funds do very little transaction activity, but most is done on the New York Stock Exchange. Counting all index funds together, they account for maybe one-third of one percent of all exchange transactions. Our 18 outside advisers do business largely with brokers. We like advisers with low turnover, but they pretty much have to do business with brokers.

Mr. KANJORSKI. You have a significantly lower cost. What do you attribute that to?

Mr. BOGLE. I attribute that cost to—

Mr. KANJORSKI. Other than your brains.

Mr. BOGLE. Well, it is thriftiness, but it begins with having a mutual company. Think about it this way. If the mutual fund has a 1 percent fee and the pre-tax profit margin has been about 50 percent, that means if we eliminate that pre-tax profit margin by being mutual in nature and operate at cost, we are already down from 1 percent to one-half of one percent. The second thing is, we negotiate fees. We do not say to the adviser, these fees are just fine. I have done a lot of these negotiations and they are not entirely fun, but sooner or later, you get a better fee, and we've done them five or six times over 20 years for each fund. It pays off for the shareholder and then we are cheap in how we spend our shareholders money. That is the third part of the advantage we provide.

Mr. KANJORSKI. Do you think we should separate the investment houses from starting the fund, and that may be an internal conflict that has to be broken?

Mr. BOGLE. I would love to do that, but I do not see how it is practicable, honestly.

Mr. KANJORSKI. I see I am shaking up a lot of folks here.

Mr. GENSLER. I do not see how one would do that, but I would mention your brain surgery analogy is a very good one. Where it falls down, if I might say, is if you take the best brain surgeons, next year you presume they are still going to be very good brain surgeons. If you take the top 50 percent of performers, next year

45 percent of them are in the bottom half—close to what you would say is random chance. It is a little better than random chance.

In terms of negotiating fees, just to give a little sense, the best academic study in the last year done on fees showed that pension plans, the big state pension plans, whether it is Pennsylvania's or Louisiana's and so forth—the state pension plans go out and negotiate fees. Their fees for advisory services are one level, and mutual fund fees are 2.5 times that level before considering all the administrative costs. So it is not the servicing or the envelopes that there are plenty of. Why is that? Many of the companies at this table and in the industry actually provide both services. I would imagine that many of them—if $1 billion from the Pennsylvania state pension plan came in would probably manage that in the equity market for 25 or 30 basis points, or if they had a good day, 40 basis points. But the standard in the industry might even go down to 20 basis points. The mutual funds, if you take the standard $1 billion large diversified fund is 2 to 2.5 times that. There just is not the competition. There is not the tension in our commercial environment.

Mr. KANJORSKI. How would we get it there?

Mr. GENSLER. I think it is the hardest challenge—much harder than disclosure. It may well be in fund governance. It may well be. I do not have a specific recommendation that this Congress and the SEC put more pressure on the deciders of these fees; that the fund directors act in their fiduciary responsibility that was first embedded in the Investment Company Act of 1940.

Mr. KANJORSKI. But is not that going to mean that it would force them to a level of mediocrity for safety purposes?

Mr. GENSLER. No, I do not think so. I do not think that the public pension plans in America—by the way, if you take all state pension plans in America, 57 percent of their U.S. equity dollars are indexed. That is still 43 percent that are not.

Mr. HAAGA. Maybe that is why their fees are lower.

Mr. GENSLER. No, I am not talking about the index side, because indexing for $1 billion you can get on a single-digit basis points.

Mr. KANJORSKI. Do you think out of the seven witnesses here, we could come up with recommendations that the seven witnesses could agree upon?

Mr. GENSLER. I suspect not, sir, because I think the industry group, as many industry groups in many industries, will be more likely not to wish to embrace reform and change. I would hope that they would, but it is not the customary way of America.

Mr. BRADLEY. Could I speak to that quickly?

Mr. KANJORSKI. Yes.

Mr. BRADLEY. I have a concern about the framing. Behavioral finance teaches us a lot about how people frame the problem and it actually frames the answers. When you think about the purpose of markets, it is not to make investment companies rich. It is to fund new ideas in America. It is to underwrite small ideas that Bill Gates had in a garage out in California; fund it with an investor's risk capital because the bank will not do it; grow the company up so it becomes a mid-cap company or middle-size company; then it gets large and then it gets in the S&P 500. Even the S&P 500 in 1999 and 2000 added major high-tech volatile companies at the top. So the idea that capital formation is only about investor returns is

too narrow a perspective; it is a risk-return equation. I would argue that mutual funds are a way for little people to help fund capital formation in businesses in America and, in return be rewarded over time.

Mr. WAGNER. I would like to add to that. Sitting here listening to this, I hear ″governance″ coming up all the time over here. Most mutual fund boards that I have ever encountered are toothless tigers. They are selected by the investment manager and they do not report independently to the fund holders, I believe in most situations. We have independent directors for corporations that are really independent and do represent the shareholders—

Mr. KANJORSKI. At Enron.

Mr. WAGNER. and I do not see a similar thing in the mutual fund industry.

Mr. KANJORSKI. But how far do you want the government to get involved in what is a private decision, it seems to me, of selecting or classifying or categorizing board members? I mean, people have a right to be stupid. Is not that a principle—caveat emptor?

Mr. GENSLER. There is most certainly that in a free market, and I very much believe in free markets. That is the burden of all of us and the benefit of our system. But I think as Congress saw 60-some years ago, there is an inherent conflict, and at times it may be worthwhile addressing that balance and just saying on the margin whether there are things to help the system out.

Mr. HAAGA. If I can jump in here, a couple of things—one is my colleague Mr. Gensler says that it is not the American way to reform yourself. I would say it is the mutual fund way. You can just look back at history and look at our participation in regulatory initiatives. I might also add that although the 1940 Act requires for most funds only 50 percent independent directors, our best practices, which have been adopted by virtually every mutual fund, call for two-thirds. So we are almost at the point that Jack Bogle would have us go.

Lastly, I just cannot leave un-commented upon the suggestion that has been made that the only way that you can measure the independence and effectiveness of a board is by counting how many times they fired the management organization. That is a very unusual step. A few years back, we merged with, actually bought, a management company and took over management of its funds. Their board had told them that they needed to go find a good home for the funds. They were tired of their management. That shows up not as a firing that everybody is looking for, but it shows up in the merger statistics that for some reason Jack Bogle finds objections to. Let me tell you, that was a firing and I think a lot of the other mergers that have taken place are prodded if not ordered by directors.

Furthermore, we have talked about not firing advisory organizations. Advisory organizations do not manage the individual funds, but portfolio counselors manage the individual funds, and plenty of those have been fired. Finally, even without firing, as someone who has spent a lot of time in boardrooms with a lot of boards, we get a lot of pressure to fix things that are not going right. The boards, do it the right way, they say—give us a special meeting about this fund; we want to discuss its results and what you are doing about

it. And they listen to our answers. If they do not like them, and sometimes they do not, we have another meeting and we come up with different answers, until they are satisfied and until things have turned around. Those will not show up in your firing statistics, but they were a case of an active board taking responsibility and putting pressure on the management to make things better on behalf of the shareholders. It goes on all the time in our industry.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Fossella?

Mr. GENSLER. I would just say that I stand corrected. I am delighted that the head of the Investment Company Institute has that constructive approach to reform. So I stand corrected.

Chairman BAKER. Mr. Fossella?

Mr. FOSSELLA. Thank you, Mr. Chairman. Thank you, all of you for this healthy dialogue.

It seems to me in looking at more than 200 years of experience in the industry, I would believe that all of you have an interest to see the future of this industry and a future of getting more Americans to become investors, you have an interest in seeing that it flourishes. It also seems to me that you are all looking at the same situation with varying degrees of criticisms and applause. Some have written books about it; others have made a lot of money in it.

It was alluded to before as to what can you all agree on. I am not suggesting that you all have to agree on everything. But is it not in everybody's interest that you establish a common platform for just the industry, and then allow each of you to compete—in my opinion, the American way more so—but on an honest basis, with a sense of providing integrity and truth to your owners? Mr. Bogle has been among, it seems, the most vocal in his, I do not want to say criticisms, but what he thinks would be a healthier future, where others feel that some of those criticisms are unwarranted.

So I am curious to hear from the rest of the panel. For example, Mr. Bogle just alluded to some possible, I am not saying it is the right thing or the wrong thing, but some possible statutory provisions regarding fund directors or independent directors on the board, and the issue of whether the chairman should be, or the title of the chairman, should he be the head of the fund as well. I am curious as to what you all think about that suggestion.

Mr. WAGNER. Sounds like a good one to me.

Mr. MONTGOMERY. I guess I could support that one, too. I am, by the way, both president of the advisory firm and chairman of the board of our board of directors of our fund.

Mr. FOSSELLA. Mr. Bradley?

Mr. BRADLEY. I will yield to my colleagues.

Mr. FOSSELLA. Okay. You mean you do not have an opinion?

Mr. HAAGA. I am the chairman of our fixed income funds. If they asked me to step aside, I would. I think that specifically separating the role, making the chairman an outside director, would not do much and I think it would be a problem in some organizations, so I will not embrace that. But as I said about the 80 percent thing, we are almost there, and we got there on our own. So I think some things are best left to best practices and industry developments, rather than legislated.

Mr. FOSSELLA. Okay.

Mr. GENSLER. Specifically to having the chair of the fund be independent, I think on the margin that could be helpful. I think at the core, it is questionable. At these funds, it is not just whether they hire or fire, but also how they look at fees and why they customarily would pay 2.5 times for advice what the same service providers, the same T. Rowe Price's or American Century's provide to institutional pension money. So the same advice going to the state of Pennsylvania somehow, if I am the Magellan Fund or I am T. Rowe Price's big, large diversified fund has a higher fee—to ask those questions and find some way to ask those questions and get satisfactory answers.

Mr. RIEPE. Let me just say that when I worked with Mr. Bogle and he was chairman of the funds, he never held that attitude.

Mr. BOGLE. That is quite correct, by the way.

Mr. RIEPE. Clearly, he has had a revelation.

Mr. FOSSELLA. When did this revelation take place, Mr. Bogle?

Mr. BOGLE. May I just say that just because you have been mistaken for most of your life does not mean you have to be mistaken all of your life.

[Laughter.]

Mr. RIEPE. Can I make my comment? If he starts again—

Mr. FOSSELLA. I have been mistaken most of my life, or one has been mistaken?

Mr. BOGLE. Many—

Mr. RIEPE. Let me just say that I think I would agree with what both Mr. Gensler and Mr. Haaga said in the sense that it could do something, but it is certainly not a silver bullet in any way, shape or form. If we learned anything in this latest corporate abuse experience that we have gone through, it is that just putting independent directors in a room does not guarantee that you are going to have a clean shop. Independent directors can be duped; independent directors can fall asleep and not do a good job. Either way, it simply is not an assurance. I think it makes us all feel better and it seems to make intuitive sense to have a majority of independent directors overlooking management, but it certainly does not protect one by itself.

I think in the case of investment companies, the job is easier in the sense that one does not have to worry about accounting frauds and things like that because they do not happen in investment companies. So I think that the role of the independent director is more narrow and can be more forceful. I think this stuff about toothless tigers is a lot of malarkey, when you are talking about the middle 75 percent of the bell curve. I think as Mr. Gensler suggested, there are I am sure smaller groups where a couple of directors are luncheon buddies or something of the chairman. I do not know how one legislates that. I think the SEC has to do it through rules.

Let me just comment very quickly on the pension question that Mr. Gensler brought up, because we manage money for institutions as well. I do not know where his statistic came from, but I can only hope that our mutual funds were 2.5 times what they are. Our experience is that they are higher than the pension fees that we charge, but I will also tell you that we could operate our company

with about 80 percent fewer employees if all we were in was the pension business. Although everybody does not have 35 percent margins, as Mr. Bogle suggested, I will tell you the pension managers have the highest margins because they do not have all the other service requirements and all the other people requirements that are associated with taking care of an investment company. So there is a reason there is a spread between those fees. If someone is getting 2.5 times in their mutual fund what they are managing their private accounts for, then I think they have a very tough explanation to make to their directors. I might add, that fee information goes to our independent directors; and I think most every year it is required as part of the annual contract review.

Mr. GENSLER. Just to answer the question that was had, the study, since it is not my work, it was two professors—one of business and one of law—Stuart Brown and John Friedman. It is called Mutual Fund Advisory Fees: The Cost of Conflicts of Interest, published August, 2001, University of Iowa Journal of Corporate Law. They excluded all of the amounts of money that went to service the account and just looked at advisory fees. I say that just in my conversations with the industry, generally pension funds will shoot for 20 to 25 basis points, often will pay 30, 35 basis points. That is about one-third of a percent of their money for let's say $1 billion or greater large capitalization, diversified, actively managed fund. If you look at the management fees, advisory portion in the mutual fund industry—somebody could check this with Morningstar—it is going to probably be roughly in the 60, 70 basis points. But again, if I am wrong, statistics will prove out what the real situation is.

Mr. BOGLE. Mr. Chairman, could I just respond to the Congressman's question about when my conversion took place?

Chairman BAKER. Certainly.

Mr. BOGLE. My conversion actually took place in 1974 when I was fired by Wellington Management Company, and started Vanguard as a mutual company. As such, I was chairman of the funds, and the chairman of the board of the adviser had no role in the firm whatsoever. You saw the chart that showed in 1974, our costs are down 60 percent and the industry's costs are up 60 percent, so maybe that is not such a bad idea to have that separation. It has been a conversion that's lasted 28 years, and I feel real good about the new Bogle as compared to the old one.

Chairman BAKER. Okay. Anything further, Mr. Fossella?

Mr. FOSSELLA. If I may, and I know you have other speakers, but I am just curious as to maybe not the focus of this, but to what extent in all of these numbers and statistics does our current tax system affect all of these numbers about movement in and out of funds, or the decisions? I heard different theories—behavioral, market analysis, all this other wonderful stuff. But to what extent do you think the tax code and our policies today affect individual decision making?

Mr. BOGLE. I would like to just say one very interesting thing which should be brought up at this point, and that is the mutual fund is from an income standpoint the most tax-efficient investment ever devised by the mind of man, because mutual funds that happen to earn dividend income of about 1.8 percent on their portfolios. Taxes take away about 1.5 percent, and leave only 0.3 per-

cent for the Federal Government to get its hands on. From that standpoint, tax policy, even the elimination of so-called double taxation, simply does not matter to the average mutual fund investor. Half of the shareholders pay no tax on their 401(k)s and so on, and the other half are paying taxes on a dividend yield of over three-tenths of one percent.

On that point, I want to add another comment about our ability to look so favorably on fees when someone says, well, it is only 1.5 percent of assets. That is the lowest number you can possibly get when you look at mutual fund costs. You say, what percentage is it of the market return? The 1.5 percent cost is 15 percent of a 10 percent stock market return. What percent is it of the mutual fund's income? While capital gains come and capital gains go, income and expenses go on and on.

I want to give you an interesting example. It is in one of my exhibits here. I got involved in this industry in 1949 when I read an article in Fortune magazine called "Big Money in Boston." The industry was a $2 billion industry then. The article was about a firm called Massachusetts Investors Trust—the oldest, the largest, and the lowest cost of all mutual funds. That article reported that the independent trustees of that fund had just reduced the management fee from 5 percent of income to 3.2 percent of income. They did not calculate it on the basis of assets. They calculated on the basis of income—5 percent to 3.2 percent. Last year, that same old Massachusetts Investment Trust took not 3.2 percent of income and not 5 percent of the fund's income, but 87.5 percent of that fund's income—87.5 percent of income was consumed by management fees.

One of the big concerns this industry has about putting the dollar amount of fees in the shareholders' statement is that shareholders can see that my fund's income last year was $40, or was in effect $240 gross; the manager took $200 and only left me with $40. That will be easily calculable in that statement when you look at income.

Chairman BAKER. Mr. Fossella, are you done? I want to recognize Mr. Sherman for a couple of hours.

Mr. SHERMAN. Thank you, Mr. Chairman. I have so many questions and so many ideas, I will try to get them in within the two hours allotted.

One idea that has come out of these hearings, and I think it is a good one, is that in addition to whatever basic prospectus you mail out, there ought to be a required supplementary prospectus posted on a Web page. Does anyone disagree with that, knowing that we have to argue what would be in the supplementary prospectus?

Mr. RIEPE. No, sir. We put a great deal of information out on the Web.

Mr. SHERMAN. It would just be good to standardize that, and then of course you would have your non-standardized information—the glossy thing with your picture on the cover, which would attract a lot of investors.

Mr. RIEPE. Our pictures are not in the prospectuses.

Mr. SHERMAN. Oh.

[Laughter.]

One thing I would like to focus on, because I think I have been affected by it a bit, is what I call the lock-in effect or the bait and switch. It goes something like this. You start an index fund or a bond fund, with, say, a management fee of around 20 basis points. You go out and market it effectively. You get $100 billion. And then you raise the fee to 50 or 60 basis points. Now, with a certain amount of inertia, you can be collecting the 50 or 60 basis points on the $100 billion of assets because people thought it was a good idea when they originally invested, and they do not bother to check that the fees are doubled or tripled. But there is another lock-in effect, and that is, if this is a bond fund or an index fund and the value has gone up, then no sane investor, unless they view themselves as immortal, is going to recognize a huge amount of capital gain income just so that they can invest in one of the fine funds represented here, and get out of this bait-and-switch fund. That is because you are going to be paying a huge fund just to avoid paying an extra 20 or 30 basis points a year until that great step up in basis that occurs at the termination of all of us.

So is there anything that—and I have oversimplified what I think has happened to a small part of my personal portfolio—is there anything that prevents this ruse from happening—marketing a fund at 20 basis points, and then after you have got a whole lot of cash in the fund, doubling or tripling the fee?

Mr. HAAGA. I think what you are referring to—well, the truth is, there are two ways the fees could go up. One is, as I discussed in my oral testimony—

Mr. SHERMAN. Let me add one more element to this. The way they marketed the fund is they said, because the manager is currently waiving so much of the fee, the fund in its first year only paid a fee of 20 basis points.

Mr. HAAGA. And they had to tell you what the return would have been had they not waived the fee.

Mr. SHERMAN. Right. That is a bit of a warning to anyone who has been through this process at least once.

Mr. HAAGA. Right. And as I told you, if you bought our tax exempt fund of California, it would not have happened.

Mr. SHERMAN. But is there any rule that says you cannot wake up one day, having marketed a fund as the low-cost California tax exempt bond fund, and change it to the 70 basis point a year California tax exempt bond fund.

Mr. BOGLE. There is no such law. It is cast in the light of the marketing spirit of this great business, and that is, we are going to do a nice thing; we have a 1 percent fee, and we are going to waive three-quarters of it for you. Money market funds have done this. I think over half of the money market funds will move to wave fees when their yields go down. They do not tell you when they do it. They do not tell you when they put the fee back on. It is just wrong.

Mr. SHERMAN. What if you did not even do the fee waiver. What if the official fee for 2003 is 20 basis points, and then in 2005, the official fee goes up to 50 basis points?

Mr. HAAGA. That would require a vote of the board and a vote of shareholders, so you would have gotten a proxy saying, do you

want to do this or not, and some fee increases have been turned down by shareholders and many by boards.

Mr. SHERMAN. So an increase in the management fee requires a vote of the shareholders.

Mr. HAAGA. Correct.

Mr. SHERMAN. So this fee being waived, that is a bit of a warning that that fee may not be waived in the future.

Mr. HAAGA. Correct.

Mr. RIEPE. There is a table right in the front of the prospectus that the SEC requires. If you have waived a portion of the fees, and usually what gets waived first is the advisory fee, there is a cap on expenses. Over one-third of the mutual funds now tracked by Lipper have expense caps on them in one way or another. This speaks really to the competitiveness of costs.

Mr. SHERMAN. I would like to go on to the next question. The other thing that you folks have brought up is the idea of the roulette wheel and the incubator fund. It would go something like this. Let's say you were going to start a low cap fund. You do not start one small low cap fund; you start three. One invests exclusively in corporations whose name begins with A. Another one invests exclusively in companies named with B; the third exclusively in companies with names starting with C. You do not even have to identify it. You just have that as a policy. Then at the end of a year, the A fund is in the tank; the B fund is under-performing; and the C fund tripled its money—not because of any brilliant idea; it just happened that low cap companies with the C beginning their name did very well. And then of course you advertise the hell out of the C fund.

Would we benefit from a rule that said that when you go out and advertise that C fund and its 300 percent rate of return, that you also have to disclose the rate of return on a weighted average basis of all funds in the same category managed by the same company and its affiliates, so that you would disclose not only the 300 percent rate of return of the Hasbro C fund, but you would disclose the negative 2 percent rate of return of all low cap funds administered by Hasbro.

Mr. GENSLER. Mr. Sherman, you hit upon a very interesting problem, not only incubator funds, which are legal and will continue to be legal—that is the roulette wheel.

Mr. SHERMAN. And as you pointed out, you could enhance the C fund by getting a good IPO into it.

Mr. GENSLER. That may be a little bit beyond what is good, healthy competition. But I think it does come back—your suggestion is a variation, maybe it is a stronger one—of my suggestion. It is just simply so that fund families can be seen in their full glory. Some will do better than others, but that they do not ignore the closed-down fund or that so many funds, about 5 percent a year go out of business. They aggregate all that performance data and at least have it on their Web sites so financial planners can get that information.

Mr. SHERMAN. But if I want to invest in a low cap fund, I do not care that Paul has done very well with bonds. I want to know how well his company has done with low cap funds. It does not do me any good to find out that all of the funds he has managed have a

rate of return of 6.2 percent. I mean, he could be a euro-bond fund for which he is responsible.

Mr. GENSLER. You raise a very good observation, and it may well be helpful to have it broken down by major categories. I do not know.

Mr. SHERMAN. Because otherwise this works perfectly well. If I start 10 incubator funds, I guarantee one will do very well.

Mr. HAAGA. It works perfectly well, but the one you described involving the IPOs that I think Jack Bogle said was a fraud was the subject of an SEC enforcement action. That is why we know about it. So I think the egregious case is taken care of.

There is a great deal of analysis and information out there in the Lipper and Morningstar and other things about fund families investment results. So there is a lot to know, plus of course the results of all our other funds are fully disclosed and fully advertised. So I think there is a lot to know there that even if it is, you know, you are hypothesizing that these funds could get buried, they are out there in the fund family data and they are out there in the historical data.

Mr. SHERMAN. I think it might be helpful, though, to have—I mean, it is nice to say that if you just know where to go in some Lipper chart somewhere on the Web, that the investor is protected. We need to explore what things should be in the prospectus, and perhaps the rate of return of all funds in the same sector administered by the same management team ought to be disclosed. Otherwise, the system I just—I realize enhancing the system I just described by throwing in IPOs, that gets you investigated by the SEC. But just starting three incubator funds and then advertising the one that does well, while the other two do poorly, it is not enough to just say ″aha, ″ but those who look at the Lipper report are going to be saved from being misled.

Mr. HAAGA. You also ought to remember that funds close for a number of reasons. We started our first global investing fund and the interest equalization tax came in and we closed it. So there are changes.

Mr. SHERMAN. I think my first hour has expired.

Chairman BAKER. I just learned that we may be having some votes here in a bit, and there are other members who have been here for a while. If we can, I will come back for a second round.

Mr. SHERMAN. I just want to bring up one other thing, and that is I think it is important to disclose this whole soft dollar thing, but I am not sure that those advocating such a disclosure have been able to tell us how to do it in a way that is not avoided. What I have seen in another arena trying to prevent or quash or disclose soft dollars is sometimes you just drive things underground. One of the things—maybe you can reply in writing to this, because we do need to go on to other members—is the fact that you are dealing not with brokers, but with broker-dealers. Thus, if we say you have to disclose commissions, what about markups? I would hope that the advocates for the disclosure of either what you are paying in brokerage fees or what you are getting in free services beyond execution, that those advocates would tell us exactly not only how we are going to disclose this, but how does it get disclosed if firms react to the disclosure rules, and for example, instead of buying

bonds on the market that have already been out there with a brokerage fee, simply buy new issues and can report a zero brokerage fee. There is a spread for some, a brokerage fee for others, and I look forward to seeing in writing your response to that.

I yield back.

Chairman BAKER. Thank you, Mr. Sherman.

Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Baker.

Over the weekend, Mr. Haaga, I received a couple of things that you might be familiar with. I got this little lovely piece in the mail. I do not know if you can see it or not. You probably can see this one a little bit better. You might recognize that.

Mr. HAAGA. Yes.

Mr. TIBERI. It is an Investment Company of America, but this weekend I did. My question to you is this—congratulations, by the way, on your election to the board. I think I voted for you.

Mr. HAAGA. Thank you.

Mrs. KELLY. Would the gentleman yield?

Mr. TIBERI. Yes.

Mrs. KELLY. What is going on here between the two of you? Is he a constituent of yours, sir?

Mr. TIBERI. No. The chairman of the board issue came up earlier, and the chairman of the board for Investment Company of America is a gentleman by the name of Michael Shanahan, who is also the chairman of the management company. As a shareholder, can you tell me why that is an okay thing or a good thing?

Mr. HAAGA. I think if you look at the rest of the list, you will see that we have over two-thirds of the directors are outside directors. The act of chairing the board involves putting together the agenda; it involves putting together the materials, et cetera. I do not think, in fact I know in his case, and it is certainly not in my case, it does not involve dominating the meeting.

I would also add, and I did not get to add it before, so I would like to add it now, that we have separate meetings of only the independent directors in connection with reviewing our performance and our contracts. We even have executive sessions there. In those cases, the chair of the contracts committee chairs those meetings. So we do have a chairing role and a chairing function being performed by the outside directors.

Mr. TIBERI. So you would argue that we would not—as a shareholder I should not be concerned about that potential.

Mr. HAAGA. I would argue that the specific designation of Mr. Shanahan as chairman of the board does not impede in any way the independent activity and operation of our outside directors.

Mr. TIBERI. Just following up on the question Mr. Sherman had with respect to broker-dealers, there is something called revenue payments that are sometimes paid to broker-dealers. Do you believe that fund managers like yourselves should disclose to investors what those payments are?

Mr. HAAGA. The short answer is yes. The longer answer is, where and how much and to whom. I do not call them revenue sharing. I call them expense sharing.

Mr. TIBERI. Okay.

Mr. HAAGA. Because that is a lot of what is going on. For example, we have computers on the desks of broker-dealers that they use to forward trades to us. They have information systems that we put out information to them, and educational sessions, and we split the cost with them. I do not know whether that is revenue. It looks a lot like expense to me. So the question is disclose what and to whom. We have worked hard at the ICI, and when I chaired the NASD investment companies committee, on finding ways to do that.

I think the issue would arise with what is called revenue sharing if a substantial amount of the payments actually made it to the selling broker, the one who was making the recommendation to choose one fund versus the other. They generally do not. They do not get out to the selling broker. They are made to the management company.

I also think it is important to note that a lot of them are not based on assets or sales. They are actually fixed-dollar amounts, where we are paying for some service or the cost of some facility that in effect both of us share. So I would like to find a way to disclose it. The devil is in the details of figuring out how to do it. I think if there were concerns, the fraud would be if there were huge amounts of money paid to sellers, either the firms or the individuals, to favor one fund over another, and that was how they were selecting the funds to be included in their group of sales. What happens is that they request fees at a certain level for all funds, and then all funds participate in paying them, so there is no skewing of the recommendations based on the amounts that are being paid.

Mr. TIBERI. One of the devils in the detail is also directed commissions that a lot of these revenue sharing agreements have, that the brokerage has. It says that we will give you good shelf space in our supermarket if you also have the funds direct commissions—20, 25 percent of your total commission dollars back to our trading floors. Those arrangements I think are one of the devils in the detail that hopefully could be added to this.

Mr. HAAGA. What he described is prohibited by an NASD rule, in plain English.

Mr. WAGNER. I would like to point out the AIMR has approached this four or five years ago and come up with soft dollar standards that probably need to be updated, but at least form a starting point.

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. The gentleman yields back.

Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Chairman.

First of all, I want to commend you for holding this hearing. Ninety-five million Americans hold mutual funds, and I think it is important that these retirees or investors do not pay excessive mutual fees, and that if they pay hidden costs associated—well, that they really should not pay hidden costs associated with those mutual funds without knowing it.

As you know, U.S. fund fees appear to be lower than the vast majority of the funds in other nations, and there is strong evidence recently that there has been more fee-based competition. This

being said, unfortunately academic studies have shown that many funds have experienced an economy of scale, and that they are not passing those savings on to the shareholders. In addition, these same studies have noted that shareholder insensitivity to costs may rest with widespread investor ignorance about the various shareholder charges. In other words, they are not opposed to them because they do not know about them, and that is despite a request by the Securities Exchange Commission to get the mutual fund industry to properly disclose their fees.

With that background, I would like to start with Mr. Gensler, and I would like to pose this question to you. Mr. Montgomery states that the practice of soft dollar commissions is one of the worst examples of undisclosed conflicts of interest in the mutual fund industry. What is the conflict and how does it affect fund shareholders?

Mr. GENSLER. There is a conflict, and I think it is a good question. Think of three parties—the investor, for this case it could be me; the fund company, if that is all right, if that is the chairman, just for a moment; and if you, sir, could be the brokerage house. What happens in soft dollars is that I pay you a commission—five cents a share, as Mr. Montgomery showed earlier—and part of that is a barter transaction. Part of it is that you are going to provide some services for Mr. Baker's fund company. In providing those services, it could be real estate; it could be data services; it could be a host of those—was it 1,200 services that was on that list. Barter is fine and it goes on in America. It is part of our commercial world.

But here in this situation, there are three parties. I am paying you, the investor or fund company is paying you, the broker, five cents a share and you are picking up Chairman Baker's real estate or some other expenditures. That is where the conflict is, because it is not either disclosed to me in my fees. I do not see it in that management fee, so the shortest thing would be just add it to management fees. You could say that barter arrangement should be added to management fees, or go further and actually ban it because there is this inherent conflict that Chairman Baker is going to make more profits, and I am going to make less due to our barter arrangement.

Mr. BACHUS. All right. Let me go to Mr. Montgomery and ask you the same question. We are talking about soft dollar commissions. What is the conflict and how does it affect fund shareholders?

Mr. MONTGOMERY. The conflict is that I have a choice as a participant in the mutual fund industry or in the larger investment community, when I have clients who do pay commissions and all people working through a brokerage house are going to pay commissions, so that is fine. But I have a choice when I go to pay for my Bloomberg terminal for the services of Mr. Wagner here, for many things, of paying out of our own advisory fee and profit—and by the way, research is one of the biggest ones of those—so I can pay for it out of our own profits, which you could say come from the management fee. Or I can pay for it with soft dollar commissions, which means it is a cost borne by the fund, but does not affect my own advisory fee expense structure.

So which am I going to do? One flows directly through to my bottom line, and a dollar of expense there comes directly out of my profit. Or I can pay for it with commissions, which does affect our overall performance of the fund, but does not—

Mr. BACHUS. And not even reveal that you had to spend that.

Mr. MONTGOMERY. And that is key, and not even have to reveal it. Nobody is going to see it; nobody is going to ask about it. There are rules. The SEC in their examination when they come in are going to be all over it. So it is not like no one is looking. I promise you, during the examination the SEC is all over this issue.

However, what are the incentives on my part to control those costs? They are not good. The incentive is very clearly—even if I have a 25 percent profit margin, I have four times the incentive to push it off on my shareholders as opposed to eat it myself. The only reason we do not do it at Bridgeway is it is a conflict of interest you cannot take care of, and we argue even by disclosure. It is too great a conflict of interest. Just do away with it.

Mr. BACHUS. Let me ask Mr. Bogle.

Mr. BOGLE. The same question?

Mr. BACHUS. Same question.

Mr. BOGLE. I could not give an answer any better than John Montgomery's. There is a definite conflict there, and I am not sure disclosure vitiates it, but an awful lot of research is paid for, and particular research is paid for through these soft dollars. It is interesting that mutual funds themselves, out of this $75 billion of revenues that I estimate that they got last year—it is very fair estimate—probably spend about $4 billion on their own research. All the rest of it is paid for by the soft dollars with which they could otherwise improve the returns of their clients. So it is a definite conflict.

Mr. BACHUS. Okay. Let me move to a second question, and this is for the whole panel. Should soft dollar commissions be banned in the mutual fund industry? Or short of banning the practice, what should regulators do to better protect the interest of fund investors? We will just start with Mr. Bogle.

Mr. BOGLE. I would say soft dollars create great problems, but I would suggest that we should do away with them in the entire system, and not just with respect to the mutual fund industry. The abuse, believe it or not, may be worse outside of the mutual fund industry than it is within it. We should be when we execute a transaction, we should pay for the execution. As one of the charts you saw earlier, we are paying for three or four times that with other people's money.

Mr. BACHUS. So you say prohibit it.

Mr. BOGLE. Prohibit it.

Mr. BACHUS. Okay.

Mr. WAGNER. The miner's commission in the UK actually recommended this, and that is certainly being experimented with over there, so we will have some evidence on that fairly quickly here. I think that, yes, they could go underground, as Mr. Sherman suggested earlier, that they could go into unbilled category of services that are available from the brokerage firms. So it may not solve the problem. I would opt for disclosure—what is being spent, to whom and what is being received for that payment.

Mr. BACHUS. Mr. Montgomery?

Mr. MONTGOMERY. I am in the banning category, and I think it is just an awful lot more efficient just to kill it. The costs that go into, as a mutual fund company, whether it is the adviser or the fund itself, of the regulators coming into look over the shoulders of it. It is kind of like the worst part of the tax system, with layer upon layer upon layer of loophole and exceptions. We spend a tremendous amount of money just trying to measure it and make sure that it is fair. Even if we were absolutely honorable, have integrity and want to do a good job, and maybe even disclose it—maybe somebody voluntarily discloses it—it is still a tremendous effort and cost that somebody has to pay to measure it, and I think that is inappropriate.

Mr. BACHUS. Mr. Bradley?

Mr. BRADLEY. I have a couple of comments that I would like to frame. One would be that it is already underground. So the fear that this would go underground, it is there. The reason it is there is that in 1997, the SEC did a soft dollar sweep and investigation of broker-dealers and looked at these bills they pay, because that is the only audit trial. Two-thirds of the documents at that time were unreported, undocumented. In my earlier testimony, I stated that what we heard from our accountants is, if they were documented it would create an income and expense item on a fund management company's income statement, potentially.

I think that I would be more in favor though, and I answered a similar question earlier, that we should really go back and revisit your law, section 28(e), and through rulemaking define specifically what ″paying up″ means; gather the execution-only rate from firms so that we can quantify what they pay above that execution-only rate; and then put the burden on fund companies to show their management company through quantifiable results, the value returned to investors.

Mr. BACHUS. Mr. Bogle?

Mr. BOGLE. I apologize, Mr. Bachus, for interrupting you. I was trying to make the following point. We are talking about abuses. I think it is important to note that when the SEC did their sweep a couple of years ago and found abuses, the only people that they found doing that were investment advisers, not the mutual funds. No mutual fund managers were caught up in that. We are throwing the term around back and forth about investment advisers doing that. Those were investment advisers to individuals who were being caught with the abuses.

I guess in terms of what to do about—you asked the specific question of should we ban soft dollars—and some people answered we should ban it. I think you need to define it first. I will not get into it here, but soft dollars includes a lot of things that may not be wrong. The kinds of abuses that Harold is talking about should be curtailed either through SEC regulation or legislation—probably SEC regulation.

Mr. BACHUS. And what are some of the areas that you think are particularly abusive?

Mr. BOGLE. In Harold's case, I think that the ones he mentioned—that long list of things you could pay for. When I was in private practice before 1985, I used to advise some companies

about interpretations of section 28(e). I once had a portfolio manager assert to me that if a light bulb shined on a guy doing research, that light bulb should be paid for out of soft dollars because it was research. You can imagine where that extends. There is just no stop to it.

Mr. BACHUS. So research is an area of abuse?

Mr. BOGLE. Research ought to have some intellectual content. That is what is permitted under 28(e), and the abuse is that people have taken research—you and I know what research is; it has an intellectual content to it; it is a study—and they extended it out to the light bulbs and the club membership for the guys who do the research because they need to relax after they have studied their prospectuses and things like that. That is where the abuses are. I would not mind getting rid of those abuses, but simply calling it soft dollars or simply repealing 28(e) would not do it. There is something going on that should not be going on, I will agree with that.

Mr. BACHUS. And Mr. Gensler, I think you made—

Mr. GENSLER. Even if that is at the risk of Chairman Baker losing the soft dollars in my earlier example, I would probably be on the side of banning it, or short of that, significantly curtailing it and disclosing the remaining portion.

Mr. BACHUS. Okay.

Mr. RIEPE. Let me just say three things. One, I want to be on the record as agreeing with Mr. Bogle on something. Specifically, as Chairman Baker pointed out at the beginning in his opening remarks, mutual funds represent only about 20 percent of the equity market. As Jack pointed out, the soft dollar issue is not unique to funds. Some of the major pension plans in the country use commissions that are generated from their business, and direct advisers like us to pay certain expenses that those pension plan sponsors have incurred, presumably for the benefits of the participants in those plans. So this is not a mutual fund-specific problem.

Secondly, I think, as Paul Haaga noted, the fund industry and the SEC have been doing a good job of managing it by examination and disclosure; but I do not think that is adequate, obviously, in terms of some of the abuses.

And thirdly, a specific recommendation is that I think the SEC could be asked to go back and answer that question and have the time and the resources to delve into some of the nuances of it that Mr. Haaga was referring to, and come back with a recommendation on it. I will tell you that we can live with whatever that recommendation is, and if it is a complete ban of directed commissions, then fine. If it is something else, then that is fine as well.

Chairman BAKER. Mr. Bachus, it is my intent, based on what has preceded us here today, to have a letter to the SEC probably next week, outlining a series of issues for resolution, one of which would include the soft money question. I just make the announcement for members' interest. If they want to sign onto that letter, just let us know. But I have spoken to Mr. Kanjorski and he wishes to participate in the letter as well. So it is bipartisan and it is merely to get some factual determinations and also some definition in the case of soft money, and in a recommendation with regard to that definition. So we will do that.

Mr. BACHUS. Can you note, as several gentlemen have said, this is not confined to the mutual fund industry.

Chairman BAKER. It is larger. Yes, sir.

If I may, let me recognize Mr. Castle. If we go to Mr. Castle, we can get everybody done before we have to leave for this vote.

Mr. CASTLE. Thank you, Mr. Chairman. I appreciate being recognized and I apologize for being out of the room during the question-answer, but I heard each of your testimony before I left. Let me just say, I am an admirer of almost all of you, and I agree with virtually everything that you said. I think you are the cream of the crop. We went down about two or three more panels and start to get into some of the more dubious areas of mutual funds and what has happened.

I am just going to put together one question, and again I apologize if some of this has been asked before, and then ask a couple of you to answer, and then open it up to all of you. I believe in consumer knowledge, and I believe the American public is a heck of a lot smarter than often given credit for, and the American consumer is, too, if they know what they are looking at. I think it is very hard, frankly, when you look at mutual funds to know what you are looking at. With all due respect to Vanguard's ads about lower costs and saving more money and everything else, I just think it is very hard to figure this out.

So I have a couple of thoughts, and I do not know if this has been asked before or not, but on the whole regulatory board question, should there be a separate regulatory board for mutual funds? It is a huge industry at this point. Or is that not a good idea, because it becomes a captive board, as so many others do, and perhaps it is better to be left in the SEC.

Another question I have is, what else could Congress do? Talking about it here is great, and there are a couple of TV cameras, but I have a hunch it is not going to lead the news tonight and people are not going to know a heck of a lot more after today. Perhaps we do, but a lot of other people will not. I think we need to get that information out. So what else could the government do in terms of regulations, laws, whatever it may be? What do you think about the SEC? Any ideas you have of getting the word out? I agree with the problems you stated. What is our strategy to try to correct these things?

I would like to start with Mr. Gensler because he has some experience in that. And I would like Mr. Bogle to answer this just because he is Mr. Bogle, and I think he does have the temerity of Warren Buffett. I disagree with what he said earlier. And I would then open it up to anybody else who wants to take a step at it.

Mr. GENSLER. Congressman, it is very good to see you again, by the way.

I think that the SEC has put forth what is called a concept release on a possible new regulatory structure in this area. With that, they raise some very thoughtful questions, particularly internal compliance officers and how to address compliance issues at mutual funds.

In terms of regulatory structure, I find myself torn. The SEC, as best I can tell, has the authority to do that which they need to do. So it may well be a funding issue that they want to devolve this

to what they call a self-regulatory organization, with the hopes of assessing fees so that they do not have to go through the annual appropriations dance that every agency must and under our constitution ought to go through. So I find myself feeling there are a lot of tough issues here; a lot of issues that could hopefully be dealt with around fund governance, and maybe some marginal additional disclosure. But in terms of the regulatory structure, I think at the core what the SEC is grappling with is probably more a funding issue, and to devolve it to something just to assess fees does not seem like their case has yet been made.

Mr. CASTLE. Mr. Bogle?

Mr. BOGLE. Yes, sir. Thank you, Congressman Castle.

I would like to put this in a little broader context. It is very clear that in corporate America we have moved from an era of owners' capitalism to managers' capitalism, where companies are run in the interests of their managers, rather than their owners. We have to get back to our roots. That is a long and complicated job.

The mutual fund industry really never has had an era of owners' capitalism. In its first 25 or 30 years it had a fiduciary-type orientation. That is why fees were so much lower. The average equity fund fee back in, say, 1951, was less than half of what it is today. Then, the fiduciaries took the place of the fund owners, who are large and disorganized, small investors and so on. But just like corporate America, we have moved into an era of managers capitalism in the mutual fund business.

Managers make a lot of money in this business. I am reminded of Upton Sinclair's comment that it is amazing how difficult it is for a man to understand something if he is paid a huge salary not to understand it. That is really true. It is a universal rule of life. How do we get back to our industry's fiduciary roots? Well, we start off, I would say, by much better disclosure—in shareholders' statements, yes, the amount they pay; in annual reports with a dedicated page on the first or second page showing the fund's returns relative to its costs, turnover costs, turnover, dollar amount of fees—things like that, every fund has to show on one of the first two pages; and other disclosure issues that we have talked about today.

Next, I think there is something we can do to improve the structural imbalance between the rights of fund shareholders as manifested through their fiduciary boards of directors and the rights of the managers. That is, strengthen the board. The 1940 Act calls for that implicitly. One thing you can do, and should do, is have an independent chairman of the board, just like we are calling for in corporate America, because in both cases the manager as chief executive has too much power. Another improvement would be a larger number of independent directors. Finally, I think, and I am not a lawyer here, which may make this better or worse, is a federal standard of fiduciary duty for mutual fund directors. That would open up a lot of opportunities to have the fund owners served properly and fairly.

Mr. CASTLE. Thank you, Mr. Bogle. Unfortunately, we are going to have to cut it off. I am interested in the question. If any of you have a written answer you would like to submit on that—the whole

issue of what can the government be doing to help resolve some of the problems which we have discussed here today.

With that, I yield back to the Chairman.

Chairman BAKER. Thank you, Mr. Castle.

There is one further question I had. Mr. Haaga, does the ICI have a formal position with regard to the SEC proposal now pending with regard to disclosure of proxy voting?

Mr. HAAGA. The proposal has been adopted. Our position was—and I am glad you asked that, because we get characterized as being against it. There were a number of parts of that proposal, and we agreed with most of them—all but one of them. We even suggested a more rigorous alternative to another one of them, which is to include the independent directors to oversee potential conflicts. The only part with which we disagreed was that of sharing the individual proxy votes with, in the original proposal it was anybody who asked in paper. Now, we are gratified that we can put it up on our Web site or the SEC's Web site.

Chairman BAKER. And with that modification, does that—

Mr. HAAGA. It has been adopted and we will live with it.

Chairman BAKER. I know the SEC has adopted it, but the OMB is in the process of promulgation, I believe, so it is not effective.

Mr. HAAGA. Right.

Chairman BAKER. I just wanted to clarify the industry position.

Mr. HAAGA. Well, the industry, of course, we will live with it. We want to make sure that the OMB and the SEC properly take into account, costs. This was adopted in a great hurry, and I think there was not, frankly, an adequate analysis of the potential costs. If they do an analysis of the potential costs and they adopt it, we will comply with it, as always.

Chairman BAKER. Let me express to you and all the panelists today my appreciation for your longstanding patience. This was a lengthy hearing, but I think it provided members with a much better insight into the areas that are performing properly; into those areas where perhaps we need to make some enhancements. To that end, I have conferred with Mr. Kanjorski and Members, as I said repeatedly, we will get a letter out to the SEC to try to get professional resolution of making that statement. So all parties who are interested can make appropriate comment. And then we would, at some future time, return to this subject to try to bring some closure.

I think the most important asset of the hearing, as Mr. Haaga indicated in his opening statement this morning, was that we want to bring about consumer confidence that capital markets are efficient, transparent, and most importantly, responsive to shareholders. That is our goal, and we will work diligently toward that end, and I appreciate your courtesies in helping the committee get there. Thank you.

Our meeting is adjourned.

[Whereupon, at 1:34 p.m., the subcommittee was adjourned.]

A P P E N D I X

March 12, 2003

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

"Mutual Fund Industry Practices and Their Effect on Individual Investors"
March 12, 2003

Thank you, Chairman Baker, for holding this important and timely hearing. This morning, we will discuss the state of the mutual fund business. Our inquiry is simple: are investors getting a fair shake?

At last count, there were 95 million mutual fund investors in the United States. For most Americans, mutual funds are the primary vehicle for accessing the capital markets and building wealth.

The rapid growth in fund ownership over the past 20 years is unquestionably a positive development. Mutual funds provide the opportunity to invest small sums of money in return for a diversified investment in stocks, bonds, and other securities.

Selecting a suitable fund can be a challenge for many investors. Some funds buy large-capitalization stocks, others buy small or mid-caps. Some buy foreign companies, or corporate or municipal bonds. Still other funds invest entirely in one sector of the economy. There are multiple classes of shares, different investment styles, and so on. Add to this the fact that there are now almost 5,000 stock mutual funds.

All of these funds are competing for investor dollars. While there is clearly competition in the fund industry, some question whether it is working the way it does in other industries. That is to say, are costs going down for investors?

Recent data indicate that the answer is "no." Fees and expenses, in fact, are going up, and this despite the efficiencies created by these enormous economies of scale. And while investors have become sensitive to certain fees like sales loads, other fees are either hidden or opaque, escaping the attention of even savvy fund investors. This precludes them from "comparison shopping," a strong market influence that would encourage fee-based competition and would likely bring down costs.

What are investors getting in return for these increasing costs? The evidence is troubling. Noted financial commentator Jim Glassman has said "what is truly remarkable is that hundreds of funds do worse than the rules of chance would seem to allow." He adds that the low-cost Vanguard 500 Index fund has "beaten 76 percent of its managed-fund peers over the past 10 years," according to Morningstar.

Even worse, the NASD and SEC have recently discovered widespread evidence that fund investors are not even receiving the discounts on sales loads that funds promised in their prospectuses. While preliminary reports indicate this failure to provide "breakpoint" discounts does not appear to be the result of fraudulent behavior, one commentator is reported as attributing the problem to "laziness or sloppiness." That is simply unacceptable. I am pleased that the regulators are acting quickly, I urge them and fund directors to take steps immediately to repair this breakdown and to make investors whole.

Along with rising fees that are often hidden or not easily understood, and chronic underperformance, this Committee intends to examine the role of mutual funds in corporate governance. Last year, Congress passed the Sarbanes-Oxley Act, in an effort to help rebuild investor confidence in public companies. New, and mostly sensible, regulations have been enacted for accountants, corporate executives and directors, investment bankers, research analysts, and attorneys.

Until very recently, though, mutual funds have not been the focus of regulators and lawmakers, despite the fact that funds own about 20 percent of U.S. equities. The voting power represented by these securities carries great potential to influence U.S. corporate governance. Whether mutual funds have used their powerful position to do so is an important question that merits attention.

Another important issue to this Committee concerns the role of independent fund directors. Are they looking out for the best interests of shareholders in the fund, as is their fiduciary duty? At least one prominent investor emphatically says no. In his recent letter to Berkshire Hathaway shareholders, Warren Buffett said that fund directors had an "absolutely pathetic" record, particularly with regard to removing underperforming portfolio managers and lowering fees charged to investors.

Some have asked, where were directors during the frenzied creation of a multitude of tech funds during the bubble of the 90s that left so many investors holding the bag? An article in yesterday's Wall Street Journal observed that during the tech bubble, stewardship often gave way to salesmanship – borrowing a phrase from one of our distinguished witnesses here today, Vanguard founder Jack Bogle.

In recent months, the SEC has acted on a number of important mutual fund initiatives – often in the face of fierce industry opposition, I might add. Last December, the Commission issued a proposed rule that would enhance portfolio disclosure and help clarify fund fees. The Commission also recently required funds to disclose both their proxy voting policies and procedures and their actual proxy votes. These are good steps, but more needs to be done. I have the utmost confidence that we can count on Chairman Donaldson to continue Harvey Pitt's fine work on behalf of fund investors.

I look forward to hearing the testimony of this distinguished panel, and yield back the balance of my time.

###

STATEMENT OF THE HONORABLE
Wm. Lacy Clay
Before
The Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Mutual Fund Industry Practices and Their Effect on Individual Investors"

March 12, 2003

Mr. Chairman, I commend you for holding this hearing. There are in excess of 95 million individuals who own mutual funds in the United States. This represents nearly half of all households in the country. The majority of these households are in the working, middle class of the population, and over 30% of the total households have their mutual funds in retirement plans. Since such a broad spectrum of the population is affected by the issues relating to these funds with cost considered to be among those having the most impact, transparency is necessary.

Transaction costs are the largest expense to the investor in the mutual fund market. Often times these costs have exceeded the profits of the investor. These figures are almost never disclosed and are regarded as the "routine cost of during business." Congress and the SEC have many times provided direction to lower costs in the market.

Transaction costs are not the only costs: there are sales charges, management fees, expense ratios and other charges that are applied without transparency. Investment returns seem at times to be the least of the concerns of the industry. They are not the least of the concerns of the investor.

We must have cost information that is shared by the investor so that reasonable decisions can be made in regard to their investments. The better the investing public is informed about mutual fund costs; the likelihood is that prices will stabilize as investors know the true value of the funds.

Mr. Chairman I ask unanimous consent to submit my statement to the record.

March 12, 2003

Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

I would like to thank Chairman Baker for holding this important hearing on mutual fund industry practices and their effect on individual investors. I also appreciate that our distinguished guests have taken the time to share their views with us on these topics.

As a former investment banker, I am quite familiar with the issues we will cover today. I am very interested in the results of the GAO report that will be released in April 2003 regarding current trends in mutual fund advisory fees and 12(b)(1) fees. I am also pleased to see that the SEC has proposed a new rule requiring mutual funds to more precisely disclose expenses, holdings and performance in shareholder reports. The fundamental goal of these efforts should be to provide investors with the relevant information they need to make informed decisions.

The corporate scandals that led to the Sarbanes-Oxley Act taught us that the integrity of the capital markets depends on investors receiving accurate, timely, and transparent information. Many individual investors and pension funds in my home state of Illinois lost millions of dollars due to the Enron and WorldCom collapses. Illinois' pension funds estimate that they lost more than $107 million because of the drop in the value of WorldCom stock after accounting irregularities were exposed. This was on top of the $45 million these pensions lost in the Enron collapse. For example, the Illinois State University Retirement System and Teachers' Retirement System, which invest retirement monies on behalf of hard-working teachers and municipal employees, suffered massive losses as a result of these corporate meltdowns. As a result, they are now understandably reluctant to invest their hard-earned dollars in stocks or mutual funds. Additional transparency in the mutual fund industry will go a long way to helping investors regain confidence in the markets.

Among the issues being evaluated by the GAO are whether funds' expense ratios are too high and whether trading commissions and broker incentives should be included in the calculation of expense ratios. According to Morningstar, the average mutual fund expense ratio has risen from 1.23% to 1.28% since 1999. Small percentage changes in such fees reduce investors' returns over time. The expense ratio, which is the percentage of a mutual funds' assets that are used to pay portfolio management fees and operating expenses, is perhaps the most essential piece of information for investors. Because it shows investors the overall costs of investing in a fund, it must be comprehensive and accurate. As mutual funds are not currently required to include all of their actual costs in the calculation of expense ratios, the numbers may be misleading to investors. I would

like to hear from today's witnesses about why fees have been rising at the same time returns have been falling. It would also be helpful to hear the opinions of the industry representatives here today regarding greater expense ratio transparency.

Another issue I hope today's witnesses will address is the integrity of mutual fund boards of directors. Berkshire Hathaway Chairman Warren Buffet recently described mutual fund directors' performance as a "mockery of stewardship." As Mr. Buffet stated, mutual fund boards should be focused on two main tasks: hiring the best investment manager available and negotiating for lower fees on the shareholders' behalf. Yet, when it comes to either goal, Mr. Buffett describes directors' performance as "absolutely pathetic." Although mutual funds are required to have boards consisting of at least 50% "independent" directors, those directors do not always fulfill their responsibilities because they often lack the knowledge or desire to question fund managers' plans or performance.

Additional issues I would like addressed today are the prospect of creating a self-regulating organization to oversee the mutual fund business, the wisdom of mutual fund advertisements touting past performance, and the tendency of some funds to experience "style drift."

I look forward to working with my colleagues and the SEC on these critical matters, with the mutual goal of ensuring individual investors have accurate and transparent information in order to make informed decisions.

March 12, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "Mutual Fund Industry Practices and their Effect on Individual Investors"

Thank you, Mr. Chairman, for calling this important hearing and for your dedicated leadership along with that of our Full Committee Chairman, Mr. Oxley, on mutual fund industry disclosure practices and specifically the rights of individual shareholders.

Issues surrounding the disclosure practices within the Mutual Fund Industry have been of great interest to me throughout my career in Congress and specifically as sponsor of the "Mutual Fund Tax Awareness Act of 1999," HR 1089, during the 106th Congress. I was happy to work with the SEC on this issue and eventually see the Final Rule on Disclosure of Mutual Fund After-Tax Returns come into effect of April 16, 2001. Requiring the communication of this information to individual shareholders goes a long way in assisting with fund performance comparisons and enabling better informed investing decisions; however, I'm not convinced that it has gone far enough.

Specifically, today I would like to revisit a recommendation made by the General Accounting Office (GAO), that mutual funds be required to send fund shareholders account statements that include the dollar amount of the fund's fees that each investor has paid. I am concerned that the current Mutual Fund Fee Table provided to investors in fund prospectuses is often ignored and not presented in a meaningful format for the average mutual fund investor. Disclosure of expenses as a percentage of assets allows for better comparison among funds but it does not effectively communicate real costs.

As is stated in the Securities and Exchange Commission's (SEC) "Division of Investment Management: Report on Mutual Fund Fees and Expenses" from December 2000: "With respect to fund fees and expenses, we believe that investors need information, in addition to information about the dollar amount of fees, that helps them to understand the fees that they pay. Moreover, they need to be able to compare the fees of their fund to the fees of other funds and other types of investments. To satisfy these broader needs, we believe

that any additional required fee information, including the dollar amount of fees, should be provided in semi-annual and annual shareholder reports."

It is the case, as the GAO detailed in its report from June of 2000 to our full Committee Chairman in his previous capacity as Chairman of the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce, that "funds are not required to provide information on the actual dollar amount of each investor's share of the operating expenses that were deducted from the fund. This contrasts with most other financial products and services for which specific dollar charges are generally required to be disclosed."

Additionally, I would like to hear your comments on recommendations to improve disclosure of portfolio transaction costs to consumers. The cost of these expenses can be very significant and even exceed the amount of the fund's expense ratio; yet, these costs are not clearly presented to consumers. Mutual Funds disclose their commission costs in the Statement of Additional Information, but this document is not provided to shareholders unless they request it, and it is certainly not presented in a manner that can be easily used to compare portfolio transaction costs among funds.

I am considering legislation on these issues and would welcome your comments on improving shareholder understanding of, and accessibility to, this information.

Thank you again, Mr. Chairman, for you leadership in this area and I look forward to a thorough discussion of the issues I have presented.

Opening Statement
For
Congressman Rubén Hinojosa (TX-15)

Committee On Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Hearing on "Mutual Fund Industry Practices and Their Effective on Individual Investors"

March 12, 2003

Mr. Chairman and Mr. Ranking Member,

I want to thank you for calling this important hearing on the mutual fund industry. In the last two decades, mutual funds have brought our nation's capital markets to the American people. Presently, most working Americans participate in mutual funds as part of their retirement and savings plans. In fact, 95 million Americans now own shares in mutual funds.

For this reason, I feel that Congress must look into the practices of the mutual fund industry and ensure that American consumers are protected. Specifically, we must examine the soundness and practicality of fees charged to mutual fund shareholders. With the mutual fund industry surpassing the U.S. banking system in the number and volume of consumer deposits, now is an ideal time to take up this discussion. We must ensure that consumers get what they are paying for and that deceptive practices are not used to hide excess charges on these financial products.

Congress has a responsibility to look at mutual fund shareholder fees and annual operating expenses otherwise known as "12b-1" fees that make up fund expense ratios. I find it hard to believe that in most mutual funds a consumer could hypothetically invest $10,000 over 30 years in a fund that achieves gross returns of 11 percent, yield a return of $149,967, and have to pay $78,956 of this return in expense fees. That charge is extreme.

These charges are even more disconcerting when one realizes that consumers would probably make more money simply investing in index funds, mutual funds that do not have a specialized fund manager and simply index to the market. In the coming days, I hope that we have some serious discussions about this industry and how to achieve accountability and transparent disclosures.

However, I do commend the mutual fund industry for working to make our capital markets more accessible, and I look forward to today's testimony. I also look forward to the release of the GAO report Chairman Oxley and Chairman Baker have commissioned. Thank you Mr. Chairman. I yield back my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON MUTUAL FUND INDUSTRY PRACTICES AND THEIR EFFECT ON INDIVIDUAL INVESTORS

WEDNESDAY, MARCH 12, 2003

Mr. Chairman, thank you for the opportunity to offer my initial thoughts about mutual funds before we hear from our witnesses. I want each of them and you to know that I approach today's hearing and future discussions on mutual fund issues with an open mind.

As we begin our examination of mutual funds in the 108th Congress, I feel it is important to review some basic facts about this dynamic industry. According to the Securities and Exchange Commission, at the end of fiscal 2002, mutual funds managed $6.1 trillion in investments, significantly more than the $3.7 trillion deposited at commercial banks. Additionally, the SEC calculated that 93 million investors living in 54 million households owned mutual funds.

The mutual fund industry has also evolved dramatically in the last several decades. The number of mutual funds has grown from 564 in 1980 to nearly 8,300 today. In addition, assets in mutual fund portfolios totaled just $56 billion in 1978. By 1990, this figure increased to $1.1 trillion, and by the turn of the century mutual fund assets had expanded another sixfold. Today, mutual funds also represent about 20 percent of our nation's equities market. Without question, we can therefore conclude that mutual funds constitute a major sector of our nation's economy.

As the mutual fund industry has grown, it has worked to bring the benefits of securities ownership to millions of hardworking Americans. Many securities experts have noted that the typical investor would find it expensive and difficult to construct a portfolio as diversified as that of a mutual fund. I wholeheartedly agree. Mutual funds have clearly provided an economical way for middle-class Americans to obtain the same kind of professional management and investment diversification that was previously available only to large-scale institutions and wealthy investors. In short, mutual funds have worked to democratize investing.

Despite this tremendous success, securities experts continue to examine how we can improve the performance of the mutual fund industry and advance the interests of U.S. investors. Some recent public policy debates in this area have focused on disclosing proxy votes to mutual fund shareholders, modifying industry oversight through the creation of a self-regulatory organization, and increasing the frequency of mutual fund holdings disclosures. Although each of these issues is important, today we will generally focus our examinations on the cost of mutual fund ownership, an issue that many consider as the most consequential.

As you know, Mr. Chairman, I have made investor protection one of my top priorities for my work on this committee. Understanding the costs of operating a mutual fund and learning how such expenditures affect investing is, in my view, therefore very important. These fees and loads will, after all, have a significant effect on investor returns. A recent story in *USA Today*,

for example, determined that for government securities mutual funds, the group with the lowest expense ratios averaged a 41 percent gain over five years while those with the highest expense ratios grew by 34 percent during the same time frame. Small differences in annual fees will ultimately result in major differences in long-term returns.

During our deliberations today, I expect that we will hear many conflicting views on the issue of mutual fund fees. Some of our witnesses will cite studies showing that these expenses have increased in recent years, while other panelists will refer to analyses demonstrating a gradual decrease in such fees. Although each side in this debate will seek to use statistics to its advantage, our job should be to learn more about the industry today so that we can work to improve public policy in the future.

For my part, I hope that these experts will answer a number of questions that I have about mutual fund fees. I would like to determine whether investors have obtained the benefits of economies of scale as the size and scope of the mutual fund industry has grown. I also want to learn more about the calculation of 12b-1 fees, the use soft dollar arrangements, and the effects of portfolio transaction expenses.

In closing, Mr. Chairman, I look forward to hearing from our expert witnesses on these important issues. Mutual funds have successfully worked to help middle-income American families to save for an early retirement, higher education, and a new home. We need to ensure that this success continues. I therefore look forward to working with you to examine these other matters related to the mutual fund industry in the weeks and months ahead.

Statement of Congressman Bob Ney
Before the Capital Markets Subcommittee hearing on
"Mutual Fund Industry Practices and Their Effect on Individual Investors"

Thank you Mr. Chairman. I am pleased to be here for this important hearing. I think that ensuring investors are protected and have access to high quality information should always be a top priority of this committee.

There can be no doubt that mutual funds have been an important tool in the democratization of our capital markets. Investing in securities used to be the privilege of an elite few. Now, over 50% of US households invest in the markets. Mutual funds have been vital in giving investors access to our markets through a safe and affordable channel. Many Americans lack either the time or expertise to manage their own investments, so they trust mutual funds to do this for them.

Because of the increase in demand for safe investment vehicles the mutual fund industry has grown and become highly competitive. There are now over 600 firms offering over 8,000 different mutual funds. Investors currently have the ability to choose between a number of different types of funds, from indexed to actively managed, depending on their investment needs. Furthermore, due to the fierce competition in the fund industry, and the massive cash flow into funds, the cost to investors for participating in these funds has dropped dramatically. The GAO and SEC have reported that fees are declining, and an ICI study found that mutual fund fees have declined consistently over the years, 40% since 1980.

What we are here to determine today is whether or not the funds have done enough to provide investors with the information they need on what kinds of fees are being charged and how those affects investors returns. More importantly the question is

whether or not investors understand the fee structure of mutual funds, and if the fees are priced fairly. Currently there is a rigorous and highly regulated disclosure regime, with investors being able to look up mutual fund costs and fees in a number of different places, from the Internet to prospectuses. The question is, do we need to do more? We certainly must keep the needs of investors in mind as we proceed today as well as the need to maintain investor confidence. The goal of this review should be to build investor confidence in our markets - which remain the best regulated in the world - not to tear it down.

I want to again thank Chairman Baker for holding this hearing and being an active watchdog for our nation's investors. I look forward to hearing from our witnesses; it is certainly a distinguished panel.

Statement of John C. Bogle

Founder and Former Chief Executive of the Vanguard Group and
President of the Bogle Financial Markets Research Center

Before the U.S. House of Representatives
Sub-Committee on Capital Markets, Insurance and
Government Sponsored Enterprises of the
Committee on Financial Services
March 12, 2003

Summary

1. **Higher costs lead to lower investment returns—immediately in the case of money market funds, promptly in the case of bond funds, and over time in equity funds, irrespective of style and risk. Over the past twenty years, costs have deprived the average equity fund investor of nearly one-half of the stock market's return. Costs matter.**
2. **Over the years, the mutual fund industry has changed in many ways that have ill-served fund investors. With substantially rising expense ratios and portfolio turnover, the gap between equity fund returns and stock market returns has doubled.**
3. **Despite the industry's 114-fold increase in assets—from $56 billion in 1978 to $6.4 trillion in 2002—the huge economies of scale involved, and the addition of much lower cost bond and money market funds, the expense ratio of the average mutual fund during this period has risen from 0.91% to 1.36%, an increase of 49%. There is, however, at least one exception to this trend of rising costs. The expense ratio of the average Vanguard fund during the same period has declined 58%, from 0.62% to 0.26%.**
4. **Mutual fund costs include not only expense ratios, but sales charges, portfolio transaction costs and other expenses. In fact, expense ratios represent less than one-half of the all-in costs incurred by fund investors.**

5. Powerful evidence shows that, despite the staggering growth in mutual fund assets and huge economies of scale in fund operations, fund expense ratios have risen sharply over the years, meaning that the aggregate dollar amount of fees have risen even more rapidly than fund assets.
6. Given the impact of fund costs, their rise over the years, and the apparent near-obliviousness of investors to these factors, far better cost disclosure is required. Including information about the dollar amount of an investor's specific costs in shareholder statements is an important first step, and can be accomplished efficiently and economically.
7. Fund annual reports should prominently feature data showing fund returns, expense ratios, portfolio turnover, the costs of such turnover, and total expenses paid by the fund.
8. We have far too little solid information about the nature and extent, and sources and uses, of the expenses fund investors incur. It's high time for an economic study of the mutual fund industry.
9. Particularly in areas where relative cost is virtually the sole difference between success and failure (i.e. money market funds), disclosure of the costs that *managers* incur for each of the services they provide is essential.
10. Given the obvious success that true arms-length negotiation of advisory fees has enjoyed in the few instances where it is practiced, methods of providing such negotiations between funds and their advisers should be fostered. Increasing the participation of independent directors, providing them with their own staff, and requiring that the chairman of the fund's board be an independent director would all be constructive steps.

The better the investing public is informed about mutual fund costs, the more likely it is that these costs will at last be forced to return to reasonable levels and redress the inbalance between the interests of fund investors and the interests of fund managers. Giving fund boards true independence from the fund's adviser would be a major step forward.

Statement

I have been both a student of, and an active participant in, the mutual fund industry for more than half a century. My interest began with an article in the December 1949 issue of *Fortune* magazine that inspired me to write my Princeton University senior thesis ("The Economic Role of the Investment Company") on this subject. Upon graduation in 1951, I joined Wellington Management Company, one of the industry pioneers, and served as its chief executive from 1967 through January 1974. In September 1974, I founded the Vanguard Group of Investment Companies, heading the organization until February 1996, and remaining as senior chairman and director until January 2000. Since then I have served as president of Vanguard's Bogle Financial Markets Research Center.

Vanguard was created as a *mutual* organization, with its member mutual funds as the sole owners of the management company, Vanguard Group, Inc. The company operates the funds on an "at-cost" basis. Essentially, we treat our clients—the fund shareholders—as our owners, simply because they *are* our owners. We are the industry's only *mutual* mutual fund enterprise

Recognizing the simple mathematics of the financial markets is our stock in trade. If a market's annual return, for example, is 10% and the total cost of financial intermediation is 2½%, then the net annual return to investors in that market is 7½%—75% of the market's return. These mathematics are eternal, immutable, and unarguable. So the firm that I created is dedicated above all to minimizing the operating expenses, the management fees, and the portfolio transaction costs that our shareowners incur. The objective is to deliver to our investors a return that is as close as humanly possible to 100% of the return of any market in which they chose to invest.

I believe it is fair to say that we have succeeded in minimizing the costs of fund ownership. Since Vanguard's creation, the Vanguard fund expense ratios have steadily declined, from 0.73% in 1974 to 0.60% in 1985, to 0.30% in 1994, to 0.27% in 1999, when they leveled off. **Exhibit I.** Last year, the operating expenses and management fees paid by our funds came to 0.26% of their net assets, the lowest "expense ratio" of any firm in this industry. During 2002 the average expense ratio reported by Lipper Inc. for all stock, bond, and money market mutual funds was 1.36%. That 1.10% cost saving, applied to our present fund net assets of $550 billion, results in *annual* savings for our owners of $6 billion.

Recognizing the critical nature of the link between mutual fund costs and mutual fund returns has been central to Vanguard's rise to industry leadership in asset growth, cash flows, and market share. (Our share of industry assets has risen for twenty consecutive years, from 1.9% in 1982 to 8.7% in 2002.) That growth has come largely in areas where the link between cost and return is virtually causal: Stock index funds (in 1975, we created the first index mutual fund); index and index-like bond funds (we also created the first such funds); and money market funds, which are sufficiently commodity-like to assure that their net yields hold a direct, virtual one to one, relationship to costs: *The lower the cost, the higher the yield to investors*. The net assets of the Vanguard funds in these three categories total $425 billion, or 77% of our asset base.

Costs Matter

This linkage between cost and return is not just academic theory. It appears most clearly in money market funds, whose *gross returns* inevitably cluster around the interest rate for short-term commercial and bank paper. But when the *net yields* of money market funds are considered, the variations are enormous. With a correlation of 0.96 (1.00 is perfect), the rankings of money fund *yields* during the five years 1997-2002 closely paralleled the rankings of money fund *costs* during the same period. Simply put, the *lowest*-cost decile of funds earned a gross return of 4.80% and deducted an expense ratio of 0.37%, for a net yield of 4.43%. The *highest*-cost decile earned 4.67%, deducted 1.74%, and produced a net yield of 2.93%. **Exhibit II**. *Money fund investors could have improved their annual yield by 51% simply by choosing the lowest-cost funds.*

While the correlation between the costs and returns of actively-managed equity funds is less visible, it is nonetheless powerful and profound. A study of stock fund returns during the decade ended June 30, 2001, for example, showed that the low-cost quartile of funds earned an average net return of 14.5% per year, while the average high-cost fund earned an average of 12.3%, a 2.2% gap that was even *larger* than the 1.2% expense ratio gap between the two groups (0.64% vs. 1.85%). **Exhibit III, Appendix**.

An additional statistical test showed that this clear linkage between cost and return prevailed even more strongly when fund returns were adjusted for risk. The higher-cost funds were clearly assuming *higher* risks, and the return gap in favor of the low-cost quartile rose to 3.0% per year.

The cost-return relationship also prevailed when funds were grouped by their investment styles (large-cap growth, small-cap value, etc.), using the nine "Morningstar boxes." Significantly, the low-cost advantage prevailed in *all nine* of the style boxes, with eight of the comparisons yielding a risk-adjusted return advantage for the low-cost funds in the narrow range of 1.9% to 4.3%. (In the small-cap value group, there were only six funds in each quartile. Here, the low-cost funds produced 5.3% per year in extra return.) **Exhibit III, Page 3**.

Risk-Adjusted Returns
Ten Years Ended June 30, 2001

	Low-Cost Quartile	High-Cost Quartile	Low-Cost Advantage
Large-Cap Value	15.3%	13.4%	1.9%
Large-Cap Blend	14.6	11.0	3.6
Large-Cap Growth	13.3	10.2	3.1
Mid-Cap Value	15.8	11.5	4.3
Mid-Cap Blend	14.3	12.4	1.9
Mid-Cap Growth	13.7	11.6	2.1
Small-Cap Value	15.9	10.6	5.3
Small-Cap Blend	15.1	11.8	3.3
Small-Cap Growth	16.6	13.7	2.9
All Funds	13.8%	10.8%	3.0%

In both theory and practice, therefore, *costs matter*. It therefore follows that fund investors should have full disclosure of all investment costs.

A Changing Industry

The mutual fund industry that I read about in *Fortune* magazine in 1949 is almost unrecognizable today. Over and over again, the article spoke of "trustee," "trusteeship," "the investment trust industry," words that we rarely see today. Over the half-century-plus that followed, in my considered judgment, the fund industry has moved from what was largely a business of stewardship to a business of salesmanship, a shifting of our primary focus from the management of the assets investors have entrusted to our care to the marketing of our wares so as to build the asset base we manage.

While there may be room to argue about the exact nature of the change in industry *intangibles*, there can be no question about the change in industry *tangibles*. These changes can be easily measured. **Exhibit IV.** In summary:

1. Today's mutual fund industry is far larger ($6.5 trillion of assets vs. $2 *billion*), and offers more asset allocation choices (then 90% stock funds, now 50% bond and money market funds).

2. Equity funds are more risk-oriented, with only one of eight among 3,650 equity funds generally reflecting the broad stock market today, compared with *nine* out of ten of all 75(!) equity funds doing so in 1949.

3. Then, funds were managed by investment committees. Now, the individual portfolio manager is the *modus operandi*.

4. Measured by annual portfolio turnover—then 16%, now 110%—our equity fund investment philosophy has moved from long-term *investing* to short-term *speculation*.

5. With that change, we have moved away from our earlier active role in corporate governance to a role that is largely passive.

6. Our shareholders, on average, now hold their *fund* shares for much shorter periods—just over two years, compared to 16 years in the 1950s and 1960s.

7. As the creation of new funds (often speculative funds, formed to capitalize on the market fads of the day) has soared, the fund failure rate has risen to an all-time high. (At present rates, fully one-half of all of today's funds won't be around a decade hence.)

8. The costs of fund ownership have also soared, with expense ratios of the largest funds rising 134%—from 0.64% in 1951 to 1.50% in 2002.

9. Once a profession practiced almost entirely by privately-held enterprises, the management of mutual funds has largely become the business of giant financial conglomerates, which own 36 of the 50 largest fund managers.

The question is: Have these changes in the fund industry been a service to fund shareholders? Or have they been counterproductive to their interests?

Mutual Fund Expenses

The final section of Exhibit IV endeavors to answer that question: *These changes have adversely affected the returns earned by equity fund investors.* Largely because of far higher

costs, the returns earned by the average mutual fund in the "new" industry has lagged the returns of the stock market itself (measured here by the Standard & Poor's 500 Stock Index) by a substantially larger amount than the lag during the era of the "old" industry.[1] Specifically, the performance lag has nearly doubled, from 1.6 percentage points per year to 3.1 percentage points per year. Here are the figures:

	Annual Rate of Return	
	Old Industry 1950-1970	**New Industry 1982-2002**
Stock Market	**12.1%**	**13.1%**
Average Equity Fund	**10.5**	**10.0**
Lag	**1.6%**	**3.1%**
% of Return Captured by Average Fund	**87%**	**76%**

When the impact of these returns and these lags are compounded over time, the shortfall in the returns earned by fund investors is dramatic. This example shows the returns on a $10,000 initial investment at the start of each period:

	Profit on $10,000 Initial Investment	
	1950-1970	**1982-2002**
Stock Market	**$88,820**	**$105,250**
Average Equity Fund	**63,670**	**56,765**
Total Shortfall	**$25,150**	**$48,485**
% of Cumulative Market Profit Captured by Average Fund	**72%**	**54%**

It is the investor who puts up 100% of the capital and takes 100% of the risk. Yet in this example, the investor in the average mutual fund received only a bit over one-half of the market's profit in the recent bull market. It would seem obvious that we ought to know *why*.

Fund Costs Make the Difference

As it turns out, the major reason that the return of the average equity fund lagged the stock market by 3.1% is the costs that investors' funds incur—the management fees, the operating

[1] To make matters worse, the return of the average mutual fund *shareholder* fell far short of the return earned by the average *fund*. While the average fund earned 10% during the past two decades, the average fund investor earned only 2.0%. (See Exhibit IV, pages 15-16.)

expenses, the-out-of-pocket fees, the portfolio transaction costs, the sales charges, and the "opportunity cost" represented by the significant cash positions typically held by funds. I estimate the *average* annual impact of these costs over the past 20 years as follows:

Cost Category	Amount
Management Fees	**0.9%**
Other Operating Expenses	**0.4**
Expense Ratio	**1.3%**
Portfolio Transaction Costs (estimated)	**0.8**
Sales commissions (annualized)	**0.5**
Opportunity Cost[2]	**0.5**
Total	**3.1%**

It may be coincidental that the fund costs *exactly* match the fund lag, but it is *not* coincidental that the two numbers are *similar*. For intuition tells us, and the record confirms, that equity mutual funds as a group produce *before-cost* returns that are similar to the returns earned by the stock market itself. After all, when funds buy and sell stocks, it is often among one another and with other financial institutions. It would strain credulity to imagine that an entire giant equity fund industry—now owning nearly *one-fourth* of all of the stocks in the market—could provide a higher return (or, for that matter, a lower return), before costs, than the return of the very equity market in which it invests.

Trends in Fund Expenses

It seems obvious not only that it is costs that make the difference between success and failure in investing, but that fund costs have been in an upward trend over the long-term and are today at the highest levels in history. Certainly we *know* that the expense ratio of the average equity fund has risen from 0.98% in 1978 to 1.61% in 2002, a 64% increase. **Exhibit V**. (Source: Lipper Inc.)

[2] In this two-decade period in which annual stock returns averaged 13%, short-term investments earned an average of about 5%, an eight percentage point differential. A typical fund with about 6% in cash reserves, therefore, would have incurred an opportunity cost about 48 "basis points" (one-half of one percent per year).

Such sweeping industry averages, heavily weighted by the thousands of new funds that entered the industry, present one perspective on the rise in fund costs. Another perspective shows an even larger increase. An examination of the changes in the expense ratios of the 25 funds that dominated the "old" industry back in 1951 shows that, despite the fact that the average assets of these funds had risen nearly 60-fold, their average expense ratio had risen 66%—from just 0.64% to 1.06%. Of the 20 funds that survived this half-century era, only three (Vanguard Wellington, Fidelity Fund, and American Fundamental) reduced their expense ratios. The average expense ratio of the other 17 funds rose from 0.60% in 1951 to *1.16%* in 2002, an increase of nearly 100%. **Exhibit VI.**

This substantial increase in expense ratios, combined with the staggering growth of fund assets, means that the revenues generated to fund managers rose almost exponentially. Specifically, these 25 original funds were operated at an average cost of just $520 *thousand* in 1951; in 2002, the average cost of the 20 remaining funds came to $44 *million*, a 85-fold increase, dwarfing the 57-fold increase in assets.

Of course, like the Consumer Price Index, fund operating costs have risen during this long era, and of course funds are providing more investor services than heretofore (though modern information technology has created substantial efficiencies). But the fact is that there are *staggering* economies of scale involved in the investment management process. (When a fund grows from $500 million to $5 billion, the manager hardly requires ten times as many security analysts.) *There is no evidence whatsoever that fund managers have shared these economies of scale with fund owners.* Indeed, the evidence presented in Exhibit VI clearly shows that the preponderance of managers have not only arrogated these savings to themselves, *but have increased fees as well*, adding to their already substantial profit margins.

Following the Money

I estimate that the direct expenses incurred by *all* mutual funds of *all* types in 2001 amounted to about $73 billion dollars (1.1% of average fund assets of $6.7 trillion), of which about $15 billion represented direct operating costs and $58 billion represented fees paid to fund managers. Based on the pre-tax profit-margin of 45%, typical of publicly-held fund managers, we can estimate that the profits of fund managers total about $26 billion. Thus the managers' costs of operating the funds came to about $32 billion. Some $27 billion was probably

represented by marketing costs and other operating costs, with no more than $5 billion—about 7% of total fund costs—expended on portfolio management and research services, the principal service that fund investors seek.

The foregoing figures are, I believe, reasonable estimates. But the fact of the matter is that we simply *don't know* nearly as much as we should about where the money goes in the mutual fund industry. *We ought to know.* It is high time that either the SEC or General Accounting Office conduct an economic study of this industry, showing the specific sources and uses of shareholder dollars. Given the obvious and crucial role of fund costs in shaping fund returns, it is high time to "follow the money," wherever the trail may lead.

Other Studies of Costs

The Investment Company Institute has produced numerous studies of mutual fund costs over the years. They purport to show that what they refer to as "the cost of fund ownership" is not only far below the cost figures presented earlier in this statement, but reflects a long-term secular downtrend. But because of a flawed statistical approach and an remarkably narrow definition of "cost," the ICI conclusions are not supportable. **Exhibit VII.** In brief:

1. By weighting the data, not by the average *fund* or by fund *assets*, but by *sales*, the ICI captures, not a long-term reduction in the costs charged by the industry, but investors' ever-increasing selection of lower cost funds. Price competition, however, is properly defined, *not by the action of consumers, but by the action of producers.*

2. The ICI's original 1998 study noted that the cost reduction had come largely in funds with extremely high costs, and that the lowest-cost decile actually *increased* costs by an estimated 27%. (This analysis was subsequently dropped.)

3. The study acknowledged that much of the cost reduction was attributable to index funds and funds sold to large institutions; costs for regular equity fund investors were 10% higher than the reported figure.

4. The ICI data also *exclude* many of the costs of fund ownership, including the substantial costs of portfolio turnover. I estimate that these other costs would increase their (flawed) 2001 annual cost figure of 1.28% for equity fund ownership to 2.70%, an increase of more than 100% (i.e. the ICI understates fund costs by fully 50%). If *unweighted*, the cost would rise to another 0.61% to 3.31%, 160% above the ICI figure.

Cost Disclosure

Investors are largely unaware of the high level of mutual fund costs, and even less aware of the powerful effect of these costs on the compounding of their returns over the long-term. Since managers have an obvious vested interest sustaining this ignorance, I believe that we urgently need new SEC rules that require greater cost disclosure. Some recommendations:

1. Annual mutual fund shareholder statements should inform each fund owner as to the *dollar amount* of expenses he or she is incurring through the fund's expense ratio. This figure should not be *backward*-looking, for the calculation complexities are truly awesome. It should be *forward*-looking, showing the expected annual expense based on the value of the shareholder's investment at year-end. At the same location where the statement presents the year-end dollar value of the account, it should also present the dollar amount of expenses expected during the coming year. That figure would simply be the product of multiplying the account balance by the fund's most recent annual expense ratio, or, if materially different, a reasonable estimate of the projected expense ratio during the coming year. A footnote would present both the calculation methodology and the expense ratio used to make the calculation. For example, if a shareholder's year-end value were $11,212 and the expense ratio were 1.58%, an annual expense of $177 would be projected on the shareholder's statement.

2. The present prospectus cost-impact statement combining expense ratio and sales charges and providing costs on a $10,000 investment over three-, five-, and ten-year periods should be modified by adding transaction costs so the "all-in" cost of fund ownership is fully disclosed. This disclosure should be included in both the annual report and prospectus. I emphasize that these transaction costs go well beyond mere commission costs, to market spreads, market impact, etc., even as I recognize that these costs are difficult to measure with precision. But even a rough estimate (although I believe most managers have much better information than that) would be better than no estimate at all. Once we have had some experience with the reporting of these transaction cost data, we should consider adding transaction costs to the direct expenses presented in the shareholder statement. For example, using the above example, if estimated transaction costs were equal to 1.00% of net assets, all-in costs would be 2.58%, or $289 in annual costs for the shareholder.

3. Cost disclosure in fund annual reports must be enhanced, so that shareholders can relate fund cost to fund returns. Funds should be required to present a table, either on the inside cover of the report or the immediately facing page, the following information:

   a) The fund's total return for the year, compared to a) whatever market sector benchmark (if any) it deems appropriate, *and* b) the annual return of the broad market in which it invests (i.e. the *total* stock market, *total* taxable bond market, *total* exempt bond market), etc.

   b) Rate of portfolio turnover during the year, and the estimated impact of transaction costs on returns (i.e., the ratio of transaction costs to net assets).

   c) *Total* costs for the year as a percentage of net assets, including a) the expense ratio, and b) the transaction cost ratio.

d) The total *dollar amount* of costs incurred by the fund during the year, including the amount of the management fee, the amount of the 12b-1 fee, and other operating expenses.

Like the disclosure of each investor's costs in the annual shareholder statement, this added disclosure in the annual report and would enhance the investors' understanding of the amount of costs they are incurring and the impact of costs on the returns they receive.

A Money Market Fund Example

Cost disclosure is important because cost plays such a crucial role in shaping the returns earned by fund owners. While the importance of cost applies to all types of mutual funds, it is most obvious in money market funds. There, the tension between operating a fund in the interest of shareholders and operating it in the interests of management companies can be measured directly. *The impact is virtually dollar-for-dollar.* There is simply no way to seriously allege that a money fund's portfolio manager can outguess in a meaningful way the vast, efficient and professional market for short-term funds. (In fact, the record is clear that in the few cases where managers have attempted to do so, they have lowered quality standards, resulting in substantial losses for the fund, typically made whole by its management company.)

As shown earlier in Exhibit I, money fund performance comes down almost entirely to relative costs. While there are few examples about the nature of the costs that money funds incur, those that we have are instructive. The Vanguard money market funds, for example, are operated *at cost* by their own employees, and report the exact amount of costs that they incur on each of the principal activities involved: 1) investment management; 2) distribution of shares; and 3) shareholder services and operations. The Smith Barney money market funds, on the other hand, are among a handful of money funds that pay separate fees to their external service providers for each of these three services. Thus, we can make a fair comparison of where the money goes. During 2000, the money fund assets of the two groups were virtually identical, so the comparison is striking. **Exhibit VIII**.

The aggregate assets of the Smith Barney money funds in 2000 were $64.8 million compared to $67.4 million for the Vanguard money funds. *Yet the expenses of the two organizations were radically different.* Smith Barney's costs totaled almost $380 million, nearly 90% higher than Vanguard's costs of just over $200 million. The former's expense ratio was

0.59%, nearly *double* the latter's. Specifically, under their investment management contracts, the funds paid Smith Barney $257 million to "select the fund's investments and oversee (their) operations." The actual cost of Vanguard's analysts and portfolio managers was $8 million. Adding in another $8 million for management overhead brought the total to almost $16 million. What could *possibly* account for this gap of $241 million? It couldn't be distribution or shareholder services for, they are accounted for separately. A money market fund requires only so much management, and it can't cost but a small fraction of a quarter of a billion dollars. To the extent that $241 million gap between Vanguard's *costs* and Smith Barney's *fees* represent a profit to Citicorp, those profits come at the direct cost of the return earned by the funds' shareholders.

It is for this obvious reason that shareowners deserve complete information, not only about the costs incurred by their *funds* in the form of management fees, but the costs incurred by their *managers* in return for providing those services. Simply providing this information to investors should help bring the fees that mutual funds pay to their service providers into a more reasonable relationship to the actual costs those providers incur, especially in commodity type funds where the ability of managers to add sustained value is not a possibility. (Or, if it is argued that there is a small possibility, it is dwarfed by the size of the fees themselves.)

Fee Negotiations

The cost example used above is, in a sense, unfair. Of course a *mutual* at-cost organization such as Vanguard should deliver lower costs than one operated by a profit-making firm such as Smith Barney. But the gap seems, well, disproportionate. What is more, while Vanguard operates its money funds, most bond funds, and all index funds at cost, it also has entered into numerous contracts with external investment advisers—profit-making entities—all who provide their services to Vanguard's *actively managed* funds, engaging in arms-length negotiations to establish appropriate fees.

The fee scales we have negotiated over the years go back to Vanguard's founding in 1974, when our investment management fees were reduced in an amount more-than-commensurate with the direct costs that the funds would incur when the firm assumed the responsibility for Vanguard's operations. They were reduced again in 1977, and again by an amount more-than-commensurate with the extra costs incurred, when Vanguard assumed the

responsibility for distribution. At that point, controlling its own operations and distribution, Vanguard was in a position to negotiate with its former management company, Wellington, *solely* on the basis of its investment advisory services, just as do the trustees of large corporate pension funds.

As circumstances changed and fund assets grew over the years, Vanguard negotiated frequent fee reductions with the external independent investment managers responsible for its actively-managed funds. Taking into account not only these fee reductions but the economies of scale involved in Vanguard's shareholder services and other operations, the average expense ratio for the equity funds (including index funds) in the Vanguard Group *declined* from 0.74% in 1978 to 0.66% in 1984, to 0.38% in 1994, and to 0.33% in 2002. During the same period, the expense ratio of the industry's average equity fund actually increased from 0.98% in 1978 to 1.61% in 2002. **Exhibit IX**.

Credit for much of this 55% *drop* in Vanguard's unit costs in face of a 64% *increase* in the unit costs of other equity funds came from unremitting arms-length negotiations with our external advisers, the most recent of which took place in 1995. Our goal was to adopt steeply-sliding fee scales that would not require negotiations as assets grew, in effect to demand that our investors receive their fair share of the advisers' economies of scale, and in part to anticipate future growth that would not require the give-and-take tension of frequent fee renegotiations. For example, the Vanguard Wellington Fund effective fee rate, paid to adviser Wellington Management Company, was reduced as follows:

1978	-30%
1983	-6%
1986	-15%
1991	-26%
1995	-17%

At the fund's 2002 asset total of $22 billion, with a base fee of $8.5 million, and each additional billion-dollar increase in assets resulting in an additional fee of just $300,000 (three basis points), the advisory fee average rate is 0.04%. In 2002, the fund's expense ratio (the fund's share of Vanguard's costs of 0.30%, plus the advisory fee of 0.04%) was 0.34%, 70% below the 1.18% expense ratio of its balanced fund peer group. *If Wellington were today paid under the 1975 fee scale, its fee would have been $92 million, or $83.5 million larger than the $8.5 million actually paid to its external advisor.*

The Vanguard GNMA fund presents a similar, if starker, illustration. Following its founding in 1980, the fund grew substantially, and both its advisory fee and its expense ratio dropped steadily, from 0.65% at the outset to 0.34% in 1990, to 0.24% in 2002. The fund's advisory fee scale was reduced as follows:

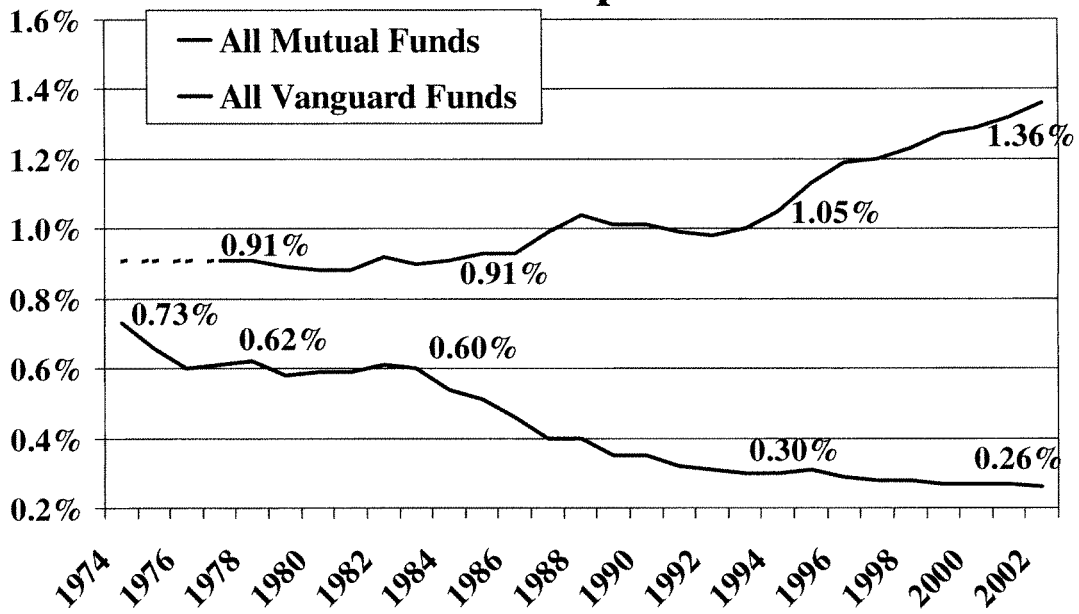
1983	-56%
1986	-12%
1991	-14%
1995	-48%

For 2002, the advisory fee amounted to 0.009% of the fund's assets (i.e., less than *one basis point*). (The average management fee on other GNMA funds appears to be about 0.45%.) At the fund's present size of $27 billion, it generates fully $2,600,000 in advisory fees to Wellington's fixed-income group, doubtless well in excess of their costs. While each additional $1 billion of assets produces an added fee of only $90,000, the extra assets—invested as they are in securities whose principal value is guaranteed and interest payments are guaranteed by the U.S. Government—creates no extra costs for credit research. This miniscule fee rate, added to the fund's share of Vanguard's operating expenses of 0.23%, brings its total expense ratio to 0.24%, fully 77% below the expense ratio of the average GNMA fund, a major advantage to investors. *If the Vanguard GNMA fund had adhered to its original fee schedule, its fee last year would have been $21 million, more than $18 million larger than the $2.6 million fee actually paid to its external advisor.* **Exhibit X** presents the actual fee schedules for Vanguard's Wellington Fund and GNMA Fund over the years.

Lower fees have been heavily responsible for the fact that both our Wellington and GNMA funds have provided superior returns to their shareholders over the years. *In 1987 – 2002, for example, Wellington outperformed 90% of all balanced funds, and GNMA outperformed 99% of all GNMA funds.* Yet our fee *rate* reductions are normally very small, and only nominally erode huge *increases* in the *dollar amount* of fees received by our external advisers. But the examples in Exhibit X clearly illustrate both the tremendous cumulative impact a number of reductions can have over time, and the huge value fee negotiations can have for fund investors. Such arms-length negotiation, however, is conspicuous only by its absence in the mutual fund industry. Establishing some way for funds to negotiate with advisers is a change long overdue.

Exhibit I

Mutual Fund Expense Ratios



Source: Lipper Inc.

Lipper data are not available until 1978. Thus, ERs for 1974 – 1977 are assumed to be the same as 1978's, 0.91%.

Exhibit II

Money Market Fund Gross Returns, Expense Ratios, and Net Returns; 1998 - 2002

Please note the consistency between each fund's rank in net return and expense ratio (ER). While 94% of the funds earned *gross returns* between 4.90% and 4.60%, the top decile of funds earned *net returns* averaging 4.43%, while the bottom decile earned 2.93%. The difference between the two deciles: expense ratios averaged 0.37% for the top group; expense ratios averaged 1.74% for the bottom group. (The statistical correlation between costs and net returns was 0.96.)

Net Return Rank	Expense Ratio Rank (1 is lowest)	Fund Name	Gross Avg Ann Return 1998 - 2002	Avg ER 1998 - 2002	Net Avg Ann Return 1998 - 2002
1	1	Elfun Money Market	4.77	0.19	4.58
3	2	Transam Prem:Csh R;Inv	4.75	0.25	4.50
12	2	INVESCO Treas MM R;Inv	4.68	0.25	4.43
5	4	Scudder MM;Prem S	4.75	0.27	4.48
6	5	TIAA-CREF:Money Market	4.77	0.29	4.48
2	6	ScudderYldWise Money	4.80	0.29	4.51
7	7	Bunker Hill Money Mkt;R	4.75	0.30	4.45
16	8	McMorgan:Prin Pres	4.72	0.30	4.42
4	9	Vanguard Prime MM;Inv	4.82	0.33	4.49
21	10	ABN AMRO:Money Mkt;I	4.72	0.34	4.38
11	11	Deutsche Mny Mrkt	4.78	0.35	4.43
17	12	Strong Heritage Mny;inv	4.78	0.36	4.42
19	13	Fremont:Money Market	4.78	0.38	4.40
35	14	Mercantile:Prime MM;Inst	4.70	0.38	4.32
22	15	SSgA:MM;A	4.77	0.39	4.38
68	16	Capital Cash:Mgt;Org	4.58	0.40	4.18
10	17	CitiFunds Prem:Liq Rsvs	4.83	0.40	4.43
20	18	Schwab:Val Adv Mny;Inv	4.81	0.41	4.40
29	19	Active Assets Money Tr	4.77	0.42	4.35
15	20	Flex-funds:Money Market	4.84	0.42	4.42
9	21	Marshall:MM;Inv	4.87	0.43	4.44
13	22	Fidelity Cash Reserves	4.85	0.43	4.42
14	23	Fidelity Sprt Money Mkt	4.86	0.44	4.42
28	24	Scudder Money Market Fd	4.81	0.45	4.36
18	25	T Rowe Price Sum:Cash	4.86	0.45	4.41
8	26	Dreyfus BASIC MM	4.90	0.45	4.45
34	27	Harbor:Money Market;Inst	4.77	0.45	4.32
24	28	Amer Cent:Premium MM;Inv	4.82	0.45	4.37
43	29	Nicholas Money Market	4.75	0.46	4.29
45	30	Managers:Money Market	4.74	0.46	4.28
33	31	Preferred:Money Market	4.79	0.46	4.33
51	32	Excelsior:Money	4.71	0.47	4.24
53	33	Vision:Inst Prime MM	4.72	0.48	4.24
27	34	Fidelity Sel Money Mkt	4.84	0.48	4.36
26	35	WellsFargo:Cl MM;S	4.85	0.48	4.37
30	36	Finl Insts:Summit Cash;A	4.82	0.48	4.34
36	37	Putnam Money Mkt;A	4.80	0.48	4.32
23	38	USAA Money Market	4.87	0.49	4.38
25	39	RBB:Money Mkt;Sansom St	4.86	0.49	4.37
49	40	GE Funds:Money Market;A	4.75	0.49	4.26
48	41	UBS PACE MM	4.77	0.50	4.27
91	42	Sit Money Market Fund	4.64	0.50	4.14
32	43	Eclipse:MM;NL	4.83	0.50	4.33
46	44	WT:Wilm Prime MM;Inv	4.79	0.51	4.28
88	45	UMB Scout Mny Mrkt:Prime	4.66	0.51	4.15
72	46	ABN AMRO:CC Mny Mkt;N	4.68	0.51	4.17
50	47	Eureka:Prime Money;Tr	4.76	0.52	4.24
44	48	Command Money Fund	4.82	0.54	4.28
39	49	Harris Ins:Mny Mkt;N	4.84	0.54	4.30
31	50	Merrill Retire:Rsvs;I	4.88	0.54	4.34
60	51	AXP:Cash Management;A	4.74	0.54	4.20
47	52	Amer AAdv:MM;Plan	4.81	0.54	4.27
79	53	Salomon Bros:Csh Mgt;2	4.70	0.54	4.16
80	53	Salomon Bros:Csh Mgt;A	4.70	0.54	4.16
81	53	Salomon Bros:Csh Mgt;B	4.70	0.54	4.16
86	53	Salomon Bros:Csh Mgt;O	4.69	0.54	4.15
70	57	PaineWbr Cashfund	4.73	0.55	4.18
38	58	Northern Fds:Money Mkt	4.86	0.55	4.31
64	58	Crdt Suis Cash Rsv	4.74	0.55	4.19

Net Return Rank	Expense Ratio Rank (1 is lowest)	Fund Name	Gross Avg Ann Return 1998 - 2002	Avg ER 1998 - 2002	Net Avg Ann Return 1998 - 2002
84	60	Members:Csh Reserves;A	4.70	0.55	4.15
40	61	CMA Money Fund	4.85	0.56	4.29
66	62	Sm Barney Money:Cash;L	4.75	0.56	4.19
57	63	First Funds:Cash Rsv;C	4.78	0.57	4.21
42	64	ING:Aeltus Money Mkt;I	4.86	0.57	4.29
104	65	Pac Cap:Cash Assets;Orig	4.67	0.57	4.10
41	66	ING:Aeltus Money Mkt;A	4.86	0.57	4.29
82	67	Armada:Money Market;A	4.72	0.57	4.15
54	68	Amer Cent:Prm MM;Inv	4.80	0.58	4.22
52	69	Morg Stan Liquid Asset	4.83	0.59	4.24
128	70	American Funds Cash;A	4.63	0.59	4.04
85	71	Neuberger Cash Rsvs;Inv	4.74	0.59	4.15
67	72	UBS PW RMA Money	4.78	0.59	4.19
119	73	AIG Money Market;B	4.66	0.59	4.07
87	74	Sm Barney Money:Cash;A	4.75	0.60	4.15
96	75	Amer Perform:Cash Mgmt	4.72	0.60	4.12
105	76	PIMCO:Money Mkt;C	4.70	0.60	4.10
108	76	PIMCO:Money Mkt;A	4.69	0.60	4.09
55	78	Janus Money Market;Inv	4.82	0.60	4.22
98	79	Columbia Daily Income;Z	4.71	0.60	4.11
75	80	Enterprise:MM;C	4.78	0.61	4.17
69	81	Enterprise:MM;A	4.79	0.61	4.18
74	81	Enterprise:MM;B	4.78	0.61	4.17
62	83	STI Classic:Prm MM;Tr	4.81	0.61	4.20
71	84	Strong Money Market Fund	4.79	0.61	4.18
125	85	Perform:Money Mkt;A	4.67	0.62	4.05
59	86	ARK Fds:Mny Mkt;A	4.82	0.62	4.20
56	87	T Rowe Price Prm Rsv	4.84	0.62	4.22
63	88	Amer AAdv Mile:MM;Mile	4.82	0.63	4.19
95	89	Scudder Cash Rsrv;A	4.76	0.63	4.13
78	90	Putnam Money Mkt;M	4.79	0.63	4.16
99	91	Great Hall:Prime MM:Inv	4.74	0.63	4.11
131	92	PBHG:Cash Reserves;PBHG	4.67	0.64	4.03
61	93	Merrill Ready Assets	4.84	0.64	4.20
90	94	Franklin Money Fund	4.78	0.64	4.14
127	95	Vision:MM;A	4.69	0.64	4.05
113	96	Galaxy:Money Mkt;Rtl A	4.72	0.64	4.08
130	97	Gartmore:MM;Prm	4.68	0.65	4.03
209	98	Seligman Cash Mgmt:A	4.34	0.65	3.69
58	99	Nations Cash Rsv;Inv A	4.86	0.65	4.21
107	100	Golden Oak:Pr Ob MM;A	4.74	0.65	4.09
189	101	Reynolds:MM	4.44	0.65	3.79
73	102	Cash Accum:Natl MM	4.82	0.65	4.17
106	103	Scudder Cash Rsrv;Prm	4.76	0.66	4.10
111	104	WM:MM;A	4.75	0.66	4.09
116	105	MFS Money Market	4.74	0.66	4.08
147	106	Value Line Cash Fund	4.66	0.66	4.00
76	107	Centennial MM Trust	4.83	0.67	4.16
77	108	Prudential MoneyMart;A	4.83	0.67	4.16
122	109	SS Research MM;E	4.73	0.67	4.06
109	110	Principal Cash Mgmt;A	4.76	0.67	4.09
97	111	Fidelity:Prime;Dly Mny	4.80	0.68	4.12
37	112	Touchstone Inv:MM;A	5.00	0.68	4.32
102	113	Victory:Financial Rsvs	4.79	0.68	4.11
142	114	Riggs:Prime MM;Y	4.69	0.68	4.01
123	115	Expedition:MM;Insv	4.74	0.69	4.05
118	116	WM Blair:Ready Rsvs;N	4.77	0.69	4.08
114	117	MainStay:MM;A	4.78	0.70	4.08
115	117	MainStay:MM;B	4.78	0.70	4.08
139	119	ABN AMRO:Money Mkt;S	4.71	0.70	4.01
89	120	CitiFunds:Cash Resrv;N	4.84	0.70	4.14
83	121	Dreyfus MM Reserves;Inv	4.85	0.70	4.15
144	122	Wayne Hummer Money Mkt	4.71	0.70	4.01
92	123	Special:Mny Mkt;B	4.84	0.70	4.14
65	124	Dreyfus Liquid Assets	4.89	0.70	4.19
157	125	Legg Mason Cash Reserve	4.67	0.71	3.96
129	126	Fifth:Prm MM;Inv A	4.75	0.72	4.03
153	127	AAL Funds:MM;A	4.69	0.72	3.97
155	128	Heritage Cash Tr:MM;A	4.70	0.73	3.97
156	128	Heritage Cash Tr:MM;C	4.70	0.73	3.97
94	130	Marshall:MM;Adv	4.86	0.73	4.13

Exhibit II

Net Return Rank	Expense Ratio Rank (1 is lowest)	Fund Name	Gross Avg Ann Return 1998 - 2002	Avg ER 1998 - 2002	Net Avg Ann Return 1998 - 2002
137	131	UBS PW Retire Mny	4.75	0.73	4.02
93	132	CBA Money Fund	4.87	0.74	4.13
110	133	TD Waterhouse:Mny Mkt	4.83	0.74	4.09
100	134	Oppenheimer Money Market	4.86	0.75	4.11
161	135	Liberty:Mny Mkt;A	4.68	0.75	3.93
112	136	Dreyfus Worldwide Dlr MM	4.83	0.75	4.08
133	137	Deutsche Cash Mgmt;Inv	4.77	0.75	4.02
121	138	Schwab:Money Mkt	4.82	0.75	4.07
120	139	Eclipse:MM;Serv	4.82	0.75	4.07
201	140	Alger:Money Market	4.49	0.75	3.74
158	141	BNY Hmltn:Money;Class	4.70	0.75	3.95
150	142	WellsFargo:Mny Mkt;A	4.75	0.76	3.99
124	143	One Group:Prime MM;A	4.81	0.76	4.05
171	144	Huntington:MM;Inv A	4.62	0.76	3.86
141	145	HighMark:Div MM;A	4.78	0.77	4.01
148	146	Victory:Prime	4.78	0.78	4.00
165	147	AmSouth:Prime MM;A	4.67	0.78	3.89
103	148	Dreyfus Gen Mny Mkt;A	4.88	0.78	4.10
136	149	STI Classic:Prm MM;Inv	4.80	0.78	4.02
146	150	Munder:Cash Invest;A	4.78	0.78	4.00
140	151	First Amer:Prme Oblg;A	4.80	0.79	4.01
170	152	Eaton Vance Cash Mgt	4.65	0.79	3.86
101	153	SAFECO MM Tr:MM;Inv	4.91	0.80	4.11
135	154	Homestead:Daily Income	4.82	0.80	4.02
206	154	Ivy:Money Market Fd;B	4.51	0.80	3.71
152	156	First Inv Cash Mgmt;A	4.78	0.80	3.98
164	156	MFS Cash Reserve;A	4.72	0.80	3.92
149	158	Phoenix-Gdwn Mny Mkt;A	4.79	0.80	3.99
138	159	W&R Adv:Cash Mgmt;A	4.83	0.81	4.02
177	160	Pac Cap:Cash Assets;Srvc	4.66	0.82	3.84
143	161	Vintage Mut:Liqd Ast;T	4.83	0.82	4.01
117	162	SAFECO MM Tr:MM;Adv A	4.90	0.82	4.08
154	163	Cash Equiv:Money Market	4.79	0.82	3.97
162	164	Monarch:Cash Fund;Inv	4.76	0.83	3.93
216	165	Ivy:Money Market Fd;C	4.46	0.83	3.63
180	166	Drey/Founders:MM;F	4.65	0.83	3.82
151	167	BlackRock:MM;IA	4.82	0.84	3.98
163	168	Scudder Cash Inv;S	4.78	0.85	3.93
134	169	Evergreen MM;A	4.87	0.85	4.02
183	170	Guardian Cash Mgmt;A	4.66	0.85	3.81
176	171	Advantus Money Market	4.69	0.85	3.84
126	172	SAFECO MM Tr:MM;Adv B	4.90	0.85	4.05
160	173	CDC Nvest Cash:MM;B	4.78	0.85	3.93
159	174	CDC Nvest Cash:MM;A	4.78	0.85	3.93
132	175	Calvert Soc Inv:MM	4.87	0.85	4.02
145	176	Dreyfus MM Instr:MM	4.86	0.86	4.00
213	177	Ivy:Money Market Fd;A	4.52	0.87	3.65
194	178	INVESCO Cash Rsvs;Inv	4.65	0.88	3.77
182	179	Edward Jones Mny Mkt;Inv	4.70	0.89	3.81
166	180	Delaware Cash Rsv;A	4.78	0.89	3.89
185	181	Pioneer Cash Reserve;A	4.69	0.89	3.80
199	182	Hibernia:Cash Reserve;A	4.65	0.90	3.75
196	183	Babson Money Mrket	4.66	0.90	3.76
181	184	NorthTrack:Cash;X	4.73	0.91	3.82
173	185	Van Kampen Reserve;A	4.77	0.91	3.86
197	186	J Hancock MM Fund;A	4.67	0.91	3.76
168	187	LIR Premier MM	4.79	0.91	3.88
169	188	Fidelity:Prime;Cap Res	4.80	0.93	3.87
179	189	SunAmerica Mny Mkt;A	4.77	0.93	3.84
175	190	BB&T:Prime Mny Mkt;A	4.79	0.94	3.85
178	191	ProFunds:Money Mkt;Inv	4.78	0.94	3.84
174	192	Amer AAdv:MM;Pltm	4.79	0.94	3.85
203	193	Security Cash Fund	4.69	0.95	3.74
191	194	Lutheran Bro:MM;B	4.73	0.95	3.78
188	195	Lutheran Bro:MM;A	4.74	0.95	3.79
187	196	Scudder Cash Rsrv;Qual	4.75	0.95	3.80
186	197	Putnam Money Mkt;B	4.78	0.98	3.80
192	198	Short Term Inc:MM;A	4.76	0.98	3.78
172	199	RBB:Money Mkt;Bedford	4.84	0.98	3.86
211	200	ING Lexington Money Mkt	4.66	0.99	3.67
198	201	Reserve Fd:Primary;R	4.75	0.99	3.76

Exhibit II

Net Return Rank	Expense Ratio Rank (1 is lowest)	Fund Name	Gross Avg Ann Return 1998 - 2002	Avg ER 1998 - 2002	Net Avg Ann Return 1998 - 2002
190	202	Cortland Tr:General MM	4.77	0.99	3.78
215	203	AFD Exchange Rsvs;A	4.62	0.99	3.63
195	204	Alliance Cap Res:Capital	4.76	1.00	3.76
193	205	Alliance Cap Res:Money	4.77	1.00	3.77
202	206	Hartfd:Money Mkt;A	4.74	1.00	3.74
167	207	Dreyfus Gen Mny Mkt;B	4.88	1.00	3.88
204	208	Cash Acct Tr:MM;Svc	4.74	1.01	3.73
184	209	Federated Prime Csh	4.82	1.02	3.80
210	210	AIM Inv:Money Market;CRs	4.70	1.03	3.67
212	211	Riggs:Prime MM;R	4.72	1.05	3.67
200	212	Vintage Mut:Liqd Ast;S2	4.81	1.06	3.75
205	213	Amer AAdv Mile:MM;Pltm	4.79	1.08	3.71
208	214	Federated Money Mkt Mgmt	4.83	1.14	3.69
214	215	Delaware Cash Rsv;Con	4.78	1.14	3.64
207	216	Oppenheimer Cash Rsv;A	4.84	1.14	3.70
218	217	Liberty:Mny Mkt;C	4.65	1.14	3.51
217	218	Franklin/Temp Money;C	4.76	1.18	3.58
221	219	Guardian Cash Mgmt;B	4.65	1.21	3.44
230	220	EquiTrust MM Fund	4.54	1.23	3.31
223	221	Sm Barney Exchge Rsv;L	4.62	1.23	3.39
224	222	AFD Exchange Rsvs;C	4.61	1.24	3.37
222	223	AXP:Cash Management;B	4.71	1.29	3.42
225	224	Members:Csh Reserves;B	4.66	1.30	3.36
219	225	Vintage Mut:Liqd Ast;S	4.81	1.32	3.49
220	226	Principal Cash Mgmt;B	4.79	1.34	3.45
226	227	Scudder Cash Rsrv;B	4.74	1.38	3.36
241	228	ASAF:Money Mkt;A	4.58	1.46	3.12
234	229	WellsFargo:Mny Mkt;B	4.71	1.46	3.25
229	230	First Amer:Prme Oblg;B	4.79	1.47	3.32
227	231	BlackRock:MM;IB	4.81	1.49	3.32
228	232	BlackRock:MM;IC	4.81	1.49	3.32
238	233	AFD Exchange Rsvs;B	4.63	1.50	3.13
237	234	PIMCO:Money Mkt;B	4.68	1.50	3.18
233	235	One Group:Prime MM;B	4.79	1.51	3.28
232	236	Evergreen MM;C	4.84	1.55	3.29
231	237	Evergreen MM;B	4.84	1.55	3.29
236	238	First Inv Cash Mgmt;B	4.76	1.55	3.21
235	239	Phoenix-Gdwn Mny Mkt;B	4.77	1.55	3.22
242	240	Van Kampen Reserve;B	4.75	1.64	3.11
260	240	Seligman Cash Mgmt;D	4.38	1.64	2.74
259	242	Seligman Cash Mgmt;B	4.38	1.64	2.74
243	243	Van Kampen Reserve;C	4.75	1.65	3.10
246	244	SS Research MM;C	4.70	1.67	3.03
245	245	SS Research MM;B	4.70	1.67	3.03
240	246	Oppenheimer Cash Rsv;C	4.82	1.69	3.13
239	247	Oppenheimer Cash Rsv;B	4.83	1.70	3.13
244	248	Hartfd:Money Mkt;B	4.73	1.70	3.03
250	249	Eaton Vance Money Mkt	4.64	1.71	2.93
248	250	Liberty:Mny Mkt;B	4.69	1.71	2.98
249	251	Pioneer Cash Reserve;B	4.67	1.73	2.94
253	252	J Hancock MM Fund;B	4.66	1.76	2.90
251	253	Pioneer Cash Reserve;C	4.68	1.77	2.91
256	254	AIM Inv:Money Market;C	4.69	1.80	2.89
255	255	AIM Inv:Money Market;B	4.69	1.80	2.89
254	256	MFS Cash Reserve;B	4.70	1.80	2.90
257	256	MFS Cash Reserve;C	4.67	1.80	2.87
247	258	AAL Funds:MM;B	4.89	1.88	3.01
252	259	Delaware Cash Rsv;C	4.79	1.89	2.90
258	260	ProFunds:Money Mkt;Svc	4.78	1.94	2.84
261	261	ASAF:Money Mkt;C	4.57	1.96	2.61
262	261	ASAF:Money Mkt;X	4.57	1.96	2.61
263	263	ASAF:Money Mkt;B	4.56	1.96	2.60
		Average	4.75	0.84	3.91

Source: Lipper Inc.

Exhibit III

An Index Fund Fundamentalist

Goes back to the drawing board.

John C. Bogle

In 1997, I prepared a study of the returns for the mutual funds in each of the nine Morningstar "style boxes," a matrix with large-, mid-, and small-capitalization funds on one axis and value, blend, and growth funds on the other (Bogle [1998]). For the five-year period 1992 through 1996, the study presents powerful evidence that the low-cost quartile of funds in each box had earned not only higher returns than those in the high-cost quartile, but also returns that significantly exceeded the cost differential.

The results can be summarized as follows: average return of low-cost funds, 14.9%; average return of high-cost funds, 12.3%. This difference of 2.6 percentage points is *double* the 1.3 percentage point expense ratio differential of the funds (annual expense ratio of low-cost quartile, 0.7%; expense ratio of high-cost quartile, 2.0%). The differential *increases* slightly when risk-adjusted returns are substituted for total returns.

As a result, I concluded:

> An investor who doesn't seriously consider limiting selections to funds in the low-expense group and eschewing funds in the high-expense group is someone who should take off the blinders—perhaps even a bit of a fool [1998, p. 38].

John C. Bogle is founder and former chairman of The Vanguard Group in Valley Forge, PA 19482.

THE ROLE OF COSTS

Emboldened by the magnitude and consistency across the nine style boxes, I then asked, in effect: *Since*

the lowest-cost funds in the marketplace today are index funds, why not just buy index funds in each of the style boxes? I then tested that proposition, and I found the results equally compelling.

In seven of the nine boxes, the comparable-style index produced higher returns, and in all nine boxes, the index funds assumed lower risks. In terms of risk-adjusted returns, the index fund's superiority was substantial in eight boxes, and marginally lower in but one (small-cap growth). Holding risk constant, the indexes delivered a return surplus of 3.6 percentage points per year (16.5% versus 12.9%) in the large-cap group, 4.2 percentage points (18.0% versus 13.8%) in the mid-cap group, and 4.4 percentage points (19.5% versus 15.1%) in the small-cap group.

Armed with this evidence on the relationship between fund costs and fund performance, I then concluded: "The magnitudes . . . are so large and so consistent as to devastate the concept of high-cost active management."

Prudently, however, I added the caveat:

> We should go only so far with five-year numbers in a strong equity market . . . . But a shorter period . . . would be even less satisfactory, and a longer [ten-year] period . . . would cut the number of funds we could observe by half, making for a less reliable sample. . . . Analysis of the [five-year] data . . . deserves testing in other periods and under a variety of market conditions [1998, p. 40].[1]

This article does exactly that, using the ten-year period ending June 30, 2001.

RESULTS

The decade-long period from July 1, 1991, through June 30, 2001, covered in the new study clearly includes a variety of conditions—the quiet stock market of 1992-1994, the boom of 1995-1999, and the subsequent bust in 2000-2001. Interestingly, however, the annual return of the S&P 500 stock index was virtually the same during the past decade (15.1%) as during the earlier study (15.2%). The variation in actual returns between the best and the worst style boxes was wider in the prior study: 3.2 percentage points (15.1% to 11.9%). In the current study, the variation in average return between the extremes is remarkably slight: 1.3 percentage points (14.5% to 13.2%).

Exhibit 1 presents the data.

EXHIBIT 1
ANNUAL RATE OF RETURN
Ten Years Ended June 30, 2001*

	Value	Blend	Growth
Large-Cap	13.6%	13.2%	13.4%
Mid-Cap	14.4	14.5	13.8
Small-Cap	14.5	14.3	14.4

**Source: Morningstar. Includes 634 mutual funds in operation throughout the period.*

EXHIBIT 2
ANNUAL RATE OF RETURN
Ten Years Ended June 30, 2001

	Low-Cost Quartile	High-Cost Quartile	Low-Cost Advantage
Large-Cap Value	14.8%	12.8%	2.0%
Large-Cap Blend	14.7	10.9	3.8
Large-Cap Growth	14.2	11.2	3.0
Mid-Cap Value	15.3	12.5	2.8
Mid-Cap Blend	15.4	14.2	1.2
Mid-Cap Growth	14.7	12.5	2.2
Small-Cap Value	16.8	12.0	4.8
Small-Cap Blend	15.6	11.3	4.3
Small-Cap Growth	15.4	14.5	0.9
All Funds	14.5%	12.3%	2.2%

The hypothesis that the funds in the low-cost quartile would outperform those in the high-cost quartile was again clearly validated during this period, as Exhibit 2 shows. The expense ratio differential during this period was 1.2 percentage points (0.6% for the low-cost funds, 1.8% for the high-cost funds), about the same as the 1.3 percentage point spread in the prior study. But the performance differential is once again approximately double the cost differential, 2.2 percentage points. Each $1.00 of extra cost, then, resulted in a loss of $1.83 of return in the ten-year period, as compared to $2.00 in the five-year period.

Unlike the 1992-1996 period, when the risk exposure of the high-cost funds (standard deviation, 12.2%) was only slightly higher than for the low-cost funds (11.8%), the risk exposure differential during 1991-2001 has increased sharply. The standard deviation of the low-cost funds averaged 17.4%, versus 20.1% for the high-cost funds, a 15.5% greater risk exposure. As a result, the *risk-adjusted* returns of the low-cost funds averaged 13.8%, versus 10.8% for the high-cost funds, raising the performance differential to 3.0 percentage points annually during the past decade. That is, each $1.00 of extra cost resulted in a loss of $2.50 in risk-adjusted return.

It is not possible to understate the significance of

EXHIBIT 3
RISK-ADJUSTED RETURNS
Ten Years Ended June 30, 2001*

	Low-Cost Quartile	High-Cost Quartile	Low-Cost Advantage
Large-Cap Value	15.3%	13.4%	1.9%
Large-Cap Blend	14.6	11.0	3.6
Large-Cap Growth	13.3	10.2	3.1
Mid-Cap Value	15.8	11.5	4.3
Mid-Cap Blend	14.3	12.4	1.9
Mid-Cap Growth	13.7	11.6	2.1
Small-Cap Value	15.9	10.6	5.3
Small-Cap Blend	15.1	11.8	3.3
Small-Cap Growth	16.6	13.7	2.9
All Funds	13.8%	10.8%	3.0%

**Calculation method described in Modigliani and Modigliani [1997]. Style-specific benchmarks are used to calculate risk-adjusted returns. See the appendix for detailed figures.*

these differences. *Costs matter,* and they matter even more now than the 1992-1996 study suggests.[2]

The consistency of the advantage in risk-adjusted return that low-cost funds have achieved over high-cost funds is remarkable, as Exhibit 3 shows.

The Sharpe ratio provides another way of viewing risk-adjusted returns. In the 1992-1996 study, the average Sharpe ratio for the low-cost funds was 1.13, or 35% higher than the 0.84 for the high-cost funds. Even this substantial difference widened in the ten-year study. The Sharpe ratio of 0.77 for the low-cost funds compares to 0.52 for the high-cost funds, an improvement of fully 48% (*Exhibit 4*).

This differential is even more consistent across the nine style boxes than was the case before, when eight of the nine style boxes fit the pattern. In the ten-year study, the low-cost funds demonstrate substantial superiority in all nine of the style boxes.

INDEX FUNDS

As a result of the powerful link between cost and return evidenced in the 1992-1996 study, I then asked if costs matter so much—as they obviously do—and if index funds are the lowest-cost funds—*why not just hold index funds that replicate each of the nine style boxes?*

That proved to be a profitable avenue of exploration. Taking all mutual funds as a group, and comparing them to a mix of comparable index funds, the earlier study shows the results in Exhibit 5.

As Exhibit 5 shows, the Sharpe ratio of the index funds (1.23) exceeds that of the average managed fund (0.99) by fully 24%; that of the high-cost funds (0.84) by 46%; and even that of the low-cost funds (1.13) by 9%.

The consistency of the relationship found between index funds and managed funds throughout the nine style boxes is remarkable. In eight of the nine boxes, the appropriate index fund Sharpe ratio exceeds that of the average managed fund by from 0.16 to 0.46. (In the four fund groups with the largest—and therefore more statistically significant populations—the range is narrower, +0.16 to +0.31.) Only in the small-cap growth fund segment does the small-cap growth index fund fall short, by 0.06. (More about that group later.)

The new study clearly confirms the finding of the earlier study. During the ten years ended June 30, 2001, the index fund advantage is again compelling, as summarized in Exhibit 6. The index fund advantage over the

EXHIBIT 4
SHARPE RATIOS
Ten Years Ended June 30, 2001

	Low-Cost Quartile	High-Cost Quartile	Low-Cost Advantage	5 Years Ended Dec. 31, 1996 % Difference
Large-Cap Value	0.91	0.74	23%	60%
Large-Cap Blend	0.82	0.51	61	24
Large-Cap Growth	0.62	0.40	55	33
Mid-Cap Value	1.01	0.60	68	63
Mid-Cap Blend	0.81	0.66	23	56
Mid-Cap Growth	0.48	0.35	37	45
Small-Cap Value	1.04	0.57	82	9
Small-Cap Blend	0.74	0.46	61	(7)
Small-Cap Growth	0.60	0.43	40	8
All Funds	0.77	0.52	48%	35%

average fund is slightly less than in the 1992-1996 study—18% above the Sharpe ratio of the average fund (0.79 versus 0.67) compared to 24%. The advantage *increases* from 46% to 52% over that of the high-cost funds (0.79 versus 0.52), but *declines* from 9% to 2% above that of the low-cost funds (0.79 versus 0.77).

Once again, the index funds prevail over active managers, albeit at somewhat lower margins of advantage (*Exhibit* 7). The uniformity of advantage is striking. The index funds provide higher risk-adjusted returns in eight of the nine style boxes. The sole exception is the apparent superiority of active managers in the small-cap growth category, as evidenced also in the earlier study.

SUMMING UP THE STUDIES

It is highly significant that the ten-year study so powerfully reinforces the findings of the five-year study. Once again, low-cost funds outpace high-cost funds. Once again, costs matter even more than we expect (i.e., a 1% reduction in costs generates an increase in risk-adjusted return that is much higher than 1%). Once again, index funds—the fund category with the lowest costs—give an excellent account of themselves.

The 1998 study concludes: 1) higher returns are directly associated with lower costs; and 2) the notion that indexing works only in large-capitalization markets no longer has the ring of truth. Both conclusions are reinforced in the current study.

MUTUAL FUND RETURNS ARE CONSISTENTLY OVERSTATED

However one regards the validity of these data, it must be recognized that *the average returns of the actively managed mutual fund that I have presented are significantly overstated.* First and foremost, they are *survivor-biased.*

Only the funds that survived through the decade to report their performance at the close of the period are included in the sample. The 634 funds for which Morningstar reported ten-year records represent the survivors of an estimated 890 funds that began the decade. The records of the remaining 256 funds are lost in the dustbin of history. It is reasonable to postulate that the poorer performers dropped by the wayside, thereby biasing the study results in favor of the manager.

How much bias? We can't be sure. Independent studies confirm that survivor bias is substantial. In Malkiel [1995] and Carhart et al. [2001], survivor bias ranges

EXHIBIT 5
FIVE YEARS ENDED DECEMBER 31, 1996

	Expense Ratio	Annual Return	Risk*	Sharpe Ratio
All Funds	1.25%	13.7%	11.9%	0.99
High-Cost Quartile	2.03	12.3	12.2	0.84
Low-Cost Quartile	0.69	14.9	11.8	1.13
Index Funds	0.25	15.1	9.7	1.23

**Standard deviation of returns, 1992–1996.*

EXHIBIT 6
TEN YEARS ENDED JUNE 30, 2001

	Expense Ratio	Annual Return	Risk*	Sharpe Ratio
All Funds	1.16%	13.7%	18.7%	0.67
High-Cost Quartile	1.85	12.3	20.1	0.52
Low-Cost Quartile	0.64	14.5	17.4	0.77
Index Funds	0.20	14.4	16.2	0.79

**Standard deviation of returns, 6/30/91 to 6/30/01.*

from 1.5% to 3.1% per year. If we were to assume a bias of 2% during the ten-year period ended June 30, 2001 (greater for each of the small-cap groups, less for the large-cap groups), the annual risk-adjusted return of the average managed fund would drop from 12.5% to 10.5%, a 3.9 percentage point shortfall to the 14.4% return of the total stock market, and more than double the active fund shortfall of 1.9 percentage points I have suggested. When they fail to acknowledge the role of survivor bias in the data, studies that purport to show that indexing doesn't work leave much to be desired.

Several years ago, Morningstar estimated the survivor bias for each of its style boxes over the five-year period 1992-1996 (see Barbee [1999]). Even in that relatively short period, the bias was equal to almost 1% per year. Interestingly, in the light of my earlier finding that only small-cap growth funds had succeeded in outpacing their target index, the annual survivor bias in that style box was 1.7%. If we assume, for the purposes of argument, that the (necessarily higher) ten-year bias is 3.0% per year, the data showing a 1.7 percentage point annual advantage over the index for small-cap managers becomes a 1.3% *disadvantage.*

SOME FUND RETURNS ARE INFLATED

Even the records of those funds that do survive are to some degree suspect. It is hardly without precedent for small funds, often those run by large advisors, to inflate

EXHIBIT 7
SHARPE RATIO: INDEX FUNDS VERSUS MANAGED FUNDS
Ten Years Ended June 30, 2001

	Index Fund	Managed Fund	Index Advantage	Index Advantage	Five Years Ended Dec. 31, 1996
Large-Cap Value	0.88	0.81	0.07	9%	25%
Large-Cap Blend	0.84	0.69	0.15	22	20
Large-Cap Growth	0.68	0.55	0.13	24	23
Mid-Cap Value	1.00	0.82	0.18	22	29
Mid-Cap Blend	0.87	0.74	0.13	17	30
Mid-Cap Growth	0.48	0.45	0.03	7	24
Small-Cap Value	1.06	0.84	0.22	26	40
Small-Cap Blend	0.73	0.67	0.06	9	20
Small-Cap Growth	0.38	0.48	(0.10)	(21)	(9)
All Funds	0.79	0.67	0.12	18%	24%

their records by purchasing IPOs, quickly flipping them, and generating returns that do not recur when the fund becomes large. Two managers have been fined by the SEC for this practice.

One managed a fund that reported a 62% return for 1996, an excess return largely accounted for by purchasing just 100 to 400 shares of 31 hot IPOs. The other rose 119% during the 18 months following its initial offering, 83 percentage points of which came from first-day gains realized on newly public stocks. In yet another case, a fund advertised (in boldface type) a 196.88% return in 1999, acknowledging (in small print) that a significant portion came from IPOs. Yet these records are included in the industry data as if they were holy writ.

Actively managed funds also surrender a substantially greater portion of their pre-tax performance to taxes, in an amount that could have increased index fund superiority by as much as another 1.5 percentage points per year or more during the past decade. The 13.7% pre-tax annual return reported by the average mutual fund fell to an after-tax return of 11.1%, a loss of fully 2.6 percentage points to taxes.

Since only one index fund has operated during the entire past decade, after-tax style-box returns for the indexes are not available. But the largest S&P 500 index fund bore a tax burden of just 0.9%—far lower than the tax burden for the average fund. Ignoring taxes represents one more overstatement of fund returns by most studies of manager performance.

Finally, fund sales charges are ignored in most fund comparisons (including my data). Nonetheless, sales charges represent a hidden reduction in reported returns. If we assume that a decade ago three-quarters of all funds carried an average initial sales charge of 6%, the cost, amortized over the ten years would reduce returns reported by funds by another 0.5 percentage point annually. The high turnover of fund shares by investors, however, indicates that the average holding period is no more than five years. Thus, the actual reduction in annual return engendered by sales charges would be significantly higher than that, another substantial reduction in the return of managed funds.

When we consider all these factors, it must be clear that, whatever the relationship between style-box returns in managed funds and index funds, the reported returns of managed funds are significantly overstated. And, even when we accept the overstated fund data as presented, mutual funds as a group, style box by style box, with only one exception, fall well short of their index fund benchmarks, largely as a result of the costs they incur. *Index funds win.*

THE DATA VERSUS THE FACTS

You might say: So what else is new? For it must be obvious that if we take all stocks as a group, or any discrete aggregation of stocks in a particular style, an index that owns all of those stocks and precisely measures their returns must, and will, outpace the return of the investors who own that same aggregation of stocks but incur management fees, administrative costs, trading costs, taxes, and sales charges. Active managers as a group will fall short of the index return by the exact amount of the costs the active managers incur. *If the data we have available to us do not reflect that self-evident truth—well, the data are wrong.*

There are infinite ways the data can mislead. We count each mutual fund as a unit in calculating average returns, while the industry's actual aggregate record is reflected only in an asset-weighted return. Funds rarely stay rigidly confined to their style boxes; a growth fund may own some value stocks; a small-cap fund may own mid-cap and large-cap stocks.

Of course, it is at least theoretically possible that

mutual fund managers as a group may be smarter than other investors, and in fact consistently outpace the market by an amount sufficient to overcome their substantial costs. Let's think about that.

Is it realistic to believe that fund managers who—including the pension accounts they manage—control the investment process applicable to upward of 35% of the value of all U.S. equities can outpace other managers, advisors, and individuals? For example, for fund managers to outpace the market by 1 percentage point annually after costs of, say, 2% (excluding taxes) would require an excess return of 3%. In that case, all other investors as a group would then lose to the market by about 2 percentage points per year, or by 4 percentage points after costs.

In reasonably efficient markets such as those in the U.S., where prices are set largely by professional investors, such a gap would seem inconceivable. Further, the available data showing returns earned by individual investors give every indication that, like institutions, individuals match the market before costs and lose to the market after costs, a conclusion that would surprise no one who has ever examined performance data with care.

IMPORTANT SUCCESS

Even someone who has never plied the fund performance seas must understand this central fact of investing: *Investment success is defined by the allocation of financial market returns—stocks, bonds, and money market instruments alike—between investors and financial intermediaries.* Despite the elementary, self-evident, and eternal nature of this capital market equation—gross return minus cost equals net return—the dialogue between advocates of indexing and advocates of active management continues unabated, for there is a lot of money at stake—certainly well over $100 billion per year. Mutual fund direct costs alone (excluding sales charges and transaction fees) account for some $70 billion; fund trading costs likely account for an additional $50 billion or more.

The reality is that the horses ridden by the mutual fund jockeys are handicapped with so much weight that the entire fund industry cannot possibly win the race for investment success. Given the limitations on the data available that I have noted above, of course, if one searches long enough and hard enough, one can possibly identify interim periods when the equation will appear to be disproven.

But the reality is what it is. While there can be debate over the figures, there can be no debate over the facts: For investors in the aggregate, the capital market equation is unyielding. Yes, some managed funds can, and some do, outpace the indexes, but there is no sure way to identify them in advance.

INDEXING AND MARKET EFFICIENCY

There is one more misconception to put to rest. As Minor puts it:

> If [Bogle] is right [about the role of cost and the superiority of indexing], he will be wrong; and if he is wrong, he will be right. The more people become convinced they can beat the market (i.e, Bogle is wrong), the more efficient the markets become, as more intelligent and capable professionals enter the market. Ironically, it then becomes less likely they will outperform it. Or, if managers and investors come to believe that active management is a waste of money (i.e., Bogle is right), money managers will be replaced by index funds. This will reduce the number of market participants and hence worsen market efficiency. *The remaining minority of active money managers will then have a better chance of outperforming their respective markets* [2001, p. 49; emphasis added].

This allegation does not meet the test of simple logic. Whether the markets are efficient or not, as long as the index reflects the performance of the market (or any given segment of the market), it follows that the remaining participants (largely active managers) will also earn the market return (or market segment return) *before their intermediation costs are deducted*. The syllogism is 1) All investors as a group earn the market return. 2) Index funds earn the market return. Therefore: 3) All non-index investors earn the market return—but only before their costs are deducted. Result: The substantial costs of financial intermediaries doom active investors as a group to poorer returns.

Admittedly, if our markets turn inefficient—something that is hard to imagine in these days of infinite information—the "good" managers may be able to improve their edge over the "bad" managers. But it must be self-evident, that in effect each manager who succeeds in outpacing the stock market by, say, 4% per year before costs over a decade, must be balanced by another who falls short by 4%, again before costs.

Efficient markets or inefficient, active managers—good and bad together—lose. Such is the nature of financial markets.

APPENDIX

Supplemental Data

		Equity Fund Data																Index Fund Data[a]				
							Low-Cost Quartile versus High-Cost															
		Category Average					% Return[b]		% Risk		Sharpe Ratio		% Risk-Adj Return		Expense Ratio							
Number of Funds		10-Year Return[b] %	10-Year Std Dev %	10-Year Sharpe Ratio %	10-Year Risk-Adj Return %	Expense Ratio %	Low Cost	High Cost	Low Cost	High Cost	Low Cost	High Cost	Low Cost	High Cost	Low Cost	High Cost		10-Year Return[b] %	10-Year Std Dev %	10-Year Sharpe Ratio %	10-Year Risk-Adj Return %	Expense Ratio %
139	LV	13.62	14.48	0.81	14.20	1.06	14.80	12.81	14.72	14.40	0.91	0.74	15.28	13.39	0.63	1.61	LV	14.98	15.43	0.88	14.98	0.20
155	LB	13.17	16.08	0.69	13.09	1.02	14.70	10.89	16.10	15.70	0.82	0.51	14.59	10.98	0.45	1.73	LB	14.90	15.93	0.84	14.90	0.20
119	LG	13.40	21.49	0.55	12.28	1.26	14.20	11.23	20.74	22.21	0.62	0.40	13.28	10.21	0.73	2.26	LG	14.37	18.70	0.68	14.37	0.20
45	MV	14.40	15.96	0.82	13.61	1.36	15.29	12.55	13.97	16.87	1.01	0.60	15.79	11.52	0.82	2.05	MV	15.82	14.64	1.00	15.82	0.20
25	MB	14.50	18.02	0.74	13.70	1.24	15.37	14.24	18.36	20.53	0.81	0.66	14.31	12.40	0.74	1.71	MB	15.60	16.53	0.87	15.60	0.20
62	MG	13.82	27.25	0.45	13.26	1.22	14.66	12.54	28.24	28.88	0.48	0.35	13.72	11.65	0.84	1.69	MG	14.05	25.54	0.48	14.05	0.20
24	SV	14.49	15.71	0.84	13.55	1.26	16.81	11.97	15.39	17.46	1.04	0.57	15.86	10.62	0.87	1.80	SV	16.07	14.18	1.06	16.07	0.20
26	SB	14.33	19.09	0.67	14.09	1.15	15.63	11.32	19.49	20.06	0.74	0.46	15.14	11.79	0.64	1.72	SB	15.03	18.61	0.73	15.03	0.20
39	SG	14.38	27.75	0.48	14.30	1.34	15.36	14.48	24.67	29.86	0.60	0.43	16.58	13.72	0.91	1.85	SG	12.62	27.52	0.38	12.62	0.20
634	All[c]	13.69	18.73	0.67	12.48	1.16	14.48	12.29	17.45	20.11	0.77	0.52	13.78	10.82	0.64	1.85	All	14.36	16.18	0.79	14.36	0.20

[a] *S&P indexes for large-cap funds, Russell Mid-Cap for mid-cap funds, Russell 2500 for small-cap funds, and Wilshire 5000 for all funds; returns adjusted for estimated expenses.*

[b] *Annual rate of return (after expenses) June 30, 1991–June 30, 2001.*

[c] *Average, weighted by number of equity funds.*

Source: Morningstar. Prepared by The Vanguard Group, July 2001.

ENDNOTES

[1]Minor [2001] responded to that challenge by presenting data for the 1992-1996 period that seemed to contradict my conclusions.

[2]One explanation for this leverage effect, where the performance shortfall bears a 2½:1 ratio to cost, may be higher portfolio turnover. The annual turnover of the high-cost funds averaged 98%, more than 50% higher than the 63% turnover of the low-cost funds.

REFERENCES

Barbee, Olivia. "Numbers Do Lie." *Morningstar FundInvestor*, October 1999, pp. 1-13.

Bogle, John C. "The Implications of Style Analysis for Mutual Fund Performance Evaluation." *The Journal of Portfolio Management*, Summer 1998, pp. 34-42.

Carhart, Mark, Jennifer Carpenter, Anthony Lynch, and David Musto. "Mutual Fund Survivorship." Working paper, New York University, Stern School of Business, 2001.

Malkiel, Burton G. "Returns from Investing in Equity Mutual Funds 1971 to 1991." *Journal of Finance*, Vol. L, No. 2 (1995).

Minor, Dylan. "Beware of Index Fund Fundamentalists." *The Journal of Portfolio Management*, Summer 2001, pp. 45-50.

Modigliani, Franco, and Leah Modigliani. "Risk-Adjusted Performance." *The Journal of Portfolio Management*, Winter 1997.

To order reprints of this article please contact Ajani Malik at amalik@iijournals.com or 212-224-3205.

Contact The Vanguard Group for information and prospectuses on the mutual funds we advise and distribute. Our phone number is 1-800-523-1036. © 2002 The Vanguard Group, Inc. All rights reserved. Vanguard Marketing Corporation, Distributor.

Exhibit IV

The Mutual Fund Industry in 2003: Back to the Future

Remarks by John C. Bogle
Founder and Former Chairman, The Vanguard Group
Before the Harvard Club of Boston,
the Harvard Business School Association of Boston,
and the Boston Security Analysts Society
Boston, Massachusetts
January 14, 2003

It was just over 53 years ago when my career was determined by a fortuitous but life-altering moment in Princeton University's Firestone Library. Ever the contrarian, I was eager to find a topic that had not previously been the subject of a Princeton thesis when, in the December 1949 issue of *Fortune* magazine, I stumbled upon an article describing the mutual fund industry.

The title of the article was "Big Money in Boston." It featured the nation's oldest and largest mutual fund, Massachusetts Investors Trust (M.I.T.). The story described it as "the leader of a rapidly expanding and somewhat contentious industry of great potential significance to U.S. business." I immediately realized that I had found my topic.

The extensive study of the industry that followed led me to four conclusions: One, that mutual funds should be managed "in the most efficient, honest, and economical way possible," and that fund sales charges and management should be reduced. Two, mutual funds should not lead the public to the "expectation of miracles from management," since funds could "make no claim to superiority over the (unmanaged) market averages." Three, that "the principal function (of funds) is the management of their investment portfolios"—the trusteeship of investor assets—focusing "on the performance of the corporation . . . (not on) the short-term public appraisal of the value of a share (of stock)." And four, that "the prime responsibility" of funds "must be to their shareholders," to *serve* the individual investor and the institutional investor alike.

When I graduated in 1951 my work was rewarded with a job at Wellington Management Company, one of the industry pioneers, then with some $140 million of our assets under management. I became head of Wellington in 1965, and in 1967 merged it with a then-small

Boston manager named Thorndike, Doran, Paine, and Lewis. In January 1974, I was fired for my efforts. (It's a long story!) Painful as it was for me, I pulled myself together and by September of that year had founded Vanguard. As they say, "the rest is history." In short; no thesis, no career in the mutual fund industry; no firing, no Vanguard. There's a lot of luck in life! (Although I'm not sure our competitors would consider it *good* luck!)

In retrospect, that seminal *Fortune* article that inspired my thesis described an industry that is barely recognizable today. Not just in size, for, as I predicted, an era of growth lay ahead for this industry. If "Big Money" described a *tiny* industry, I'm not sure what adjective would be adequate to describe today's giant. And while more than one-half of fund assets were managed "in Boston" then, that share is now down to one-sixth. The mutual fund industry today is international in scope.

The vast changes in the size of this industry and in the types of funds we offer today—the difference between funds *past* and funds *present*—are but one reflection of the radical change in the very character of this industry. What *Fortune* described a half-century ago was an industry in which the idea was to sell what we made: *Funds that offer the small investor peace of mind,* an industry that focused primarily on stewardship. By contrast, the industry we see today is one focused primarily on salesmanship, an industry in which marketing calls the tune in which we make what will sell, and in which short-term performance is the name of the game.

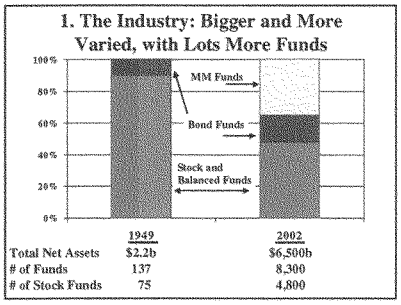
This change in character is not an illusion. Since that *Fortune* article was published slightly over a half-century ago, there are specific, quantifiable ways in which this industry has changed. Today I'll examine nine of them, and then conclude with an appraisal their impact on the effectiveness with which mutual funds serve their shareholders: *Have these changes been good for our investors or not*? I'll be using industry averages to measure these changes. Of course some fund firms—but not nearly enough, in my view—have strived to retain their original character. But overall, the mutual fund industry has changed radically. Let me count the ways:

1. Funds are Far Bigger, More Varied, and More Numerous

The mutual fund industry has become a giant. From its 1949 base of $2 *billion*, fund assets soared to $6.5 *trillion* at the outset of 2003, a compound growth rate of 16%. If we'd grown at the 7% nominal growth rate of our economy, assets would be just $72 *billion* today. (Such is the magic of compounding!). Then, 90% of industry assets were represented by stock

funds and stock-oriented balanced funds. Today such funds compose only about half of industry assets. Bond funds now represent one-sixth of assets, and money market funds—dating back only to 1970—constitute the remaining one-third. Once an equity fund industry, we now span the universe of major financial instruments—stocks, bonds, and savings reserves—a change that has been a boon not only to fund managers, but to fund investors as well.

So too has the number of funds exploded. Those 137(!) mutual funds of yesteryear have soared to today's total of 8,300. More relevantly, the total number of common stock funds has risen from just 75 to 4,800, although it is not at all clear that the *nature* of this increase has created investor benefits, for, in retrospect, "choice" has done investors more harm than good.



2. Stock Funds: From the Middle-of the-Road to the Four Corners of the Earth

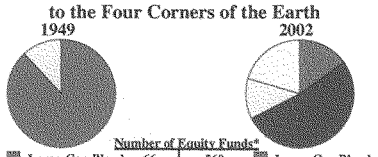
For as the number of stock funds soared, so did the variety of objectives and policies they follow. In 1950, the stock fund sector was dominated by funds that invested largely in highly-diversified portfolios of U.S. corporations with large market capitalizations, with volatility roughly commensurate with that of the Standard & Poor's 500 Stock Index. Today such middle-of-the-road funds represent a distinct minority of the total, and most other categories entail higher risks. Only 560 of the 3,650 stock funds measured by Morningstar now closely resemble their blue-chip ancestors.[1]

[1] The accepted terminology in equity funds reflects this change. We have come to accept a nine-box matrix of funds arranged by *market capitalization* (large, medium, or small) on one axis, and by *investment style* (growth, value, or a blend of the two) on the other. Yesteryear's middle-of-the-road funds would today find themselves in the "large-cap blend" box, constituting just 23% of the funds in the diversified U.S. fund category, and 15% of the Morningstar all-equity fund total.

What's more, we now have 450 specialized funds focused on narrow industry segments, from technology to telecommunications (particular favorites during the late bubble), and 750 international funds, running the gamut from diversified funds owning shares of companies all over the globe to highly specialized funds focusing on particular nations, from China to Russia to Israel. Among our 4,800 stock funds, there must now be one for every purpose under heaven.

A half-century ago, investors could have thrown a dart at a list of stock funds and had nine chances out of ten to pick a fund whose return was apt to parallel that of the market averages. Today, they have just one chance out of eight! When that old *Fortune* article noted that most funds did no more than give investors "a piece of the Dow Jones Average," it presciently added, "the average is not a bad thing to own." But today, for better or worse—probably worse—selecting mutual funds has become an art form.

2. Stock Funds: From Middle-of-the-Road to the Four Corners of the Earth



	Number of Equity Funds*		
Large-Cap Blend	66	560	Large-Cap Blend
Specialized	9	1,890	Other Div. Equity
		450	Specialized
		750	International
Total	75	3,650	Total

*2002 total is number covered by Morningstar

3. From Investment Committee to Broadway Stardom

These vast changes in fund objectives have led to equally vast changes in how mutual funds are managed. In 1950, the major funds were managed almost entirely by *investment committees.* But the demonstrated wisdom of the collective was soon overwhelmed by the perceived brilliance of the individual. First, the "Go-Go" era of the mid-1960s and then the recent bubble brought us hundreds of more aggressive "performance funds," and the new game seemed to call for free-wheeling individual talent. The term "investment committee" vanished, and "portfolio manager" gradually became the industry standard, now the model for some 3,200 funds of the 3,650 stock funds listed in Morningstar. ("Management teams" run the other 450 funds.)

The coming of the age of portfolio managers whose tenure lasted only as long as they produced performance moved fund management from the stodgy old consensus-oriented investment committee to a more entrepreneurial, free-form, and far less risk-averse approach. Before long, moreover, the managers with the hottest short-term records had been transformed by their employers' vigorous public relations efforts and the enthusiastic cooperation of the media, into "stars," and a full-fledged star-system gradually came to pass. A few portfolio managers actually *were* stars—Fidelity's Peter Lynch, Vanguard's John Neff, Legg Mason's Bill Miller, for example—but most proved to be *comets*, illuminating the fund firmament for a moment in time before they flamed out. Even after the devastation of the recent bear market, and the stunning fact that the tenure of the average portfolio manager is just five years, the system remains largely intact.

3. Committees, Stars, and Comets

Management Mode

1950: Almost Entirely Investment Committees

2002*:	**Investment Committee -**	**0 (?)**
	Single Portfolio Manager -	**1,600**
	Multiple Port. Managers -	**1,550**
	Management Team -	**450**

*Source: Morningstar. No manager listed for 50 funds.

4. Turnover Goes Through the Roof

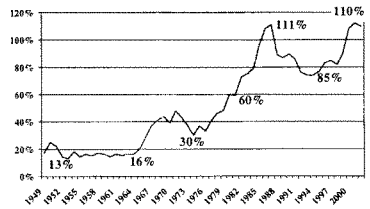
Together, the coming of more aggressive funds, the burgeoning emphasis on short-term performance, and the move from investment committees to portfolio managers had a profound impact on mutual fund investment strategies—most obviously in soaring portfolio turnover. M.I.T. and the other funds described in that *Fortune* article didn't even *talk* about long-term investing. They just *did* it, simply because that's what trusteeship is all about. But over the next half-century that basic tenet was turned on its head, and short-term speculation became the order of the day.

Not that the long-term focus didn't resist change. Indeed, between 1950 and 1965, it was a rare year when fund portfolio turnover much exceeded 16%, meaning that the average fund held its average stock for an average of about six years. But turnover then rose steadily and surely and fund managers now turn their portfolios over at an astonishing average annual rate of 110%(!). Result: Compared to that earlier six-year standard that prevailed for so long, the average stock is now held for just eleven months.

The contrast is stunning. At 16% turnover, a $1 billion fund sells $160 million of stocks in a given year and then reinvests the $160 million in other stocks, $320 million in all. At 110%, a $1 billion fund sells and then buys a total of $2.2 billion of stocks each year—nearly seven *times* as much. Even with lower *unit* transaction costs, it's hard to imagine that such turnover levels aren't a major drain on shareholder assets.

Let me be clear: If a six-year holding period can be characterized as long-term investment and if an eleven-month holding period can be characterized as short-term speculation, mutual fund managers today are not investors. We are speculators. When I say that this industry has moved from investment to speculation, I do not use the word "speculation" lightly. Indeed, in my thesis I used Lord Keynes' terminology, contrasting *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset"). I concluded that as funds grew they would move away from speculation and toward enterprise (which I called "investment"), focusing, not on the price of the share, but on the value of the corporation. As a result, I concluded, fund managers would supply the stock market "with a demand for securities that is *steady, sophisticated, enlightened,* and *analytic.*" I was dead wrong. We are no longer stock *owners.* We are stock *traders,* as far away as we can possibly be from investing for investment icon Warren Buffett's favorite holding period: *Forever.*

4. Turnover Goes Through the Roof

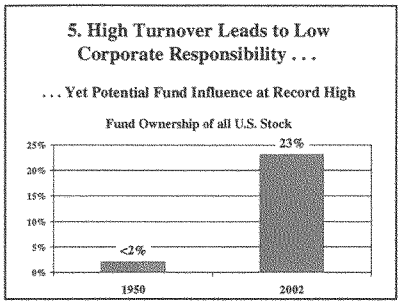


5. High Stock Turnover Leads to Low Corporate Responsibility

Whatever the consequences of this high portfolio turnover are for the shareholders of the funds, it has had dire consequences for the governance of our nation's corporations. In 1949, *Fortune* wrote, "one of the pet ideas (of M.I.T.'s Griswold) is that the mutual fund is the ideal champion of . . . the small stockholder in conversations with corporate management, needling corporations on dividend policies, blocking mergers, and pitching in on proxy fights." And in my ancient thesis that examined the economic role of mutual funds, I devoted a full chapter to their role "as an influence on corporate management." Mr. Griswold was not alone in his activism, and I noted with approval the SEC's 1940 call on mutual funds to serve as "the useful role of representatives of the great number of inarticulate and ineffective individual investors in corporations in which funds are interested."

It was not to be. Just as the early hope I expressed that funds would continue to invest for the long term went aborning, so did my hope that funds would observe their responsibilities of corporate citizenship. Of course the two are hardly unrelated: A fund that acts as a trader, focusing on the price of a share and holding a stock for but eleven months, may not even own the shares when the time comes to vote them at the corporation's next annual meeting. By contrast, a fund that acts as an owner, focusing on the long-term value of the enterprise, has little choice but to regard the governance of the corporation as of surpassing importance.

While funds owned but two percent of the shares of all U.S. corporations a half-century ago, today, they own 23 percent. They could wield a potent "big stick," but, with few exceptions, they have failed to do so. As a result of their long passivity and lassitude on corporate governance issues, we fund managers bear no small share of the responsibility for the ethical failures in corporate governance and accounting oversight that were among the major forces creating the recent stock market bubble and the bear market that followed. It is hard to see anything but good arising when this industry at last returns to its roots and assumes its responsibilities of corporate citizenship.

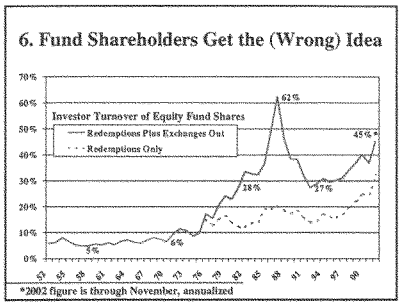


6. The Fund Shareholder Gets the (Wrong) Idea

The change in this industry's character has radically affected the behavior of the mutual fund shareholder. In the industry described in the *Fortune* article as having "tastes in common stocks that run to the seasoned issues of blue-chip corporations," shareholders bought fund shares and held them. In the 1950s, and for a dozen years thereafter, fund redemptions (liquidations of fund shares) averaged 6% of assets annually, suggesting that the average fund investor held his or her shares for 16 years. Like the managers of the funds they held, fund owners were investing for the long pull.

But as the industry brought out funds that were more and more performance-oriented, often speculative, specialized, and concentrated—funds that behaved increasingly like individual stocks—it attracted more and more investors for whom the long-term didn't seem to be relevant. Up, up, up went the redemption rate. Last year it reached 45% of assets, an average holding period of slightly more than two years. The time horizon for the typical fund investor had tumbled by fully 90%.

As "buy and hold" turned to "pick and choose," the average fund owner who once held a single equity fund came to hold four. *Freedom of choice* became the industry watchword, and "fund supermarkets," with their "open architecture," made it easy to quickly move money around in no-load funds. Trading costs are hidden in the form of access fees for the shelf-space offered by these supermarkets, paid for by the funds themselves, so that swapping funds seemed to be "free," tacitly encouraging fund shareholders to trade from one to another. But while picking tomorrow's winners based on yesterday's performance is theoretically attractive, in practice it is a strategy that is doomed to failure.

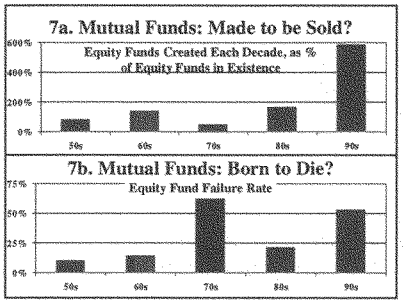


7. The Modern Mutual Fund . . . Made to be Sold

It is easy to lay the responsibility for this astonishing telescoping of holding periods on gullible, flighty, and emotional fund investors, or on the change in the character of our financial markets, especially in the boom and bust in the stock market bubble of 1997-2002. It was clearly a mania driven by the madness of crowds. But by departing from our time-honored tenet, "we sell what we make," and jumping on the "we make what will sell" bandwagon, creating new funds to match the market mania of the moment, this industry was a major contributor to that bubble. As technology and telecom stocks led the way, we formed 494 new technology, telecom, and internet funds, and aggressive growth funds favoring these sectors. In all, the number of stock funds, which grew by 80% in the 1950s and 48% in the 1970s, burgeoned almost 600% in the 1990s.

Not only did we form these funds, we marketed them with vigor and enthusiasm, through stock brokers and through advertising. Case-in-point: Right at the market peak, 44 mutual funds advertised their performance in the March 2000 issue of *Money*. *Their average return over the previous twelve exuberant months came to +85.6%*! Small wonder that this industry took in $555 billion of new money—more than a *half-trillion dollars*—during 1998-2000, overwhelmingly invested in the new breed of speculative high-performance funds. Most of the money, of course, poured into those winners of yesteryear *after* they led the market upward. So their assets were huge when they led the market on the way down, the investors' money gone up in smoke. First the cash flow stopped, and then it turned negative—an $18 billion *outflow* in the year just ended. Today, it is not *irrational exuberance* but *rational disenchantment* that permeates the community of fund owners, many of whom, unaware that the great party was almost over and that a sobering hangover lay ahead, imbibed far too heavily at the punch bowl.

It was not long until this flagrant formation of opportunistic new funds soon began to unwind. Fund deaths began to match, and will surely soon exceed, fund births. But it is not the old middle-of-the-road funds that are dying; it is largely the new breed of funds—those that sought out the exciting stocks of the new economy and hyped their records. While those conservative early funds were, as the saying goes, "built to last," their aggressive new cousins seemed "born to die." The fund failure rate soared. While only 10% of the funds in the 1950s were no longer in business at the end of that decade, more than half of the funds that existed during the past decade are in not business today. And this trend shows no signs of slowing, with nearly 900 funds giving up the ghost in the past three years alone, a rate that, if it continues, will produce another decade in which more than half of all equity funds cease to exist.



8. The Costs of Fund Ownership Have Soared

When "Big Money in Boston" featured Massachusetts Investors Trust, it was not only the oldest and largest mutual fund, but the least costly. The *Fortune* article reported that its annual management and operating expenses, paid at the rate of just 3.20% of its investment income, amounted to just $827,000. In 1951, its expenses come to just 0.29% of its assets. 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, M.I.T.'s expense ratio had risen to 1.20%, and its $141 million of expenses consumed 87%(!) of its investment income. 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.

The fund industry reports that the costs of fund ownership have steadily declined, but it is difficult to take that allegation seriously. The decline, if such it be, arises from investors increasingly choosing no-load funds and low cost funds, *not* from substantial management fee reductions. But even accepting the industry data at face value, the cost of mutual fund ownership is vastly understated. Why? *Because management fees, operating expenses and sales charges constitute only a fraction of fund costs.* Portfolio transaction costs—an inseparable part of owning most funds—are ignored. Out-of-pocket costs paid by fund investors are ignored. Fees paid to financial advisers to select funds (partly replacing those front-end loads) are ignored. Put them all together and it's fair to estimate that the all-in annual costs of mutual fund ownership now runs in the range of 2½% to 3% of assets.

What does that mean? While 2½% may look like small potatoes compared to the value of a typical fund investment, such a cost could cut deeply into the so-called "equity-premium" by which investors expect stock returns to exceed bond returns, giving the average equity fund investor a return little more than a bondholder, despite the extra risk. Looked at another way, 2½% would consume 25% of an annual stock market return of 10%. Over the long-term, $1 compounded in a 10% stock market would grow to $17.50 over 30 years; compounded at 7½%—a typical fund's return *after* such costs—would reduce that value by exactly one-half, to $8.75. *Costs matter!* Yet costs rise and sharply, one more indication that the fund industry has veered from its roots as an investment *profession,* moving ever closer to being just another consumer products *business.*

8. The Costs of Fund Ownership

	1951: Top 25 Equity Funds	2002: Top 25 Fund Mgrs.	Change
Total Assets (Bil)	$2.2	$1,860	845x
Average Exp. Ratio	0.64%	1.50%	+134%
		Total Equity Funds	
Fees and Op. Expenses (e)	$15 Mil.	$35 Bil.	2,300x

9. The March of the Entrepreneur

The industry that *Fortune* described all those years ago clearly placed the emphasis on fund management as a profession—the trusteeship of other people's money. The article is peppered with the words "trust" and "trustee," and frequently refers to the "investment-trust industry." Today, it seems clear that salesmanship has superseded trusteeship as our industry's prime focus. What was it that caused this sea change? Perhaps it's that trusteeship was essential for an industry whose birth in 1924 was quickly followed by tough times—the Depression, and then World War II. Perhaps it's that salesmanship became the winning strategy in the easy times thereafter, an era of almost unremitting economic prosperity. But I believe that the most powerful force behind the change was that mutual fund management emerged as one of the most profitable businesses in our nation. *Entrepreneurs could make big money managing mutual funds.*

The fact is that, only a few years after "Big Money in Boston" appeared, the whole dynamic of entrepreneurship in 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 the payment for the sale of a fiduciary office, an illegal appropriation of fund assets. If such sales were allowed, the SEC feared, it would lend to "trafficking" in advisory contracts, leading to a gross abuse of the trust of fund shareholders.

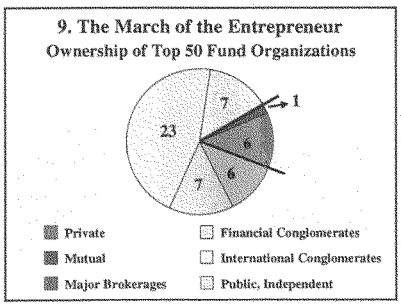
But a California management company challenged the SEC's position. The SEC went to court, and lost. As 1958 ended, the gates that had prevented public ownership since the industry began 34 years earlier came tumbling down. *Apres moi, le deluge!* A rush of initial public offerings began with the shares of a dozen management companies quickly brought to market. Investors bought management company shares for the same reasons that they bought Microsoft and I.B.M. and, for that matter, Enron: Because they thought their earnings would grow and their stock prices would rise accordingly.

But the IPOs were just the beginning. Even *privately-held* management companies were acquired by giant banks and insurance companies, taking the newly-found opportunity to buy into the burgeoning fund business at a healthy premium—averaging 10 times book value or more. "Trafficking" wasn't far off the mark; there have been at least 40 such acquisitions during the past decade, and the ownership of some firms has been transferred several times. Today, among the 50 largest fund managers, only six(!) are privately-held, plus mutually-owned Vanguard. 23

managers are owned by giant U.S. financial conglomerates, six are owned by major brokerage firms, and seven by giant foreign financial firms. (In 1982, even the executives of M.I.T. and its associated funds sold their management company to Sun Life of Canada.) The seven remaining firms are publicly-held.

It must be clear that when a corporation buys a business—whether a fund manager or not—it expects to earn a hurdle rate of, say, 12% on its capital. So if the acquisition cost were $1 billion, the acquirer would likely defy hell and high water in order to earn at least $120 million per year. In a bull market, that may be an easy goal. But when the bear comes, we can expect some combination of (1) slashing management costs; (2) adding new types of fees (distribution fees, for example); (3) maintaining, or even increasing, management fee rates; or even (4) getting its capital back by selling the management company to another owner. (The SEC's "trafficking" in advisory contracts writ large!)

It's not possible to assess with precision the impact of this shift in control of the mutual fund industry from private to public hands, largely those of giant financial conglomerates, but it surely accelerated the industry to change from profession to business. Such a staggering aggregation of managed assets—often hundreds of billions of dollars—under a single roof, much as it may serve to enhance, to whatever avail, the marketing of a fund complex's "brand name" in the consumer goods market, it seems unlikely to make the money management process more effective, nor to drive investor costs down, nor to enhance this industry's original notion of stewardship and service.



Summing Up the Half-Century: For Better or Worse?

In short, this industry is a long, long way from the industry described in "Big Money in Boston" all those years ago. While my characterization of the changes that have taken place may be subjective, the factual situation I've described is beyond challenge. This *is* an infinitely larger industry. The variety of funds *has* raised the industry's risk profile. The management mode *was* largely by committee but *is* overwhelmingly by portfolio manager. Fund turnover *has* taken a great upward leap. Fund investors *do* hold their shares for far shorter periods. Marketing *is* a much more important portion of fund activities. Fund costs, by any measure, *have* increased , and sharply. And those closely-held private companies that *were* once the industry's sole modus operandi *are* an endangered species.

All this change has clearly been great for fund managers. The aggregate market capitalization of all fund managers 50 years ago could be fairly estimated at $40 *million*. Today, $240 *billion* would be more like it. Way back in 1967, Nobel Laureate Paul Samuelson was smarter than he imagined when he said, "there was only one place to make money in the mutual fund business—as there is only one place for a temperate man to be in a saloon, behind the bar and not in front of it . . . so I invested in a management company."

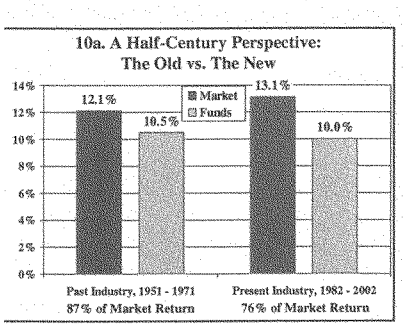
But our charge is to answer the question posed at the start of this speech. Have these nine changes served the interest of the mutual fund investor? The answer is a resounding no. It's a simple statistical matter to determine how well those on the other side of the bar in that saloon, using Dr. Samuelson's formulation, have been served, first by the old industry, then by the new.

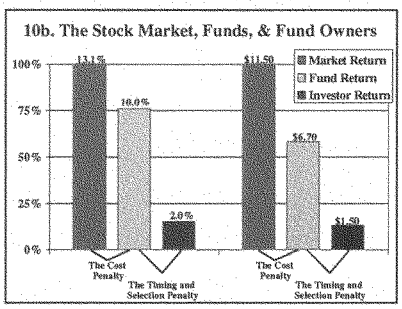
- During the first two decades of the period I've covered today (1950-1970), the annual rate of return of the average equity fund was 10.5%, compared to 12.1% for Standard & Poor's 500 Stock Corporate Index, a shortfall of 1.6 percentage points, doubtless largely accounted for by the then-moderate costs of fund ownership. The average fund delivered 87% of the market's annual return.

- During the past 20 years (1982-2002), the annual rate of return of the average equity fund was 10.0%, compared to 13.1% for the S&P 500 Index, a shortfall of 3.1 percentage points, largely accounted for by the now-far-higher levels of fund operating and transaction costs. The average fund delivered just 76% of the market's annual return.

It is the increase in *costs*, largely alone, that has led to that substantial reduction in the share of the stock market's return that the average fund has earned. But it is the change in the industry's *character* that has caused the average fund *shareholder* to earn far less than the average *fund*. Why? First, because shareholders have paid a heavy *timing* penalty, investing too *little* of their savings in equity funds when stocks represented good values during the 1980s and early 1990s. Then, enticed by the great bull market and the wiles of mutual fund marketers as the bull market neared its peak, they invested too *much* of their savings. Second, because they have paid a *selection* penalty, pouring money into "new economy" stocks and withdrawing it from "old economy" stocks during the bubble, at what proved to be precisely the wrong moment.

The result of these two penalties: While the stock market provided an annual return of 13% during the past 20 years, and the average equity *fund* earned an annual return of 10%, the average fund *investor*, according to recent estimates, earned just 2% per year. It may not surprise you to know that, compounded over two decades, the 3% penalty of costs is huge. But the penalty of character is even larger—another 8 percentage points. *$1 compounded at 13% grows to $11.50; at 10%, to $6.70; and at 2%, to just $1.50.* A profit of just fifty cents!





The point of this exercise is not precision, but direction. It is impossible to argue that the totality of human beings who have entrusted their hard-earned dollars to the care of mutual fund managers has been well-served by the myriad changes that have taken place from mutual funds past to mutual funds present. What about mutual funds yet to come? My answer will not surprise you. It is time to go back to our roots; to put mutual fund shareholders back in the driver's seat, to put the interests of shareholders ahead of the interests of managers and distributions, just as the 1940 Investment Company Act demands.

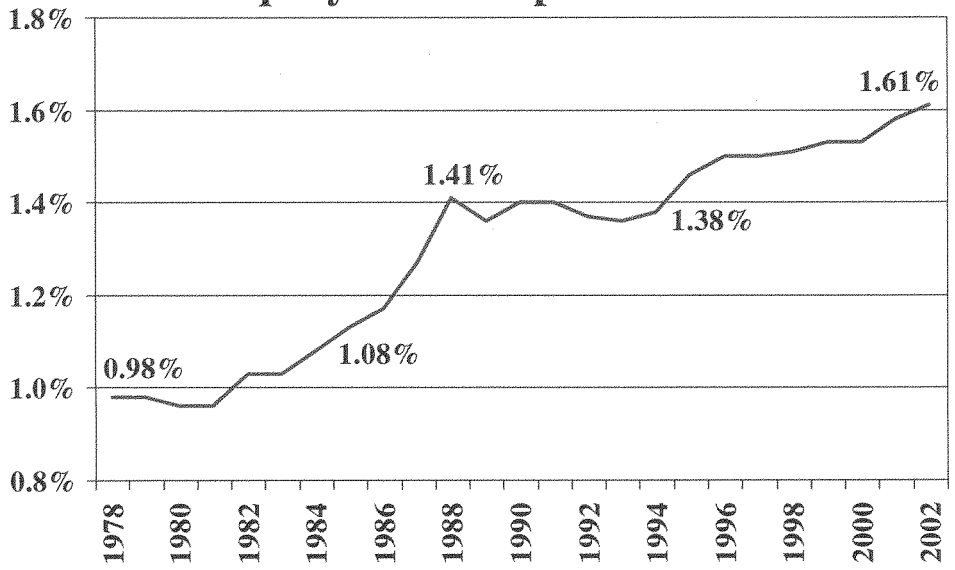
This industry must return to its focus on broadly-diversified funds with sound policies, sensible strategies, long-term horizons, and minimal costs. Some of the steps we must take are relatively painless—reducing turnover costs, by bringing turnover rates down to reasonable levels, for example—and some would be very painful—reducing management fees and sales commissions, and cutting our operating costs. But such cost reductions are necessary if we are to increase the portion of the stock market's return earned by our *funds*.

To enhance the share of our *fund* returns earned by our *shareholders*, on the other hand, we need to reorder our "product line" strategies by taking our foot off the marketing pedal, and pressing our foot down firmly on the stewardship pedal, giving the investor better information about asset allocation, fund selection, risks, potential returns, and costs, all with complete candor. After the market devastation of the past three years, I have no doubt that is what shareholders will come to demand. After all, as an article in the current issue of *Fortune* notes, "people won't act contrary to their own economic interests forever."

Fifty-plus years ago, the headline in that original *Fortune* article read: **The Future: Wide Open**. So it was then. I leave you with the same headline today. **The Future: Wide Open**. For it remains wide open, but only if we go back to the future—only if we return funds present to funds past—to our original character of stewardship and prudence. If funds come yet again to focus above all on serving our shareholders—serving them "in the most efficient, honest, and economical way possible"—the future for this industry will be not just bright, but brilliant.

Exhibit V

Equity Fund Expense Ratios



Source: Lipper Inc.

Exhibit VI

1951's Twenty-Five Largest Funds: Then and Now

	Fund	1951 Assets (million)	1951 Expense Ratio	1951 Revenue (million)	2002 Assets (million)	2002 Expense Ratio	2002 Revenue (million)	1951 to 2002 Increase in Expense Ratio	1951 to 2002 Increase in Fund Size	1951 to 2002 Increase in Fund Costs
1	Mass. Investors Trust	$ 438	0.29 %	$ 1.27	$ 6,611	1.19 %	$ 78.9	312 %	15 x	62 x
2	AXP Mutual*	323	0.58	1.88	1,608	0.91	14.6	57	5	8
3	Wellington Fund	194	0.55	1.07	22,390	0.35	78.3	(36)	115	73
4	Lord Abbett Affiliated*	170	0.66	1.12	10,944	0.90	98.3	36	65	88
5	American Fundamental*	115	0.73	0.84	16,287	0.70	113.2	(5)	141	134
6	Putnam Investors*	112	0.55	0.62	5,549	1.16	64.4	111	50	105
7	State Street Investment	107	0.59	0.63	1,400	1.20	16.8	104	13	27
8	Alliance Growth & Income*	102	0.76	0.77	6,552	1.45	94.7	90	64	122
9	Eaton & Howard Balanced	78	0.59	0.46	n/a			-	-	-
10	Eaton Vance Balanced*	75	0.64	0.48	165	1.37	2.3	114	2	5
11	Fidelity Fund	64	0.63	0.40	8,696	0.53	46.1	(16)	135	114
12	Waddell & Reed Adv Core*	53	0.80	0.43	4,589	1.06	48.6	33	86	114
13	George Putnam Fund	52	0.66	0.34	5,911	1.11	65.6	68	114	192
14	Alliance Mid Cap Growth*	51	0.63	0.32	462	1.30	6.0	106	9	19
15	Commonwealth Investment	42	0.64	0.27	n/a			-	-	-
16	Scudder Income*	36	0.69	0.25	566	0.95	5.4	38	16	21
17	American Business Shares	36	0.83	0.30	n/a			-	-	-
18	Mass. Investors Growth*	34	0.54	0.18	9,468	1.17	110.8	117	278	602
19	Keystone S2	34	0.71	0.24	n/a			-	-	-
20	Phoenix-Oakhurst G&I*	32	0.86	0.28	421	1.33	5.6	55	13	20
21	AMEX Stock*	32	0.61	0.19	2,277	0.91	20.7	49	72	108
22	Century Shares Trust	29	0.42	0.12	273	1.05	2.9	150	9	23
23	Seligman Growth*	27	0.50	0.14	459	1.35	6.2	170	17	46
24	Diversified Investment Fund	25	0.96	0.24	n/a			-	-	-
25	Seligman Common Stock*	24	0.48	0.12	298	1.28	3.8	167	12	33
	Average	**$ 91**	**0.64 %**	**$ 0.52**	**$ 5,246**	**1.06 %**	**$ 44.16**	**67 %**	**57 x**	**85 x**

*Fund name has changed

Exhibit VII

Memo Re: Investment Company Institute Releases on "Total Shareholder Costs of Mutual Funds"

A recent ICI Study (Total Shareholder Costs of Mutual Funds: An Update; September 2002) updates other studies it has provided over the past four years, purporting to show the costs of mutual fund ownership. Once again, the study relies on the sales-weighted costs of funds, rather than the more relevant asset-weighted data. Once again, it fails to report the continuing rise in fund expense ratios, or even present those expense ratios for analysis. Once again, it ignores the impact of low-cost index and institutional funds. Once again, it relies on sales charge calculations that appear to significantly understate this component of annual costs. And once again, it ignores three extremely large components of fund shareholder costs (financial adviser fees, portfolio turnover costs, and out-of-pocket fees).

Here is another way of looking at the ICI equity fund cost figure of 1.28%:

	Basis Points
ICI Figure	128
Corrected for sales charge calculation	+15E
Corrected for Index and Institutional funds	+12
Total	155
Financial adviser fees[1]	10E
Portfolio transaction costs	70E
Out-of-pocket costs	5E
Opportunity Cost (cash drag[2])	30
Total	270

Conclusion: The actual costs of mutual fund ownership appear to be more than 100% higher than reported by the ICI.

Discussion:

1. Many Costs Ignored. The ICI study simply excludes many of the costs of fund ownership. Equity fund transaction costs—an obvious cost of fund ownership—can be estimated at about 70 basis points a year. (Most independent experts would place it at a substantially higher amount.) Out of pocket fees are simply ignored; account maintenance fees, redemption fees, and penalty fees (deducted from the accounts of investors who redeem their "deferred load" funds before having paid the requisite annual total sales charge) would add further costs.

2. Operating Expense Ratios Rise—Dollar Expenses Soar 86-Fold. The 98 basis point decline in the ICI's version of total shareholder costs—from 226 basis points in 1980 to 128 basis points in 2001—came about *entirely* from lower distribution costs, which fell 109 basis points, from 149 to 40. Operating expenses actually rose—from 77 basis points to 88 basis points, despite the fact that equity fund assets rose 7,600%(!) during that period—from some $45 billion to $3.4 trillion . . . meaning that total fees (excluding 12b-1 fees) rose from $350 million in 1980 to $30 *billion* in 2001.

[1] Assumes 1% average fee paid on estimated $300 billion of equity fund assets.
[2] If stock returns average 9% and Treasury bills average 3%, the 6% spread on an average 5% cash position would be 30 basis points.

3. Sales Charge Costs Substantially Understated. Much of the alleged decline in distribution costs appears spurious, the result of amortizing front-end sales loads over a longer holding period than the facts justify (i.e., if a 6% sales charge were amortized over 10 years, it would average about 0.6% per year; over five years it would average about 1.3% per year). For their holding period data, the ICI relied on a 1990 study of redemption rates by the Wyatt Company, which in turn calculated redemption rates on a share purchase made in 1974. But in 1974 the equity fund redemption rate was 8% of assets (an average 12-year holding period); in 1990 it had risen to 38% and in 1998-2002 it averaged 39% (a 2.6 year holding period). Thus, if calculated using current redemption rates instead of data that are nearly 30 years old, the reported ICI front-end sales charge cost of 47 basis points could easily reach 90 basis points.

4. Expenses of Low-Cost Funds Rise Sharply. The ICI's original 1998 shareholder cost study reported that the *lowest* cost decile of funds had a 27% *increase* in costs from 1980-1997 (from 71 basis points to 90). Excluding Vanguard (which operates on an at-cost basis) from that group would suggest an increase of *at least* 33% for the lowest cost group of funds. (The ICI has eliminated this information from subsequent updates of the study.)

5. The Flaws of Sales Weighted Data. The long-term decline in fund costs reported in the studies is profoundly flawed by calculating cost on a sales-weighted rather than an asset-weighted basis. It also ignored the fact that the expenses of the *average* fund are about 30% *higher* than the asset-weighted expenses. The 1999 study shows (in basis points):

	Sales-Weighted Average Cost		% Change	Asset-Weighted Average Cost		% Change	Simple Average Fund Cost		% Change
	1980	1998		1980	1998		1980	1998	
Money Market	55	42	-24	55	51	-7	67	62	-7
Bond	154	109	-29	210	124	-41	216	151	-30
Equity	226	135	-40	231	132	-43	241	193	-20

The use of sales-weighted data reflects not a fall in fund costs, but a change in consumer preferences toward lower-cost and index fund and away from higher-cost funds. Price competition is properly defined, however, not by the actions of consumers, but by the actions of producers.

6. Indexed and Institutional Funds are Responsible for Much of the Reported Decline. Since 1980, index funds and institutional funds (for very large investments) have come to the fore, seriously distorting the equity fund cost analysis. ICI figures show that the reported 1998 equity fund sales-weighted cost of 135 basis points would rise to 153 basis points if they were excluded. If further adjustment is made by also excluding the three largest fund complexes, the cost rises to 165 basis points.

7. Operating Costs Continue to Rise. The most recent ICI Study (September 2002) calculates total shareholder cost for equity funds of 128 basis points on a sales-weighted basis; a further reduction of seven basis points from the 135 total for 1998. However, sales costs declined by 12 basis points, meaning that operating expenses continued their long-term rise, moving up by five basis points from 83 to 88, another 6% increase.

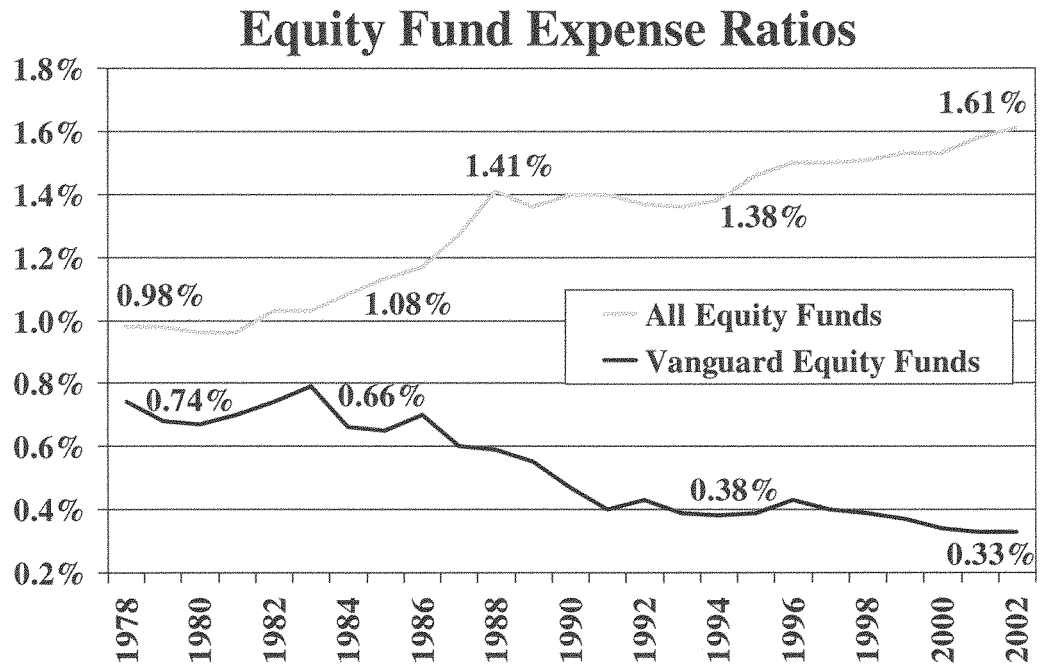
Exhibit VIII

Money Market Comparison

	Smith Barney Funds		Vanguard Funds	
	Fiscal Year 2000		Fiscal Year 2000	
Fees	Total Expenses	Expense Ratio	Total Expenses*	Expense Ratio
Investment Management	$ 257,036,799	0.40%	$ 15,394,000	0.02%
Distribution	$ 65,374,726	0.10%	$ 11,798,000	0.02%
Shareholder Services	$ 48,500,618	0.07%	$ 169,412,000	0.25%
Other	$ 8,791,460	0.01%	$ 4,527,000	0.01%
Total Expenses	$ 379,703,603	0.59%	$ 201,131,000	0.30%
Total Assets:	$ 64,865,192,337		$ 67,460,548,000	

*Vanguard's actual investment management expenses totaled $7,697; this figure was doubled to account for other general management expenses, with the "Service" expenses commensurately reduced.

Exhibit IX



Source: Lipper Inc.

Exhibit X

Fee Schedule for Advisory Services Provided to Two Vanguard Funds

Red text indicates a change in the fee schedule from the previous year.

	Wellington Fund				GNMA Fund			
Year	Fund Assets (millions)	Advisory Fee Schedule			Fund Assets (millions)	Advisory Fee Schedule		
1975	$ 776	0.445% on the first	$	250				
		0.375% on the next	$	200				
		0.225% on the next	$	150				
		0.150% on the next	$	100				
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.313%**				
		Change From Prior Year:		**n/a**				
1976	$ 847	0.320% on the first	$	250				
		0.250% on the next	$	200				
		0.150% on the next	$	150				
		0.100% over	$	600				
		Adv. Fee Exp. Ratio:		**0.209%**				
		Change From Prior Year:		**-33%**				
		Saved Under New Schedule:	$	**0.7**				
1977	$ 706	0.320% on the first	$	250				
		0.250% on the next	$	200				
		0.150% on the next	$	150				
		0.100% over	$	600				
		Adv. Fee Exp. Ratio:		**0.231%**				
		Change From Prior Year:		**10%**				
1978	$ 640	0.200% on the first	$	100				
		0.175% on the next	$	100				
		0.150% on the next	$	500				
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.162%**				
		Change From Prior Year:		**-30%**				
		Saved Under New Schedule:	$	**0.5**				
1979	$ 606	0.200% on the first	$	100				
		0.175% on the next	$	100				
		0.150% on the next	$	500				
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.162%**				
		Change From Prior Year:		**0%**				
1980	$ 612	0.200% on the first	$	100	$ 25	0.125% on the first	$	25
		0.175% on the next	$	100		0.100% on the next	$	25
		0.150% on the next	$	500		0.075% over	$	50
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.162%**		**Adv. Fee Exp. Ratio:**		**0.150%**
		Change From Prior Year:		**0%**		**Change From Prior Year:**		**n/a**
1981	$ 521	0.200% on the first	$	100	$ 25	0.125% on the first	$	25
		0.175% on the next	$	100		0.100% on the next	$	25
		0.150% on the next	$	500		0.075% over	$	50
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.164%**		**Adv. Fee Exp. Ratio:**		**0.150%**
		Change From Prior Year:		**1%**		**Change From Prior Year:**		**0%**

Copy of record filed in electronic

Year	Wellington Fund Fund Assets (millions)	Advisory Fee Schedule			GNMA Fund Fund Assets (millions)	Advisory Fee Schedule		
1982	$ 558	0.200% on the first	$	100	$ 79	0.125% on the first	$	25
		0.175% on the next	$	100		0.100% on the next	$	25
		0.150% on the next	$	500		0.075% over	$	50
		0.100% over	$	700				
		Adv. Fee Exp. Ratio:		**0.163%**		**Adv. Fee Exp. Ratio:**		**0.099%**
		Change From Prior Year:		**-1%**		**Change From Prior Year:**		**-34%**
1983	$ 614	0.175% on the first	$	100	$ 157	0.063% on the first	$	25
		0.150% over	$	100		0.050% on the next	$	25
						0.038% over	$	50
		Adv. Fee Exp. Ratio:		**0.154%**		**Adv. Fee Exp. Ratio:**		**0.043%**
		Change From Prior Year:		**-6%**		**Change From Prior Year:**		**-56%**
		Saved Under New Schedule:	**$**	**0.1**		**Saved Under New Schedule:**	**$**	**0.1**
1984	$ 614	0.175% on the first	$	100	$ 277	0.063% on the first	$	25
		0.150% over	$	100		0.050% on the next	$	25
						0.038% over	$	50
		Adv. Fee Exp. Ratio:		**0.154%**		**Adv. Fee Exp. Ratio:**		**0.041%**
		Change From Prior Year:		**0%**		**Change From Prior Year:**		**-6%**
1985	$ 813	0.175% on the first	$	100	$ 1,115	0.063% on the first	$	25
		0.150% over	$	100		0.050% on the next	$	25
						0.038% over	$	50
		Adv. Fee Exp. Ratio:		**0.153%**		**Adv. Fee Exp. Ratio:**		**0.038%**
		Change From Prior Year:		**-1%**		**Change From Prior Year:**		**-6%**
1986	$ 1,125	0.150% on the first	$	500	$ 2,100	0.038% on the first	$	1,000
		0.125% on the next	$	500		0.031% on the next	$	1,000
		0.075% on the next	$	1,000		0.025% on the next	$	3,000
		0.005% over	$	2,000		0.019% over	$	5,000
		Adv. Fee Exp. Ratio:		**0.130%**		**Adv. Fee Exp. Ratio:**		**0.034%**
		Change From Prior Year:		**-15%**		**Change From Prior Year:**		**-12%**
		Saved Under New Schedule:	**$**	**0.3**		**Saved Under New Schedule:**	**$**	**0.1**
1987	$ 1,331	0.150% on the first	$	500	$ 1,757	0.038% on the first	$	1,000
		0.125% on the next	$	500		0.031% on the next	$	1,000
		0.075% on the next	$	1,000		0.025% on the next	$	3,000
		0.005% over	$	2,000		0.019% over	$	5,000
		Adv. Fee Exp. Ratio:		**0.122%**		**Adv. Fee Exp. Ratio:**		**0.035%**
		Change From Prior Year:		**-6%**		**Change From Prior Year:**		**3%**
1988	$ 1,527	0.150% on the first	$	500	$ 1,797	0.038% on the first	$	1,000
		0.125% on the next	$	500		0.031% on the next	$	1,000
		0.075% on the next	$	1,000		0.025% on the next	$	3,000
		0.005% over	$	2,000		0.019% over	$	5,000
		Adv. Fee Exp. Ratio:		**0.116%**		**Adv. Fee Exp. Ratio:**		**0.035%**
		Change From Prior Year:		**-5%**		**Change From Prior Year:**		**0%**
1989	$ 2,099	0.150% on the first	$	500	$ 2,032	0.038% on the first	$	1,000
		0.125% on the next	$	500		0.031% on the next	$	1,000
		0.075% on the next	$	1,000		0.025% on the next	$	3,000
		0.050% over	$	2,000		0.019% over	$	5,000
		Adv. Fee Exp. Ratio:		**0.104%**		**Adv. Fee Exp. Ratio:**		**0.034%**
		Change From Prior Year:		**-11%**		**Change From Prior Year:**		**-1%**

Year	Wellington Fund: Fund Assets (millions)	Advisory Fee Schedule		GNMA Fund: Fund Assets (millions)	Advisory Fee Schedule	
1990	$ 2,449	0.150% on the first	$ 500	$ 2,469	0.038% on the first	$ 1,000
		0.125% on the next	$ 500		0.031% on the next	$ 1,000
		0.075% on the next	$ 1,000		0.025% on the next	$ 3,000
		0.050% over	$ 2,000		0.019% over	$ 5,000
		Adv. Fee Exp. Ratio:	**0.096%**		**Adv. Fee Exp. Ratio:**	**0.033%**
		Change From Prior Year:	**-7%**		**Change From Prior Year:**	**-5%**
1991	$ 3,818	0.125% on the first	$ 500	$ 5,103	0.031% on the first	$ 2,500
		0.100% on the next	$ 500		0.025% on the next	$ 2,500
		0.075% on the next	$ 1,000		0.019% on the next	$ 2,500
		0.050% on the first	$ 1,000		0.013% over	$ 7,500
		0.040% over	$ 3,000			
		Adv. Fee Exp. Ratio:	**0.071%**		**Adv. Fee Exp. Ratio:**	**0.028%**
		Change From Prior Year:	**-26%**		**Change From Prior Year:**	**-14%**
		Saved Under New Schedule:	**$ 0.3**		**Saved Under New Schedule:**	**$ 0.03**
1992	$ 5,570	0.125% on the first	$ 500	$ 6,956	0.031% on the first	$ 2,500
		0.100% on the next	$ 500		0.025% on the next	$ 2,500
		0.075% on the next	$ 1,000		0.019% on the next	$ 2,500
		0.050% on the first	$ 1,000		0.013% over	$ 7,500
		0.040% over	$ 3,000			
		Adv. Fee Exp. Ratio:	**0.061%**		**Adv. Fee Exp. Ratio:**	**0.025%**
		Change From Prior Year:	**-14%**		**Change From Prior Year:**	**-9%**
1993	$ 8,076	0.125% on the first	$ 500	$ 7,073	0.031% on the first	$ 2,500
		0.100% on the next	$ 500		0.025% on the next	$ 2,500
		0.075% on the next	$ 1,000		0.019% on the next	$ 2,500
		0.050% on the first	$ 1,000		0.013% over	$ 7,500
		0.040% over	$ 3,000			
		Adv. Fee Exp. Ratio:	**0.055%**		**Adv. Fee Exp. Ratio:**	**0.025%**
		Change From Prior Year:	**-11%**		**Change From Prior Year:**	**0%**
1994	$ 8,809	0.125% on the first	$ 500	$ 5,779	0.031% on the first	$ 2,500
		0.100% on the next	$ 500		0.025% on the next	$ 2,500
		0.075% on the next	$ 1,000		0.019% on the next	$ 2,500
		0.050% on the first	$ 1,000		0.013% over	$ 7,500
		0.040% over	$ 3,000			
		Adv. Fee Exp. Ratio:	**0.053%**		**Adv. Fee Exp. Ratio:**	**0.027%**
		Change From Prior Year:	**-2%**		**Change From Prior Year:**	**8%**
1995	$ 12,656	0.100% on the first	$ 1,000	$ 6,908	0.020% on the first	3000
		0.050% on the next	$ 2,000		0.010% on the next	3000
		0.040% on the next	$ 7,000		0.008% over	6000
		0.030% over	$ 10,000			
		Adv. Fee Exp. Ratio:	**0.044%**		**Adv. Fee Exp. Ratio:**	**0.014%**
		Change From Prior Year:	**-17%**		**Change From Prior Year:**	**-48%**
		Saved Under New Schedule:	**$ 0.6**		**Saved Under New Schedule:**	**$ 0.8**
1996	$ 18,192	0.100% on the first	$ 1,000	$ 7,441	0.020% on the first	$ 3,000
		0.050% on the next	$ 2,000		0.010% on the next	$ 3,000
		0.040% on the next	$ 7,000		0.008% over	$ 6,000
		0.030% over	$ 10,000			
		Adv. Fee Exp. Ratio:	**0.041%**		**Adv. Fee Exp. Ratio:**	**0.014%**
		Change From Prior Year:	**-7%**		**Change From Prior Year:**	**-3%**

Exhibit X

Year	Wellington Fund: Fund Assets (millions)	Advisory Fee Schedule			GNMA Fund: Fund Assets (millions)	Advisory Fee Schedule		
1997	$ 21,812	0.100% on the first		1,000	$ 8,725	0.020% on the first	$	3,000
		0.050% on the next		2,000		0.010% on the next	$	3,000
		0.040% on the next		7,000		0.008% over	$	6,000
		0.030% over		10,000				
		Adv. Fee Exp. Ratio:		**0.038%**		**Adv. Fee Exp. Ratio:**		**0.013%**
		Change From Prior Year:		**-7%**		**Change From Prior Year:**		**-6%**
1998	$ 25,761	0.100% on the first	$	1,000	$ 10,993	0.020% on the first	$	3,000
		0.050% on the next	$	2,000		0.010% on the next	$	3,000
		0.040% on the next	$	7,000		0.008% over	$	6,000
		0.030% over	$	10,000				
		Adv. Fee Exp. Ratio:		**0.037%**		**Adv. Fee Exp. Ratio:**		**0.012%**
		Change From Prior Year:		**-3%**		**Change From Prior Year:**		**-8%**
1999	$ 25,529	0.100% on the first		1,000	$ 12,548	0.020% on the first	$	3,000
		0.050% on the next		2,000		0.010% on the next	$	3,000
		0.040% on the next		7,000		0.008% over	$	6,000
		0.030% over		10,000				
		Adv. Fee Exp. Ratio:		**0.037%**		**Adv. Fee Exp. Ratio:**		**0.011%**
		Change From Prior Year:		**0%**		**Change From Prior Year:**		**-4%**
2000	$ 22,799	0.100% on the first	$	1,000	$ 13,911	0.020% on the first	$	3,000
		0.050% on the next	$	2,000		0.010% on the next	$	3,000
		0.040% on the next	$	7,000		0.008% over	$	6,000
		0.030% over	$	10,000				
		Adv. Fee Exp. Ratio:		**0.038%**		**Adv. Fee Exp. Ratio:**		**0.011%**
		Change From Prior Year:		**2%**		**Change From Prior Year:**		**-3%**
2001	$ 24,293	0.100% on the first	$	1,000	$ 18,981	0.020% on the first	$	3,000
		0.050% on the next	$	2,000		0.010% on the next	$	3,000
		0.040% on the next	$	7,000		0.008% over	$	6,000
		0.030% over	$	10,000				
		Adv. Fee Exp. Ratio:		**0.037%**		**Adv. Fee Exp. Ratio:**		**0.010%**
		Change From Prior Year:		**-9%**		**Change From Prior Year:**		**-7%**
2002	$ 22,389	0.100% on the first	$	1,000	$ 27,857	0.020% on the first	$	3,000
		0.050% on the next	$	2,000		0.010% on the next	$	3,000
		0.040% on the next	$	7,000		0.008% over	$	6,000
		0.030% over	$	10,000				
		Adv. Fee Exp. Ratio:		**0.038%**		**Adv. Fee Exp. Ratio:**		**0.009%**
		Change From Prior Year:		**2%**		**Change From Prior Year:**		**-7%**
		Advisory fees paid in 2002:	$	**8.5**		**Advisory fees paid in 2002:**	$	**2.6**
		2002 Adv. fees if 1973 schedule were still in effect:	$	**92.2**		**2002 Adv. fees if 1980 schedule were still in effect:**	$	**20.8**
		Savings realized by shareholders:	$	**83.7**		**Savings realized by shareholders:**	$	**18.2**

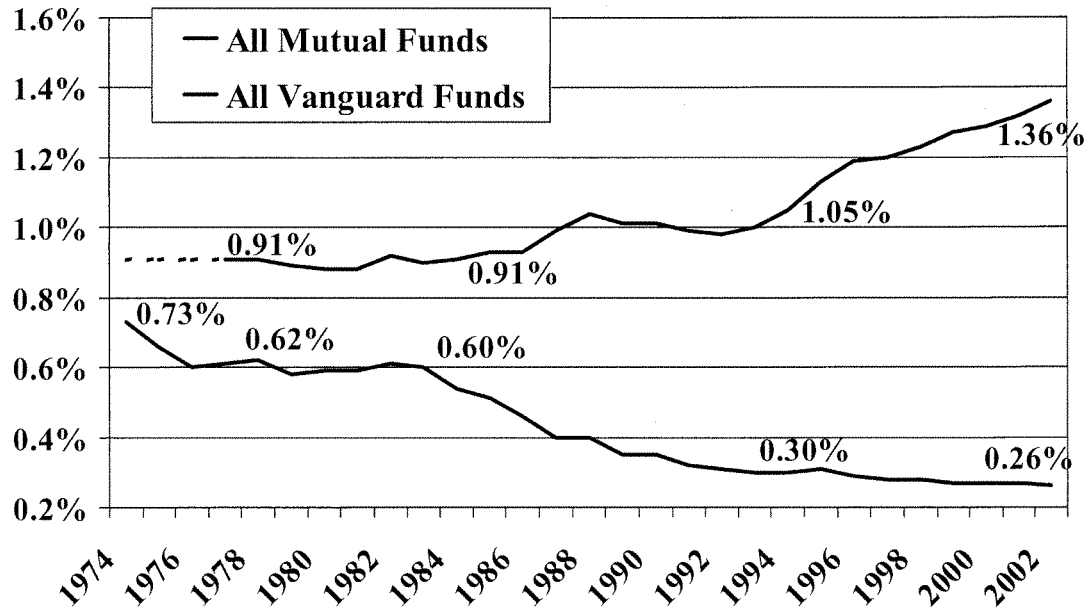
Exhibit X

Exhibits Provided by Witnesses

3/12/2003

1.

Mutual Fund Expense Ratios



Source: Lipper Inc.
Lipper data are not available until 1978. Thus, ERs for 1974 – 1977 are assumed to be the same as 1978's, 0.91%.

Money Market Fund Gross Returns, Expense Ratios, and Net Returns: 1997 – 2002

Decile	Gross Avg. Ann. Return	Avg. Exp.Ratio	Net Avg. Ann. Return
Lowest-Cost	4.80%	0.37%	4.43%
Highest-Cost	4.67%	1.74%	2.93%
Low-Cost Advantage	+2.9%	-78.7%	+51.2%

Risk-Adjusted Returns, Ten Years Ended 6/30/2001

3.

Equity Style	Low-Cost Quartile	High-Cost Quartile	Low-Cost Advantage
Large-Cap Value	15.3%	13.4%	+1.9%
Large-Cap Blend	14.6	11.0	+3.6
Large-Cap Growth	13.3	10.2	+3.1
Mid-Cap Value	15.8	11.5	+4.3
Mid-Cap Blend	14.3	12.4	+1.9
Mid-Cap Growth	13.7	11.6	+2.1
Small-Cap Value	15.9	10.6	+5.3
Small-Cap Blend	15.1	11.8	+3.3
Small-Cap Growth	16.6	13.7	+2.9
All Funds	13.8%	10.8%	+3.0%

The Mutual Fund Industry: As It Was, As It Is

4.

	Old Industry 1950 - 1970	New Industry 1982 - 2002
	Annual Return	
Stock Market	12.1%	13.1%
Avg. Equity Fund	10.5	10.0
% of Market Return Earned by Avg. Fund	87%	76%
	Profit on $10,000	
Stock Market	$88,820	$105,250
Avg. Equity Fund	63,670	56,765
% of Market Return Earned by Avg. Fund	72%	54%

Two Views of Equity Fund Costs

5.

	Annual Rate
ICI Figure	1.28%
Corrected for Sales Charge Calc.	+ .15
Corrected for Index & Inst. Funds	+ .12
Financial Advisor Fees	+ .10
Transaction Costs	+ .70
Out-of-Pocket Costs	+ .05
Opportunity Cost	+ .30
Total Annual Eq. Fund Expenses	2.70%

Money Market Fund Comparison

	Smith Barney Funds		Vanguard Funds	
	Expenses	Expense Ratio	Expenses	Expense Ratio
Inv. Mgmt.	$ 257m	0.40%	$ 15m	0.02%
Distribution	65m	0.10%	12m	0.02%
S/H Services	48m	0.07%	169m	0.25%
Other	8m	0.01%	4m	0.01%
Total	$ 378m	0.59%	$ 201m	0.30%

All fund expense data are for fiscal year 2000, during which each fund group's money market assets totaled approximately $65 billion.

The Benefit of Arms-Length Negotiations

	Vanguard Wellington Fund	Vanguard GNMA Fund
Advisory Fees Paid, 2002	$ 8.5m	$ 2.6m
Adv. Fees if First Fee Schedule were in Effect	92.2m	20.8m
Savings Realized by Shareholders	$83.7m	$18.2m

Written Testimony of **Mr. Harold Bradley**
Senior Vice President American Century Investment
Management

For a hearing on "Mutual Fund Industry Practices and their
Effect on Individual Investors", March 12, 2003

Before the House Subcommittee on Capital Markets, Insurance
And Government Sponsored Enterprises, Committee on
Financial Services

Introduction

Chairman Baker, Ranking Member Kanjorski, Members of the Subcommittee, thank you for the invitation to share my views on mutual fund industry trading practices, execution costs and their effect on individual investors.

I am proud to be associated with the mutual fund industry and its strong record as a stable, effectively regulated and affordable place for U.S. investors. My relationship with the industry is personal as most of my investments are held in mutual funds. The three-year bear market has been hard on all of us.

I represent American Century Investment Management. We manage about $70 billion for 1.5 million small investors and institutional clients. I have worked there for 15 years and served as portfolio manager, head of trading, and member of the company's Investment Oversight Committee. I have previously testified before congress in favor of decimalization and on the effect of technology on stock market structure. I have written numerous articles for industry publications and speak frequently at industry conferences addressing trading and portfolio management practices. I have served on committees of the Investment Committee Institute, the New York Stock Exchange and the NASDAQ stock market.

American Century, along with our industry, is now looking in the mirror to see what things we might do better. Nonetheless, we think that investors have been well served by mutual funds that offer professional money management, diversification and liquidity at very low cost to investors.

Commissions as Unreported Investment Manager Income

American Century has long recognized that the methods and costs for securities trading directly affect investment performance for our investors. We think Congress should work to understand how its law – section 28(e) of the 1975 Amendment to the Securities Exchange Act – encourages investment managers to ***use commissions paid by investors as a source of unreported income to pay unreported expenses of the manager.***

Specifically, we think that commissions should be negotiated and disclosed as a percent of the dollar amount of each trade rather than as a per share charge, as is the practice in all other markets except for the U.S. and Canada. We think that investment managers should identify and disclose to investors (or the board's directors) the execution-only rate for each broker to make explicit the perceived value of services beyond best execution. This should introduce true competition in trading costs that will benefit investors. We think that commissions used by investment managers to pay for goods and services customarily available to the general public for cash should be explicitly carried as a cost of managing money in a mutual fund's expense ratio.

Commissions and Stock Underwriting Practices

We also think the practices of stock underwriting should be reformed. Research and underwriting conflicts of interest have been based, in no small part, on quid pro quo arrangements available to the most generous commission payers. We recommend that IPOs be priced and allocated by Dutch auction pricing models, a method often used in public

company buyback programs. The control over both pricing and allocation of new issues by investment bankers may appear to "rig" the game in favor of large company CEOs at the expense of both mutual fund investors and individuals, effectively undermining capital formation processes.

We also think that underwriters should publish the names of the recipients of the largest 50 allocations on the day after the underwriting, so investment managers can better assess whether our investors receive appropriate allocations based on the bundled commission rates charged by most bankers. If we address these issues today, we can speed the healing of investor trust and confidence in our markets.

Section 28(e) and Its Effect on Investors

For some time, American Century has urged regulators and legislators to shine a bright light on burgeoning industry use of the Section 28(e) safe harbor. [1] The 1975 Amendment to the Securities Exchange Act allows investors to "pay up" for research services that benefit the investor, in the best judgment of the investment manager. The amount of commission that exceeds the lowest execution-only rate has been called soft dollars. Soft dollars may be "negotiated" in a number of ways. Some companies and clients prefer commission recapture programs whereby a broker will return 1c or so of "extra commissions" by check to investment managers and clients. Still others use so-called soft dollar converters who promise to pay $1,000 of the investment manager's expenses for every $1,600 of commissions directed to that broker, consistent with expectations of best execution. Most of these arrangements are not recorded on paper. Our tax people suggest that written

[1] A 1989 Trader Forum bulletin quotes former SEC Director of Market Regulation Lee Pickard as saying; "There was some controversy at that time as to whether 28(e) should have been put on the books. There were people then, perceptive perhaps, who realized 28(e) was going to result in some abuses. But it's part of the law. The SEC can't change it by itself." **Institutional Investor**, "*The Gray Areas of Directed Commission,*" 1989, p. 3.

contracts might trigger a requirement for accounting treatment of soft dollars by investment advisers.

In 1975, the idea of "paying up" was an abstract notion. Apple would not introduce the personal computer until 1982. Complex networks, commercial adoption of the Internet, and central data repositories were all a decade or more away. Today, the execution only cost of trading is readily identifiable and should be reportable.

Research Costs Six Times More Than Execution-Only

Last year, American Century traders executed more than 45% of its U.S. trading through mostly electronic, execution-only facilities at an average cost of about .85c per share. The average industry commission rate remains between 5.1c and 5.5c per share, according to Greenwich Associates (exhibit 1). That effective rate has changed little since 1991 despite a six-fold increase in trading volume because lower commission rates imply lower profits for both institutional money managers and their partners in the brokerage business (exhibit 2).

A reading of the legislative background of section 28(e) suggests that it was intended to keep fund managers out of regulatory hot water if they paid more than the lowest prevailing commission rate for services. But that was a different time. Industry practitioners feared that deregulated commissions would force a race to the bottom in price.

Lack of Visible Competition in Commission Rates

Recent reports indicate that while the average commission rate in cents per share has dropped marginally, commission costs have increased as a percent of total dollars (principal

amount) traded.[2] The U.S. and Canada are the only marketplaces in the world that do not use percent of principal as a trading cost barometer. In U.S. trading, during periods of falling equity prices, fixed costs per share represent a higher portion of trading costs. In markets with rising prices, brokers encourage publicly traded companies to split their shares – effectively doubling the cost of trading for the same dollar amount of the company when fixed costs per share are used. There is no incentive for this kind of behavior in markets where commissions are calculated as a percent of the principal amount traded.

Commission rates, measured in cents per share, have moved very little since 1986 when the SEC liberalized its interpretation of research under section 28(e). Now the pool of equity trading volumes eligible for soft dollar use is expanding. At the end of 2001, the SEC expanded its interpretation of the safe harbor to cover "flat" riskless principal trades by market makers in NASDAQ securities. This action reversed a longstanding SEC position that such trades fell outside provisions of section 28(e). Decimalization and electronic networks have pushed most of Wall Street away from principal market making in NASDAQ securities. As brokerage firms move to an explicit commission-based system for NASDAQ stocks, investment managers will likely access this new pool of available dollars for still more research and services.

We now have the systems and the data to create meaningful disclosures of these costs to investors. At best, insufficient disclosure provides investment managers little incentive to rationalize and manage the commissions, which are paid directly by investors. At its worst, section 28(e) allows some managers to boost profits during bad market conditions by paying more bills with investor commissions (exhibit 3). Greenwich Associates reported that a 27% decline in assets under management for the typical

[2] Capital Research Associates report to American Century as of 12/31/2002.

institutional manager in 2001 sharply reduced management fee income. Investment managers responded to the decline in assets, in part, by boosting soft dollar amounts paid by 17%, according to the self-reported study.[3]

A History of Worries About 28(e) and Investor Interests

It is interesting to review the regulatory history of section 28(e). The topic has been revisited every several years since 1975. Original interpretations of the statute by the Securities Exchange Commission did not permit a "safe harbor" for commissions used to purchase services "customarily available to the general public."[4] In 1986, after intense industry pressure, the SEC allowed that an investment advisor could use commissions and "pay up" for any service that assists him in making investment decisions on behalf of his clients.

Austin George, then head trader at T. Rowe Price, was quoted in 1989 as saying:

> "And, then of course, what's happening is people are starting to work backwards through all those things that for years were ordinary and expected business expenses to see how they could recover their costs. This is my personal area of greatest concern – in terms of the industry, not T. Rowe Price – because you suddenly put the trader in the position of being a potential deterrent to enhancing the profitability of the firm."[5]

The SEC subsequently reopened debate on aspects of section 28(e) with the concept release called Market 2000, in 1992. The House Subcommittee on Telecommunications and Finance held hearings on this matter in July 1993. David Silfen, a Goldman Sachs partner, testified:

> "[C]onflicts of interest are inherent in soft dollar arrangements. The money manager receives the products and services paid for by soft dollars. The client, often unknowingly, pays for these products and services as part of the brokerage commissions charged to his account. This situation presents an obvious temptation to the manager to buy items that

[3] **Greenwich Associates**, *A Closer Focus on Trading Costs*, April 2002
[4] **Institutional Investor**, *The Gray Areas of Directed Commissions*, 1989, p. 4.
[5] **Institutional Investor**, *The Gray Areas of Directed Commissions*, 1989, p. 8.

benefit itself rather than the client, or items, such as general research reports, quotations services and computer hardware and software, that other managers consider their own responsibility under their basis management fee. The money manager may also pay too much in commission or engage in unnecessary trading so as to generate more commission and thus more soft dollars."[6]

The possible misuse of commission dollars received additional SEC scrutiny in 1998 during a well-publicized soft dollar "sweep" during which broker dealers were audited for possible abuses.

Again and again, rightly placed concerns have foundered on the inadequacy of audit trails, the unrecorded nature of many soft dollar arrangements and the mutual benefit derived by industry players who work to preserve the opacity of the payment system.[7] [8]

Commissions, Accounting Bills, Phones and Exchange Fees

A major wirehouse-sponsored soft dollar "converter" had bill-paying arrangements with 264 third party "research" providers/vendors in 1988. That same broker converted commission dollars to pay 573 vendors in 1994. ***Today, the list has grown to more than 1,200 service suppliers*** (exhibit 4).

Accounting firms Ernst & Young and PricewaterhouseCoopers now can be paid with soft dollars.[9] Telephone companies, including SBC, Pacific Bell and US West can be paid with commissions. Professional development programs at the Kellogg School of Management and the Wharton School can be financed with commission streams. Recruiting firm Kforce.com is on the list. So are Compaq, Dell and CompUSA. The Standard Club of

---

[6] Oral Testimony of David Silfen, partner, Goldman Sachs and Co., July 12, 1993, House Telecommunications and Finance Subcommittee

[7] Nearly two-thirds of soft dollar agreements are unwritten and more than one-third of brokers are a party to illegal soft dollar arrangements, Benn Steil, *"Can Best Execution be Achieved in the Current Market Structure?"* AIMR Conference, December 1, 2000

[8] A check with our auditor determined that funds do not record income or expense from soft dollar practices because of the difficulty in assigning a value to research services and because of the undocumented nature of most agreements.

[9] See Appendix A, approved vendor relationships with major wirehouse soft dollar broker.

Chicago, "a private retreat of luxury and tranquility...home to Chicago's fashionable society and the business elite for over 125 years,"[10] also appears as a destination for some commission dollars.

Does not an investment manager require a phone, a newspaper and a stock quotation service to meet even minimal expectations of the investing public who pay a management fee for that service? Without specific regulatory action from the SEC and Congress that compels better disclosure and assignment of the economic value of this undisclosed income stream, more and more costs of business may soon fit the elusive and ever-expanding definitional framework of "research" under section 28(e).

SEC staff members have explained to me that definitions of best execution and research are so vague as to defy enforcement action. Recent attempts to define best execution "best practices," such as the Association for Investment Management and Research (AIMR) guidelines, have been watered down by qualified language offered by those with compelling commercial self-interests.

As an investment manager, I can tell you that good thinking by brokerage firm analysts often is invaluable in making wise investment decisions for my investors. As a trader, I can tell you that at times brokers critically augment our execution capabilities by facilitating block trades and by supplementing our internal trading resources during periods of heavy trading activity. The brokerage industry does provide valuable service to mutual fund advisors and other investment managers. However, our industry has failed thus far to adequately measure and report on the cost of these services to investors. The structural profit incentives of current practices will not change without the intervention of Congress to better define and limit the scope of section 28(e).

---

[10] Quote from Standard Club website.

Thank you for the opportunity to share my ideas on behalf of American Century and its investors.

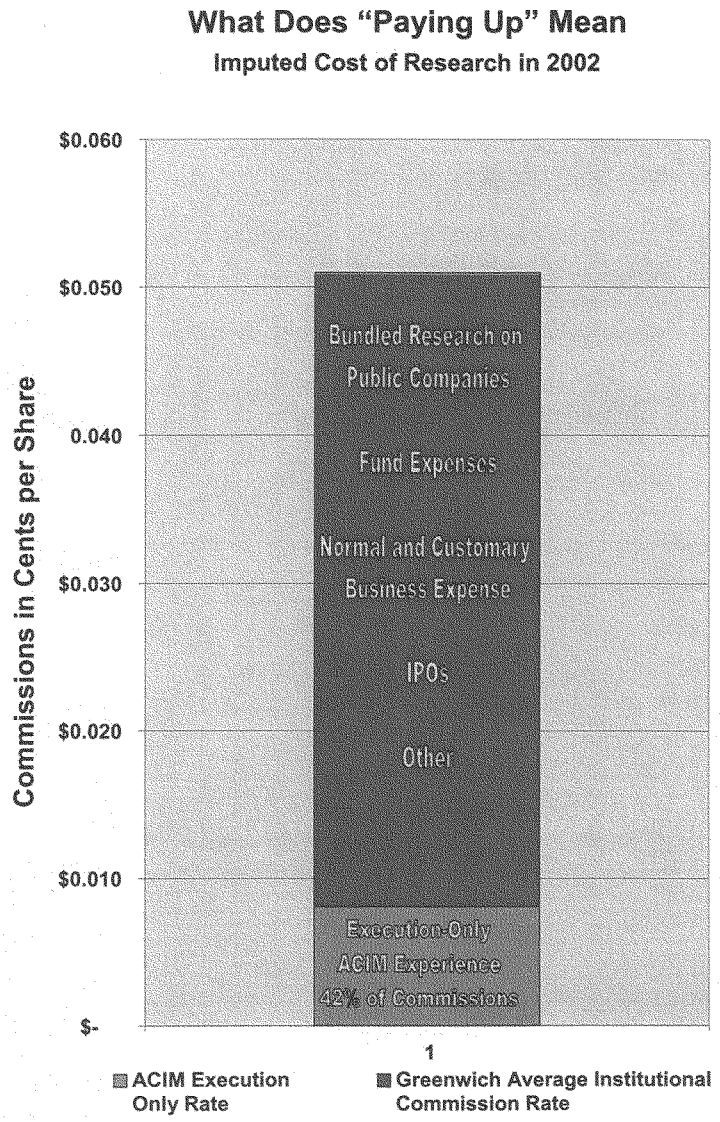

What Does "Paying Up" Mean
Imputed Cost of Research in 2002
Commissions in Cents per Share
$0.060
$0.050
0.040
$0.030
$0.020
$0.010
$-
Bundled Research on Public Companies
Fund Expenses
Normal and Customary Business Expense
IPOs
Other
Execution-Only ACIM Experience 42% of Commissions
1
ACIM Execution Only Rate
Greenwich Average Institutional Commission Rate

Exhibit 1

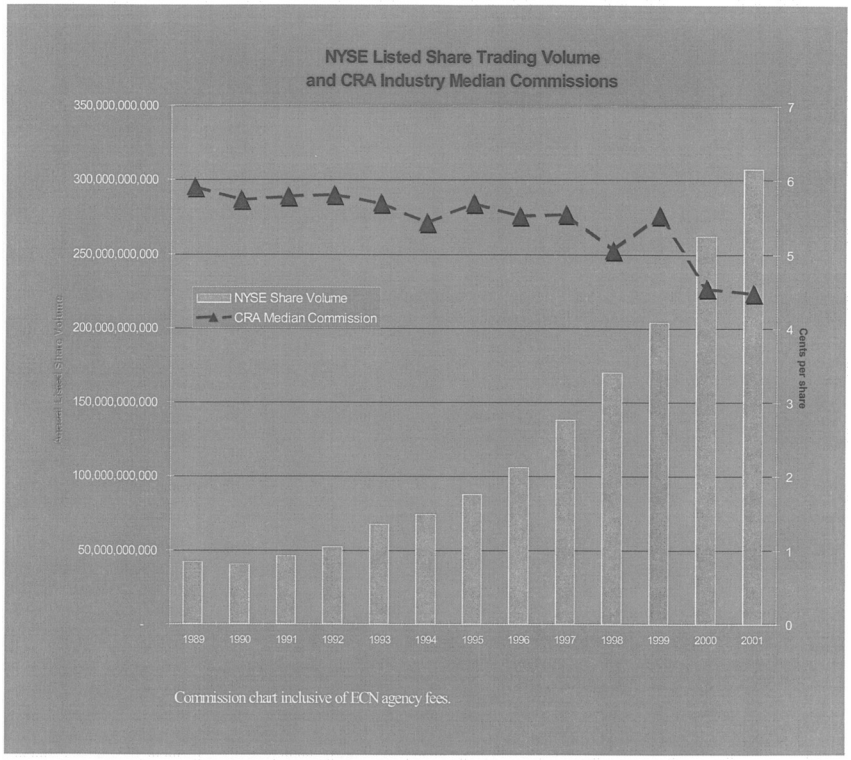

NYSE Listed Share Trading Volume
and CRA Industry Median Commissions
350,000,000,000
300,000,000,000
250,000,000,000
200,000,000,000
150,000,000,000
100,000,000,000
50,000,000,000
-
Annual Listed Share Volume
7
6
5
4
3
2
1
0
Cents per share
NYSE Share Volume
CRA Median Commission
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
Commission chart inclusive of ECN agency fees.

Exhibit 2

Impact of 28(e) on Management Company Earnings
Who Would You Rather Be?

Investor Invests $100,000 in Fund with 1% Management Fee and Pays All Commissions

Investment Company A Collects $1,000

Company A pays the following bills with cash as part of normal and customary business expense

Revenues	$1,000
• Salaries/Benefits	400
• Computer Hdwr & Telecom	250
• Marketing & Distribution Activities	
• Exchange Fees	
• Wall Street Journal	
• Trade Association Dues	
• Proxy Voting Services	
• Printing & Annual Report Prep	150
Profit	$ 200

(Services Otherwise Available for Cash)

Margin 20%

Commissions paid consider only best execution – at lowest possible commission.

Investment Company B Collects $1,000

Company B pays the same bills under 28(e) because of a manager's good faith determination that the service will benefit investors.

Revenues	$1,000
• Salaries/Benefits	400
• Marketing & Distribution Activities	300
Profit	$ 300

Margin 30%

Company B negotiates a rate for services – not usually in writing – that generates commissions sufficient for a broker to pay "manage money" bills and make a profit. Typically $1,600 in commissions pays $1,000 in bills.

Company B directs 35% of commission business to specific brokers – realizes dramatic earnings improvement with little incentive to rationalize expense.

Company B Benefits and the Investor Pays

Exhibit 3

Leading Soft Dollar "Converter" About 1,200 Vendors

Acadia Research Group
Accent Systems, Inc.
A.G. Bisset & Co., Inc.
American Health Consultants
ACNeilsen
Acromedia Systems, Inc.
Active Graphics
ADP Investor Communication Services
Advantage Data Inc
Agra Europe (London) Ltd
Airco Mechanical Inc.
Alan Reynolds Associates
Alliance Capital Management, LP
Alliance-Ibbotson Research Institute
Alliance of Healthcare Advisors
Allied Riser Operations Corporation
Allmerica Financial
Alpha Enterprises International
American Express Financial Advisors
American Skandia Investors Services, Inc.
American Stock Exchange
Ameritech
AMG Data Services
AMR Research
Analytic Systems Corp.
Anari Incorporated
ANB Investment Management
Annuity Price Center
Arbor Trading Group Inc.
Argus Research Corporation
Aristadata, Inc.
Armstrong Teasdale, LLC
APT Partners
Ark Asset Management Co., Inc.
Arrow Group
ASG Companies
Asia Society (The)
Asian Wall Street Journal (The)
Asia Pacific Communications Limited
Aspen Publishers, Inc.
Aspen Research Group, Ltd.
Asset Performance Partners
Asset Strategy Consulting
Associated Investment Services
Astro Office Products, Inc.
Atec Group
A-T Financial Information Inc.
Atlantic Group FPPM, Inc.
Atlanta Journal and Constitution, The
Attronics
Autex Group
Automotive News
Avalon Research
Avenue Technologies
Aviation Week Group
Axiometrics Inc.
B/C Computing, Inc.
Banc of America Securities
Bader Computer
BAMAR Enterprises Inc.
Bank of America
Bankers Trust Company-NY
Bargerhuff & Associates, Inc.
BARRA International
Barron's
Barrow Hanley Mewhinney
Baseline
BB&T Capital Markets
BCA Publications
Becker Vanetten, Inc.
Behavioral Economics, Inc.
Benderly Economic Associates
Berge Consulting Group
Berkeley Program in Finance
Big Dough.com
Billings Research
Biopharma Consulting Group
Bioscience Securities
Birinyi Associates Inc.
BIRR Portfolio Analysis, Inc.
BITS Inc.
Black Box Network Services
Blakeney Management
Blitz Computer
Bloomberg, LP
Bloombury Minerals Economics Ltd.
Blue Chip Growth Letter
Blue Heron Consulting
Bobbi Trading Corporation
Bogdan Computer Services, Inc.
Bond Buyer, The
Bond Investor Newsletter (The)
Bond Market Semiotics
Bonneville Market Information
Book Industry Study Group
Boston Capital Markets Group, Inc.
Boston Company Asset Management, Inc., The
Boston Energy Research
Boston Safe Deposit & Trust Co.
Boyd Watterson Asset Management LLC
Bowne of Chicago, Inc.
Boxalls
BPS Consulting Services
Brandywine Asset Management, Inc.
Breaking Views
Brean Murray & Co., Inc.
Bridge Japan Inc.
Bridgewater Associates
Brinson Partners, Inc.
British American
Brookside Corporation
BSP Solutions
BT North America
Buck Consultants
Bulls Eye Research
Burgiss Group (The)
Business Cycle Perspectives Inc.
Business Intelligence Advisors
Business Research Publications

BuzzCompany.com

C.S. McKee & Co., Inc.
Cabletron Systems
Cable Television Tokyo Ltd
Cableworx
Cadence Capital Management
Cadogan International Conferences Ltd
California Technology Stock Letter
Calamos Asset Management, Inc.
Calab Fund LP
Callan Asociates, Inc.
Cambridge Associates Inc.
Cambridge Energy Research Associates
Capital Analysts Network
Capital Hill Research
Capital Insights Group
Capital Management Sciences
Capital Market Publishers India Ltd.
Capital Reflections Inc.
Capital Resource Advisors
Capitol Publications Inc.
Carty Mailloux Consulting, Inc.
Cast Software, Inc.
CCBN.Com (Street Events)
C-Call.Com
CCH Washington Service Bureau Inc.
C.D. Crary & Co
CDrive Corp.
CDW
Center for Management Research, Inc.
Center for Research in Security Prices
Century Securities Associates Inc.
Charter Investment Group
Charter Research Corporation
Chaumont, Inc.
Check Free Corp-Investment
Chemical Institutional Asset Services
CHR Metals Limited
Cimino Associates
Citicorp-North America/Leasing Inc
Clarendon Marketing & Production
Clarsen Investment Research
Clydsedale Bank PLC
CML Market Letter Inc., The
Coach Comp America
Coleman/Bartlett's Washington Focus
Columbine Capital Services
Comerica Bank & Trust
Comline Business Data, Inc.
Commerce Bank of St. Louis
Commercial Estate Secondary Mkt.&Sec.
Commercial Property News
Commercial Real Estate
Commodity Accounting Systems
Commodity Metals Management Company
Commodity Trend Service Charts
Comp USA, Inc.
Compass Bank
Compaq Computer Corp.
Compaq Direct Plus
Complete Communications, Inc.
Comprehensive Computer Center
Compucom
Computer & Application Inc.
Computer Express, Inc.
Computer Merchants LTD
Computer Horizons Corporation
Computerwire, Inc.
Computerized Portfolio Mgmt Services Inc
Commscan, L.L.C.
Comscore Networks
Comtrade
Condor Advisers
Consensus Economics Inc.
Consolidated Natural Gas Company
Container Consulting
Containerisation International
Contravisory Research Corp.
Convergent Media Systems Corp.
Conway Pedersen Economics, Inc.
Corestates Bank
Cornerstone Peripherals Technology
Corporate Access/Condor
Cortex A[[lied Research Inc
Cost Effective Measurement Inc
CotLook Ltd.
Council of the Americas
Covato Research Corporation
Cramer Rosenthal McGlynn, LLC.
Crandall Pierce and Company
Credit Sights
CrossBorder Capital
Crowley Micrographics, Inc.
CSK
CRU International LTD
CTC Illinois Trust Company
CTS Financial Publishing
Customized Data Systems, Inc.
Cutler and Company, Inc.
CWR Computer Consultation

DAC Easy Software, Inc.
Daily Deal, The
Daily Variety
Dallah Media Productions
Dalton, Greiman, Hartman, Maher & Co
Dan Royer & Co.
Daniel Morton & Company, Inc.
Darwin Partners, Inc.
Data Broadcasting Corporation
Data Comm Warehouse
Data Transmission Network Corporation
Datastream International Ltd.
Dataware Solutions
Davis, Mendel & Regenstein, Inc.
Decision Software, Inc.
Dell Direct Sales Corporation
Dell Quotation
Dell'Oro Group
Denver Gold Group
Depository Trust Company, The
DePrince, Race & Zollo
Derivative Solutions
Des Plains Office Equipment Company
DeScenza & Co., Inc.
Detroyat Associates, Inc.
Dial Data
DiBiasio & Edgington, Inc.
Directv
Disclosure Incorporated
Docupro
Dodge & Cox
Dollarlink Software
Dorsey, Wright & Associates, Inc.
Dow Jones Financial Publishing, Co..

Dow Jones Markets, Inc.
Dowling & Partners Securities, LLC
DPC Data Inc.
Duff & Phelps Credit Rating Co.
Dunedin Fund Managers Ltd
Dympna Clarke
Dynamic Traders Group, Inc.

Eagle Development Group
Ebsco Subscription Services
Eclipse Computer Systems, Inc.
Econoclast, The
Economatica
Economic Analysis Associates, Inc.
Economic Cycle Research Institute, Inc.
Economics from Washington
Economist, The
Edgar Online
Edward Walter Design
EEI Effron Enterprises, Inc.
EFM Technical Research Limited
Egan-Jones Ratings Company
EGS Securities
Electric Power Daily
Electric Utility Week
Eliassen Group, Inc.
Elliott Wave International
Elkins & McSherry Co. Inc.
Emap Business Communications
Emery Consulting Services
Empire Group LLC
Energy Argus
Engineering News-Record (McGraw-Hill Cos.)
Ennis Knupp & Associates
Enteract Corp.
Enterprise Communications
Entex Information Services, Inc.
Equant Resources
Equity Research Associates
Ernst & Young LLP
Estima
Euromonitor International, Inc.
Eurohedge
European Investors
European Private Equity & Venture Capital
Evans-Novak Political Report
Exabyte Corporation
Excalibur Management Corporation
Excite@Home
Eze Castle Integration, Inc.

F-D-C Reports, Inc.
Fair Disclosure Financial Network
FAME Information Services
Farallon Capital Management, LLC
Farrell Advisory Associates, LLC
Faxon Company, The
Federal Filings Inc.
Federal Reserve Bank of Boston
FICOMP, Inc.
Fidelity Management Trust Company
Financial Control Systems Incorporated
Financial Information Services
Financial Planning Resources
Finucane, J.W. Financial Consulting
First Data Investor Services Group, Inc.
First Equity Corporation of Florida
First Interstate Bank of California
First Pacific Advisors, Inc.
First Source International Inc.
First Union
Fitch Investors Service
Fleet Bank of MA
Fleischman Richard & Associates
FMH Investments, LC
Forbes
Ford Investor Services
Formprint
Formula Research
Foundation for Intl Business & Eco. Res.
Fourteen Research Corporation
Franklin Research's Insight
Fraser Management Associates
Free Market Inc.
Freedom Capital Management Corporation
FRI Corporation
Front Line Systems
Frontier Analytics, Incorporated
FTSE International Limited
Future Source
Future Data Systems Inc.
Futures Magazine Group
Futures Trading Center

G A T Integrated Financial Services
G. A. Clarke & Associates, Inc.
G7 Goup, Inc.
Gabriel, Roeder, Smith & Company
Galaxy Consultancy Limited
Gann, AWD Treasure Discovered
Gancarz Software Consultants
GARP Research Company
Gartner Group
Garzarelli Outlook, The
Gateway 2000
Gateway Companies
Gateway ShopStop.Com
GE Capital Information Technology
GE Information Services Inc.
Gerson Lehrman Group
Giga Information Group, Inc.
Gilder Publishing
Gilder Technology Report
Gimme Credit Publications Inc.
Glenmede Trust Company
Global Advanced Technology Corp.
Global Information Resources, Inc.
Global Investment Research, Inc.
Global Investor Publishing
Global Market Consultants, Ltd.
Global Network (The)
Global Technology Consulting, Inc.
Global Technologies, Inc.
Global Trend Alert
Gold Stock Analyst
Golden Star Technology/Micro City
Goldman Sachs Asset Management
Gordian Institute
Gordon, Haskett & Company
Gorham Advanced Materials Institute
Grant's
Green Tree Vendor Services Corp
Greenhill
GRI Companies
Grotevant Walker Research Ptners.
Group of Thirty

Gylmesi & Wedinger P.C.

H. Buff Herr
H. Clark & Company Limited
HC Instanbul
HSBC Broking (Data Service) Ltd.
Haimovilch Medical Technology Company
Hammer Consulting Group, The
Hanner Consulting Group (The)
Hanson, Perry & Jensen, PA
Harris Corp. Digital Telephone System
Harris Investment Management
Harris Trust and Savings Bank
Harry Hansen Management, Inc.
Helix Investment Partners, LP
Hellenbrand Consulting, LLC
Hewitt Associates
High Frequency Economics, LTD.
HK Ventures
HKC Securities
HLH/Panoramic
Holt Value Associates
Hood Company (The)
Horace W. Brocking Consulting
Howe Barnes Investments
HSBC Bank USA
Hub Data, Inc.
Hueler Analytics
Hughes Design/Communications
Huntington Investment Company

I.D.E.A. Incorporated
I/B/E/S International, Inc.
Ibbotson Associates, Inc.
IBCA Limited
IC Insights, Inc.
ICM Conferences
ICMS International
IDC Portfolio Management Inc.
IDS Advisory Group, Inc.
Imark Communications, Inc.
Imprima Management Services Inc.
IMS America, Ltd.
IMI Systems Inc.
IMS Health, Inc.
Inacom Information Systems
Income Research & Management, Inc.
Independent Investor Digest
Independent Perspectives
Independent Professional Services
Independent Strategy
Indepth Data Inc.
Industrial Contractor, Inc.
Infinity (A Sunguard Company)
Info USA Marketing Inc.
Information Management Network
Information USA Marketing Inc.
Information Resources Inc.
Informix Software, Inc.
Info-Reach, Inc.
Infoshare Communications, Inc.
Infosys Technologies Limited
Infotech
ING Baring Furman Selz, LLC
Ingalls & Snyders LLC
Innotech Solutions, LLC.
Inside Mortgage Finance Publications
Inside Radio
Insight
Insight Capital Management, Inc.
Institute for International Economics
Institute for International Research, The
Institute of International Finance
Institute for Private Investors
Institutional Capital
Institutional Investor Services
Institutional Property Consultants, Inc.
Institutional Real Estate, Inc.
Institutional Research Services, Inc.
Institutional Shareholder Services
Institutional View (The)
Insurance Forum (The)
Interactive Data
Intergrated Circuit Engineering Corp.
Inter-Logic Associates, Inc.
International Capital Market Corp.
International Cement Review
International Data Corp.
International Data Corp., Asia/Pacific
International Finance Corporation
International Forecasting
International Fund Administration
International Management Services
International Monetary Fund
Internet Network Technologies
Internet Systems Design Group, Inc.
Intersec Research Corporation
Intersoft Corporation
Interstudy Publications
Intex Solutions, Inc.
Intraspect Software
Investec, Inc.
Investek, Inc.
Investment Advisers, Inc.
Investment Analytics
Investment Company Institute
Investment Counsel Association of America
Investment Data Corporation
Investment Dealers' Digest, Inc.
Investment Research Institute
Investor Economics Inc.
Investors Bank and Trust Company
Investors Business Daily
Invesco, Inc.
InvestWorks
Ista Mielke GMBH
IPC Information Systems, Inc.
IPL Technologies, LTD.
IPO Financial Network
Ira Sohn Investment Res. Conf.
J. Glass & Associates
JG Kilan Company
J.L. Kellogg Graduate School of Management
Jag Notes
Jerome Levy Forecasting Center
JM Cannell, Inc.
JMA Research Institute Inc
JMR/Financial, Inc.
John Wiley & Sons
Johnson Custom Strategies, Inc.
Johnson Rice & Company LLC
Jolson Merchants Partners
Jos Technology Inc.
Joseph DeCosimo and Company
Journal of Finance (The)
Journal Watch

J.P. Morgan Investment Management
JT Sorrells Inc
Jupiter Media Metrix
J.W. Finance Consulting

Kagan World Media
Kaufman Brothers, LP
KEA Capital
Keane Inc
Kforce.com
KMI Corporation
Kenny Information Services
Kenwood Group, Inc.
Kestrel Technologies, L.L.C.
Kilpatrick Stockton LLP
Kinder, Lydenberg & Domini, Inc.
King & Spalding
Kingsley Associates
Kinsley Power Systems
Kirkpatrick and Company
KLD Research & Analytics Inc
KMI Corporation
Knight-Ridder Information, Inc.
Knobias.com
Kobren Insight Management, Inc
Koch Financial Corporation
K.P.A. Advisory Services

LaJolla Economics
Lamers Equity Research
Lande Group/Micro Computer Systems
Lark Research
LaSalle National Bank
Laurence H Meyer & Associates, Ltd
Lavery Consulting Group
Legg Mason Wood Walker, Inc.
Lehrman Bell Mueller Canon, Inc.
Leigh Bureau
Lend Lease Rosen
Leuthold Group, The
Lexis Document Services
Lexis/Nexis
Leylegian Investment Management, Inc.
Liebert Corporation
Lifeline Industries, Inc.
Little Black Box Forecasts
Line Data Services, Inc.
Lincoln Capital Management Company
Lipper & Company. LP
Little Black Box Forecasts
Liscio Report (The)
Lloyd George Investment Management
LMC International, Ltd.
Loan Pricing Corporation
LongView Group (The)

M. Shanken Communications
MacKay-Shields Financial Corporation
Macro Computer Products, Inc.
Macroeconomic Advisers, LLC
Managed Account Reports
Manufacturing & Network Solutions
Market.com, The
Market News Service Incorporated
Market Profile Theorems, Inc.
Market Research Corporation
MarketNet Group
MarketSoft Research
Market Statistics
Market Systems Newsletter
MarketSoft Research
Market Trends Investors
Market Vane Corporation
Marquette Associates, Inc.
Marquette Financial Group
Marsico Capital Management, LLC
Martaus & Associates, Inc.
Martin Currie, Inc.
Marvin Zonis & Associates, Inc.
MBH Commodity Advisors Inc
McAffee Associates, Inc.
McCarthy, Crisanti & Maffei, Inc.
McCartney Construction Company
McClellan Financial Publications, Inc.
McDonald Investments
McDonnell Information Systems Limited
McSherry & Company
MCSI Computer Supplies
Measurisk .com
Mealey's Group, The
MediaOne
Medley Investment Group, LLC (The)
Megent Fis
Mehta Partners
Mellon Bank
Mellon Trust
Merritt Communications
Mesirow Financial
Meta Group Inc
Metal Bulletin Inc.
Metriplex, Inc.
Metropolitan West Asset Management
Metzler Services
MFS Telecom, Inc.
Michigan National Bank
Micro Design Resources
Microage Computer Stores
Microhedge, Inc.
Microland-Macroland "HQ"
MicroMedia Inc
Micron Electronics, Inc.
Micropoint Computers
Mi-Kro Computer World
Midas-Kapiti International
Middle East Economic Survey
Miller Anderson & Sherrerd, LLP
Millennium Investment Corporation
Milliman & Robertson, Inc.
Milken Institute Conference Center
Missing Link, The
Mitchell Hutchins Institutional Investors Inc.
Mitchinson Napier Bedford
ML Consulting Services
ML Trust of America
Mobile Plant
Modern Healthcare (Crain Communications)
Mondiale Partners, Ltd.
MoneyLine Network, Inc.
Money Manager Review
Money Market Directories, Inc.
Monis Software Limited
Montgomery Investment Technology
Montag & Caldwell, Inc.
Moody's Investors Services
Morgan Stanley Capital Intl Research
Morningstar, Inc.

Mosaic Research
MRL Trade Limited
MSNBC Desktop
MST Research, Inc.
Multex Systems, Inc.
Multichannel News
Municipal Emp. Rtmt. Sys. of Michigan
Municipal Market Advisors
Municipal Market Data
Municipal Treasurers' Association
Murex North America, Inc.
Murenove Inc.
Muzea Insider Consulting Services

NAA Foundation
NAIC Securities Valuation Office
Nasdaq Stock Market, Inc., The
N.A.S.I.P
Nat City Investments
Nat Institute of Investments
National Association of Real Estate Trust
National Center for Cont. Education
National City Cleveland/Trust
National Institute of Investment Research
National Mortgage News
National Order Educators
National Planning Corporation
Nationwide Financial
Navellier-MPT Review
Navigant Consulting, Inc.
NBC Levesque International Ltd.
NCM Capital Management Group, Inc.
Nebrask Investment Council
Nelson Industries Profit Sharing
Neo Technologies
Neovest, Inc.
Netteks Technology Consultants
Network Appliance
Network Access Solutions
Neovision Hypersystem
Nevada Institutional Investors
New Economy Watch
New Edge Networks
New Pittsburgh Courier
New York University Stern School of Business
New York Stock Exchange, Inc.
New York Times, The
NewsEdge Corporation
Newsware, Inc.
New Vernon Associates Inc
Nicholas-Applegate Capital Management
Nielsen Media Research
Niemeyer, Korwin-Krystyna
Nikkei Data
Nilson Report, The
Nirvana Systems Inc.
Noah Financial, LLC
North River Ventures
North Shore Printers
Northern Trust Quantitative Advisors
Northfield Information Services Inc.
Novalink Limited
NYU Stern School of Business

Oak Associates, Inc.
Oasis ComputerSolutions
Oasys
Object Design
Oceanview Financial Research, Inc.
Omgeo LLC
One Source Information Services, Inc.
Onsite Access, Inc.
Open Systems Technologies
Optima Investment Research, The
Options Price Reporting Authority
Oracle Corporation
OrbiMed Advisors, LLC
Orderpoint TIS
Orford Capital Management
Orion Research Partners
OTA-Off The Record Research
OTC, Inc.
Outstanding Investor Digest

P. C. Quote, Inc.
Pacific Bell
Pacific Growth Equities
Pacific Pension Institute
Pacific Select Distributors
Paladin Investment Associates
Pan Pacific Software LLC
Patrick Hayden (Consultant)
Patriot-News Co., The
Patterson Capital Corporation
Paul Kagan Associates
Payden & Rygel
PCI (Xylenes & Polyesters) LTD.
PC Magazine
Peachtree Software
Penfold Limited
Pensions 2000
Pennisula H/V Beach EN, The
Penobscot Group Inc., The
Pensions 2000
Pension Benefit Information
Pensions and Investments
Perception International
Performance Services Group
Performance Technologies, Inc.
Peter Cole and Company
Peter Mikolaj & Associates
Petroleum Intelligence Weekly
PharmaBooks Ltd
Philadelphia Newspapers, Inc.
Philadelphia Tribune (The)
Phileo Allied Securities
Philip S.P. Randolph, Inc.
Phillips Global Media
Phillips Office Products, Inc.
PictureTel Japan Co. Ltd
Pillette Investment Management, Inc.
Pittsburgh Post Gazette
Pira Energy Group
Pittsburgh Post Gazette
Plan Sponsor Network, Inc.
Platformedia LLC
Platt's Oilgram Price Report
Platt's Newsletter/Newswire
Plexus Group
PNC Bank
Polyconomics, Inc.
Pomeroy Computer Resources, Inc.
Portfolio Management Technology
Portfolio Solutions
PREA

Precision Timing
Precursor Group
Premier Solutions
Preservation Research
PricewaterhouseCoopers
Primark Canada, Inc.
Primark Decision Economics, Inc.
Prime, Buchholz & Associates, Inc.
Princeton Economic Institute, Inc.
Princeton Financial Systems
Princeton Retail Analysis
Private Equity Analyst, The
Proequities Inc
Professional Alternative Inc.
Professional Expert Trading Systems
Professional Training Services, Inc.
Protel Communications Ltd.
Provident Investment Counsel
Proxy Monitor, Inc.
Proxy Voter Services
PRS Group (The)
Publishers Service Exchange
Puget Sound Economic Forecaster
Putnam Advisory Company, Inc.
Putnam Investments Inc.
Pzena Investment Management

Q-Tech Communications
QED Information Systems
Quantec Investment Technology
Quantitative Analysis Service, Inc.
Queens City Financial Consultants
Quest
Quick, Moneyline, Telerate Corp.

R & B Financial Solutions
RCG Information Technology Inc.
R.H. Wrightson & Associates Inc
R.W. Mansfield Co., Inc.
Ranking Service, The
Radio Business Report
Rampart Investment Management
Real Estate Alert
Real Estate Transformation Group
Reference, Inc. The
Regulatory Research Associates
Reininga & Company
Reinganum Consulting
Reliable Corp (The)
Renaissance Capital
Renaissance Worldwide IT Consultants
Republic Security Bank
Research Network (The)
Research Works
Research Vision Limited
Resource Advisory, Inc.
Resource Center (The)
Reuters America, Inc.
Reuters India Limited
Reuters LTD (Austria)
Reuters Singapore Pte Ltd.
Richard L. Hanley Associates
Richards & Tierney Inc.
Ried Thunberg & Co Inc.
Righteous Intl. Subscription Services
Risk Conferences and Training Courses
Riskmetrics Group LLC
Rittenhouse Financial Services
Riverplace Consulting Services
Robert F. Fargo & Co., Investment Res.
Rockefeller Treasury Services
Rogers, Casey and Associates
Roxbury Capital
Roxin and Company
Royal Oaks Consultants Group
Royal Institute of International Affairs
Ruarte's Report
Rudd and Wisdom, Inc.
Ryan Labs, Inc.

Salomon Analytics Inc.
Santa Fe Institute
Sayers Consulting Services
Schroeder Advisory Services, Inc.
Schulte Roth & Zabel LLP
Schwab Performance Technologies
Schwab Washington Research Group
Scientific Investing
Seagate Software
Seamans Capital Management
SEC Insight
Sector, Inc.
Sectorbase.com, Inc.
Securities Data Publishing
Securities Industry Automation Corp.
Securities Operations Forum
Securities Research Company
Securities Software & Consulting, Inc.
Segal Company (The)
Segall Bryant & Hamill
Seidel Associates Incorporated
Select Equity Group, Inc.
Semantic Architects
Seneca Capital Management
Sentinel Pension Institute
Seward & Kissell LLP
Shands Jacksonville Medical Center
Shartsis, Friese & Ginsburg, LLP
Short Capital LTD
Siemens Business Communication
Sierra Investment Partners
Sigma Systems, Inc.
Silverback Networks, Inc.
Simplified Computer Services
Simon-Hunt Strategic Services
Sims Moss Kline & Davis LLP
Simsbury Electronics, Inc.
SIT Investment Associates, Inc.
Sitelis Design Studio
Skytel Pagers
Smith's Research & Rating Review
Smithers & Co. Ltd.
Software Spectrum
Solsource Computers, Inc.
Soliton Associates, Inc.
South African Inst. Of Race Relations
Southland Sound Corporation
Sovran Capital Management Corporation
Soyata Computers of Rochester
Spartan Institutional Research, Inc.
Spencer F. England & Co., Inc.
Spencer Fane Britt & Brown LLP
Sprucegrove Investment Management Ltd.
SSI Technologies PTE., LTD.
St. Louis Business Journal
Stafford Publications

Stalla Seminars
Standard Club (The)
Standard Valuations, Inc.
Starmine
Startspot Mediaworks
State Street Bank and Trust
State Street Global Advisors
Statsci
Statsoft
Stax Inc
Stellcom Technologies
Stern Stewart & Company
Stevens Publishing Corp.
Stock Data Corporation
Stock Management, Inc.
Stock Market Geometry
StockVal, Inc.
Stone & McCarthy Research Associates
Strain Consultants Inc.
Stratecon Corporation
Strategic Economic Decisions, Inc.
Strategic Insight
Strategic Investment Solutions
Strategic Morning Line
Street Software Technology, Inc.
Stremkal Inc.
Stroh Corporation
Sturza's Institutional Research
Sugarman and Susskind, P.A.
Sun America Capital Services, Inc.
Sun Microsystems
Superstock Investors
Syscom, Inc.
Symmetria Software LLC
Syntegra
Synergistics Technology Inc.

13D Research
Taj Technologies, Inc.
Taylor Consulting Inc.
Team Systems
Tech Hackers, Inc.
Technology Investing
Technology Solutions International
Telecommunications Reports
Telemet America Inc
Teleport Bermuda Limited
Telerate Systems, Inc.
Telesphere Corporation
Tempus International Ltd.
THL Managers V LLC
Thomson Asia PTE LTD.
Thomson Corporation HK
Thomson Financial Media
Thomson Financial Muni Group
Thomson Financial – Portfolio Solutions
Thomson Financial – Solutions
Thomson Wealth Management
Tiboco Financial Technology
Thomson Asia PTE LTD.
Tillinghast-Towers Perrin
Time Inc. Asia
Time Magazine
TIS Group, Inc.
Tokyo Stock Exchange Computer System
Topline Investment Graphics
Toronto Stock Exchange, The
Torch Capital Corporation
Toyo Keizai, Inc.
Townsend Group, The
Track Data Corp
Trade Management Systems, Inc.
Trade Web
Trade Winds
Trade Wins Publishing
Trading & Investment Programs & Systems
Tradenet Corporation
Tradition Financial Services Inc.
Trans-Lux Corporation
Transmarco Data Systems Pte Ltd.
Trans-National Research Corporation
TRD Consulting, Inc.
Trepp Management Group
Tri-State Envelope Corporation
Trias Capital Management
Trim Tabs Financial Services, Inc
TRS Staffing Solutions,Inc.
True Solutions,Inc.
Tuff Management Co.
Turnaround Letter (The)
T.W. Cooney & Associates
Twin Capital Management, Inc.

U. S. Offshore Funds Directory
U.S. Communication, Inc.
U.S. Micro
UCLA – Anderson Forecast
Unisys Corporation
United Data
United System Solutions
University of Miami Diagnostic Clinic
UNIWEB-NET
US Connect
US West Communications
Utility Pension Fund Study Group
UUNET Technologies, Inc.
Uvest Investment Services

Vanstar
Veneroso Associates
Venture Financial Systems Group, Ltd.
Venture One
Vertex Computer Cables & Products
Vestek Systems
Vickers Stock Research Corp.
W.H. Brown & Co., Inc.

Walker's Manual, LLC
Wall Street Calendar Corporation
Wall Street Journal, The
Wall Street Source, LLC
Wall Street Strategies
Warwick Business School
Washington Research Group
Wedge Capital Management, Inc.
WEFA Group, The
Wellington Management Company
Wells Fargo, Institutional Trust Division
Wharton Real Estate Review
Wharton School Executive Education
WHO Investment Consulting Company
William R. Hough & Co.
Williams Inference Service, The
Williams & Jensen

William Smith Special Opportunities Research
Williamsburg Investment Co.
Windhover Information, Inc.
Winter, Wyman & Company
Wipro Limited
WM Company, The
WM Smith Special Opportunity Research
Woodmentum Technical Research
World Steel Dynamics, Inc.
World Bank, The
World View, Inc.
Wyatt Investment Consulting, Inc.

Yankee Prognostics, Inc.
Yanni-Bilkey Investment Consulting
Yelton Fiscal, Inc.
Yon Drake & Associates

Zacks Investment Research, Inc.
Zephyr Associates, Inc.
ZPR International, Inc.,

GARY GENSLER

Testimony on Mutual Funds before

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
March 12, 2003

Introduction

Chairman Baker, Chairman Oxley, Ranking Member Kanjorski, members of the committee, thank you for the opportunity to appear here today to discuss the mutual fund industry. It is a great honor and a pleasure to again appear before you. Much has happened within the financial markets since I last appeared here during my tenure as Under Secretary of the Treasury. For that matter, much has changed for me as well. I have since then co-authored a book attempting to present common sense investing advice for middle income Americans and separately worked with Congress on the passage of the Sarbanes-Oxley Act.

Few issues before this committee touch so many Americans as those related to mutual funds. Millions of Americans invest in the stock or bond market to help achieve their long-term financial goals – a home, a college education for their children, a secure retirement. About half use mutual funds. Mutual funds are a convenient and potentially efficient investment vehicle for small investors. And yet, mutual fund companies run up approximately $70 billion per year in costs for their investors. With the dramatic declines in the stock market three years in a row, and with so many mutual funds failing to match the market's performance, investors may rightly wonder if all those fees and costs have been well spent. The book which I co-wrote explores issues of fees, costs, performance, and governance as well as suggesting better investing alternatives. Needless to say, given the title, *The Great Mutual Fund Trap,* I applaud this committee's willingness to explore these issues.

Background

Mutual funds originally were a boon to investors. People with small to moderate amounts of money had not had a realistic option for investing in stocks or bonds. Instead, they were relegated either to bank savings accounts or whole life insurance. If they did invest in stocks, they were unable to get the benefits of broad diversification.

The advent of mutual funds offered many investors a chance at the superior long-term performance of equity investing, and a convenient way to buy bonds. Mutual funds

also offered risk reduction through diversification, as most funds owned a broad spectrum of the market. Lastly, when compared with the full-service brokerage commissions of the time, at first mutual funds' costs were relatively attractive.

Mutual funds have subsequently become the investment vehicle of choice for 54 million households, one half of the households in America. Approximately 125,000 households, on average, invest in mutual funds in each of your Congressional districts. They do so directly or through brokerage accounts and retirement plans. Approximately half of tax-deferred retirement plan assets [IRAs, 401(k)s, and 403(b)s] are now held in mutual funds. There are over 4700 stock funds and 2000 bond funds for sale to investors.

In total, long-term mutual fund assets (excluding money market funds) have grown steadily from $48 billion in 1970, to $58 billion in 1980; to $567 billion in 1990; to a peak of $5.1 trillion by the end of 2000. In light of the recent market decline they now stand at just $4.1 trillion at the end of last year.[1] Of this total, just under $2.5 trillion is invested in *actively managed stock* mutual funds – that is, those that pick stocks in an effort to outperform the market. Another $1.0 trillion is invested in actively managed bond funds and over $300 billion in hybrid funds holding a combination of stocks and bonds.

Those Ankle Weights - Costs

Like most choices, however, financial choices are relative: one choice can be judged only in comparison with those forsaken. Indeed, by many objective measures, actively managed mutual funds are failing their millions of devoted clients. That's understandable, given that the mutual fund companies impose costs on investors of approximately $70 billion annually. Most of this money – $50 billion per year -- goes directly to the fund companies in the form of management fees and sales loads. The rest -- largely made up of portfolio trading costs -- is paid to the brokerage industry, which happily executes the huge trading volume generated by active fund managers.

Ask most people about their mutual funds and they may have some vague notion that the fund charges an annual management fee. Yet that is only the beginning of the costs that one pays with a mutual fund manager actively investing for you.

In total, investors can expect costs totaling close to 3 percent to disappear each year for an actively managed stock fund. Invest in a fund with sales loads, as close to one out of two investors do, then one can expect costs averaging closer to 4 percent per year. While fees for bond funds are modestly lower, they still generally overwhelm the expected returns on bonds, particular in today's low interest rate environment.

Compound these costs over a lifetime and you'll see the serious bite they take out of Americans' savings ... ankle weights that could have even brought Carl Lewis to his knees. Further consider that a lifetime of monthly investments in a low cost passive account can yield nearly twice as much as the same amount actively invested. That's the case even if active investing leads to just 2 percent less earnings per year. For example,

if a worker saves just $100 per month over a 40 year career and earns 8 percent annually, they can retire with a $348,000 nest egg. Invest in actively managed bond and stock mutual funds and the likely nest egg – $199,000 – fully 43 percent less money available for retirement.

Some mutual fund costs are disclosed to investors:

- Monthly management, administrative, and distribution fees averaging over 1 percent per year. A review of the 2,207 actively managed stock funds in the Morningstar database shows an average expense ratio of 1.44 percent.

- Sales loads charged by half of all actively managed mutual funds to buy or sell shares. The average load is 4.1 percent.[ii] With an average holding period of less than three years, the average load fund investor can pay an additional 1.4 percent per year. Loads don't even help to offset other costs. Expense ratios for such load funds also are high, with an average of 1.84 percent. And as a group, load funds actually earn lower average returns than no-load funds, *even without taking the load into account.*

While investors may not pay particular attention to these costs, at least they are disclosed. There also are very important other costs, though, that go undisclosed. They are hard for investors to measure and they do not show up on any statement. Yet all of these costs stand between investors and the returns they desire:

- Portfolio trading costs — the typical active fund manager turns over their entire portfolio once every 15 to 16 months, incurring brokerage costs and bid/ask spreads each year of approximately 0.5–1.0 percent of assets.

- The opportunity cost of holding idle cash, about 0.5 percent of assets each year during the 1990s bull market, though less now.

- Excess capital gains taxes incurred as the portfolio is turned over each year. Active fund investors, by definition forsaking a buy and hold strategy, burden taxable investors with short term capital gains taxes estimated to add costs of 1 to 2 percent of assets per year.

There is another reason why investors often don't consider the costs of investing. Mutual funds have constructed a system where the costs are practically invisible. We all have to write a check to our utility or mortgage company, but we never pay a bill for mutual fund management. Such costs are simply deducted from our monthly returns, or taken off the top if we buy a load fund. How else to explain the fact that many Americans react furiously to the $1.50 ATM surcharges they pay 20 times per year ($30) yet rarely utter a peep when they pay a 5 percent sales load on a $10,000 investment ($500)?

The Sad Averages

Those ankle weights have their effect. Looking at the results over the last ten years, Morningstar data shows that the average actively managed diversified mutual fund fell short of the market by 2.2 percent annually. Fund returns of 6.6 percent annually compare to the overall market return of 8.8 percent annually, as measured by the Willshire 5000.

Furthermore, currently reported performance results include only those funds that survived the entire period. The many funds which have been routinely merged or liquidated are not still included in these industry statistics. Looking at ten-year returns of currently active funds in 2003 will by definition exclude all the unfit funds that closed up shop during the last ten years.

This phenomenon is known as survivorship bias. It is like judging the contestants on a reality TV show simply by looking at the last few people left on the island. If someone asked a viewer how interesting the contestants were, they would probably forget the ones who were voted off in the first few weeks. What were their names again?

The most comprehensive look at survivorship bias was conducted by Burton Malkiel, who concluded that such bias was considerably more significant than previous studies had suggested. For the ten-year period 1982-1991, survivorship bias inflated average industry returns by 1.4 percent per year. Furthermore, the number of liquidating funds is rising. With 4 to 5 percent of all funds disappearing each year, survivorship bias today is likely to be even greater than during this earlier period. That, along with active funds' cash holdings may explain why reported results for active fund management look comparatively better during the recent bear market.

Triumph of Hope over Experience

There is some good news, though, for investors,. Index funds offer the choice of investing in the market as a whole – achieving broader portfolio diversification than the original mutual funds – at very low cost and with minimal current taxes. Exchange-traded index funds offer the same diversification and cost advantages with even better liquidity and tax consequences.

Yet, most Americans investing in mutual funds tend to pick actively managed funds in the hope of relying on the experts to beat the market. Worse, they pick funds based upon the hope that last year's best performers or "hot" funds will out perform the market once again next year.

Fund companies spend significant advertising dollars luring investors to this loosing strategy. A recent academic study, demonstrated that advertisements are a poor guide indeed for investors trying to decide on a mutual fund.[iii] Researchers examined

two years of mutual fund advertising in *Barron's* and *Money* magazine. In particular, they looked at advertisements by diversified (non-sector) domestic stock funds whose ads reported past performance as an inducement to purchase. In all, 294 funds were examined.

The study reached three conclusions:

- First, not surprisingly, the advertised funds had performed well in the year *before* the advertisement was run. The *pre*-advertisement returns of those funds over the past year were 1.8 percentage points better than the S&P 500 Index.

- Second, the advertisements were extremely effective in attracting new money to the funds. Compared to a control group, advertising appeared to increase inflows 20 percent over what one would otherwise have expected.

- The third conclusion, however, is by far the most significant. The *post*-advertisement performance of the funds was quite poor. The funds' *post*-advertisement performance over the next year *trailed the S&P 500 by 7.9 percentage points*.

Mutual fund advertising is a classic example of closing the barn door once the horse has left.

Perhaps the most important study of the factors affecting mutual fund performance was conducted by Mark Carhart, a former professor at the School of Business at the University of California.[iv] He found that, basically, past performance does not predict future performance. Winning funds of the past are unlikely to be the winning funds of the future. Carhart found that if you take the top 10 percent of funds in a given year, by the next year 80 percent of those funds have dropped out of that top 10 percent ranking. For the top 20 percent of funds, 73 percent drop out the next year. For the top 50 percent of funds, roughly 45 percent fall out the next year. That's not much different from what you'd expect from random chance.

Who's Fund is it Anyway?

The whole idea of a mutual fund is, as the name suggests, *mutuality*. Funds allow investors to share the costs of professional money management, in the nature of a cooperative. Legally, investors actually control their mutual funds. The company managing the assets is distinct from – and legally simply a contractor hired by – a mutual fund. Investors are able to select a board of directors to oversee their savings and hire the money management group (known as an "advisor") to invest their money. In theory, the advisor works for them to get the best returns for the lowest costs and risks. If mutual fund investors don't like their advisor's approach or costs, they can hire a new one. That is, at least in theory.

This is not something, though, that advisors have any interest in highlighting. Mutual fund companies, as distinct from the funds themselves, have their own shareholders and profits to consider. They charge high management fees even though they come directly from investors' returns. They generally are willing to take added risks in an effort to attract assets in bull markets. And they trade frequently, even if that increases trading costs and investors' short-term capital gains taxes.

In practice, mutual fund investors have very little power over "their" company. Mutual funds are set up by advisors, not by individual investors. Funds have no employees of their own. All of the research, trading, money management and customer support staff actually work for the fund's advisor. And while shareholders do vote on the fund's directors, the advisor initially selects the directors.

Directors work part-time and rely on the advisor's staff for information. Furthermore, fund companies often set up a pooled structure, whereby fund directors serve on all of the fund boards in a fund complex. For efficiency, the industry association recommends use of such 'unitary boards' or similar 'cluster boards' whereby directors serve on groups of boards for a fund family. Not surprisingly, mutual fund boards fire their advisors with about the same frequency that race horses fire their jockeys.

The Role of Fund Directors

In an effort to address these inherent conflicts, the Investment Company Act of 1940, establishes specific roles for mutual fund directors. According to the late Supreme Court Justice William Brennan, the Investment Company Act was designed to place unaffiliated fund directors in the role of independent watchdogs, to furnish an "independent check upon the management of investment companies."[v]

This standard, however, has never been interpreted very stringently. In 2001, the SEC took various actions in an effort to make fund directors more independent of their advisor. It raised the required percentage of independent directors from 40 percent to 50 percent. Independent directors, rather than the advisor, must also select and nominate other independent directors. The SEC also imposed more stringent disclosure requirements for those directors

In truth, though, the problem with mutual fund governance may be cultural, rather than simply regulatory. Even before the SEC acted, the great majority of funds had a substantial majority of independent directors. Nothing stopped those directors from negotiating the lowest rates for investors, even if they weren't legally required to do so. In practice, though, fund directors have a difficult time striking a proper balance between working with the advisor and vigorously pursuing investors' interests. Too often the outcome is simply acquiescence to whatever the advisor proposes. Many directors view their role as simply auditing the performance of the advisor and making sure there is no malfeasance or accounting problems, rather than acting as investors' vigorous advocates.

Why Governance Matters

The weakness in mutual fund governance affects investors in a number of ways. First, investors pay significantly higher fees than they would if they really ran their own company. A study conducted in 2001 showed that the largest mutual funds pay twice the amount to their advisors than public-employee pension plans do for the same services.[vi] In some cases, mutual fund advisory fees were 3 to 4 times higher than those of pension funds.

The researchers examined over 1300 diversified mutual funds and 220 separate pension portfolios. To make the analysis comparable, they looked only at advisory fees, which are paid for investment services and research. They excluded administrative and sales distribution fees, which are largely associated only with mutual funds, appropriately excluding fees for customer service, shareholder mailings and broker compensation.

They found that the larger the pension fund, the greater its ability to negotiate significantly lesser fees. As for mutual funds, size conferred far fewer benefits. For instance, the largest 10 percent of pension funds reviewed, having assets averaging $1.5 billion, paid advisory fees of only 0.20 percent. The largest mutual funds, having assets averaging nearly $10 billion each, paid advisory fees fully 2 1/2 times that.

The only explanation the authors could identify was bargaining power. Pension funds negotiate for lower fees, while mutual fund shareholders can only rely on their directors to do so. Unfortunately, it does not appear that mutual fund directors vigorously negotiate fees.

Soft Dollars

The second, hidden cost of mutual fund governance comes when the financial advisor, with the acquiescence of the funds' directors, benefits itself at shareholder expense. This is done through something Wall Street calls "soft dollars."

Most commonly, a fund company will negotiate a deal with the broker which is executing the trades for its 'family' of funds. A portion of every commission will be retained by the broker as payment for research advice or other services normally paid for by the fund company. Such agreements have a name, "commission recapture arrangements."[vii] Basically, any expense that the fund company can direct to the fund's broker adds to the fund companies' profits at the expense of individual funds and their investors.

The mutual fund industry's educational material on the role of directors has this to say about "soft dollars." (Emphasis added):

> Directors also review a fund's use of "soft dollars," a practice by which some money managers, including mutual fund advisers, use brokerage commissions generated by their clients' securities transactions to obtain research and related services from broker-dealers **for the clients' benefit**. Directors review their fund adviser's soft-dollar practices as part of their review of the advisory contract. They do this because **services received from soft-dollar arrangements might otherwise have to be paid for by the adviser.**[viii]

What's hard to figure out is how soft dollar payments can ever be "for the clients' benefits" when they "might otherwise have to be paid for by the adviser." That sounds a lot more like "for the adviser's benefit" to me.

Incubator funds & IPO Allocations

Mutual fund companies understand the rules of chance, and are not shy about using them to their advantage. When chance doesn't yield good enough results, though, they sometimes help it out a little. Through portfolio prospecting a fund company will start several small 'incubator' funds and run them for a year or two. These funds start relatively small, are not widely held, and gain little attention from the financial media. There's a reason for that: the fund company is waiting to see how things turn out before deciding whether to promote the fund.

Those funds that under-perform the market are often liquidated and disappear. The fund company suffers no embarrassment. It becomes just another fund on the survivorship bias pile. When one of the funds outperforms the market, however, it receives far different treatment. The fund company markets the fund and its extraordinary performance, hoping to build up the asset size of the fund quickly.

Through 'selective attention', fund companies can build superior performance for incubator funds through manipulation rather than chance. Fund companies have been able to steer the shares of initial public offerings ('IPOs') and other hot stocks to new funds.

Generally, to ensure interest an IPO the offering price is set by the Wall Street underwriter at a discount to the expected trading price. Investment banks allocate shares at the IPO price deciding where to bestow any discounts. The mutual fund families, in turn, can choose which of their funds will be winners. The hotter the stock or IPO, the more important it is to find the right fund. Just given the arithmetic, small funds can get more of a boost from such attention. A little bit of juice shared with a small incubator fund can go a far way. That's when the marketing department can start readying copy for next month's advertisement.

Policy Issues for Possible Consideration

In writing a personal finance book I felt there were many appropriate suggestions and bits of advice to offer average investors. At its core, *The Great Mutual Fund Trap* we advises investors to stick to fundamentals through a buy and hold strategy; broad diversification; and avoidance of excess costs and risks associated with active money management or stock picking. I believe, however, that this is appropriately largely the domain for individual choice.

Congress and the SEC have acted for over 60 years, though, to address the ever changing issues related to the inherent conflicts between mutual fund companies and mutual fund investors. In this regard, this committee or the SEC may wish to give further consideration to (a) possible greater disclosures; (b) fund governance & (c) tax deferred retirement plans.

Possible Greater Disclosure

The mutual fund industry currently provides a considerable amount of disclosure. Additional disclosures, however, may assist investors and further guard against the inherent conflicts within the industry's structure. The following thoughts on additional possible disclosures are offered as an aid in any further deliberations.

First, while the direct costs of management fees and sales loads are disclosed, many of the indirect costs are not. In particular, portfolio trading costs are generally not disclosed. This is somewhat remarkable given their significance to investor returns. They are also the largest controllable cost of a mutual fund. I believe that it would be beneficial to disclose total transactions costs, commissions as well as possibly an estimate of the costs of bid/offer spreads. If pursued, this would be most helpful if disclosed along with management fees as a percentage of average assets.

Second, while Congress took steps several years ago to require the disclosure of after-tax returns, the SEC does not require inclusion of this information in sales and promotional material unless a fund is claiming to be tax efficient. Investors wishing to know a fund's after-tax performance currently need to review the prospectus – something they should be doing, but generally are not. It may be appropriate to mandate broader use of after-tax performance data.

Third, there is a significant relationship between risk and returns. Many observers focus on risk adjusted returns to compare investments. Based upon modern theories of investing, risk adjusted returns are a way of comparing investments of different risks. There are many services that compute such statistics. It may be worthwhile considering requiring fund companies to readily disclose such information on their web sites or with promotional material.

Fourth, the SEC currently sets guidelines on the use of performance data along with promotional material. Given the persuasive evidence that past performance does not

predict future performance, the Commission might want to consider further tightening these rules.

Fifth, given the natural desire of fund companies to ignore the poor results of liquidated or merged funds, it maybe worthwhile considering requiring fund companies to maintain such disclosure on their web sites. In addition, such returns could be included in reports on a fund companies' average performance. Survivorship bias has a perfectly innocent explanation. When investors are trying to decide with which mutual fund family to invest, however, they could benefit by seeing a firm's entire track record. Many outside services and publications could also summarize the information, once made publicly available, as well.

Sixth, the mutual fund industry relies heavily on others — brokers, insurance Companies, and financial advisers — to sell its products. Additionally, fund companies actively compete to win 401(k) and 403(b) plans from large corporations and institutions. Recognizing their commercial leverage, brokers have developed sharing agreements whereby they get paid handsomely for every new sale they make. Large corporations and institutions have developed somewhat similar arrangements whereby they receive part of the mutual fund fees on plan assets. In both venues, most mutual fund families feel they have to pay, lest they lose access to new assets and market share. Consideration may be appropriate to greater disclosure of these revenue sharing arrangements.

Mutual Fund Governance

Mutual funds, like other types of commercial entities must be operated for the benefit of its owners. Unlike most businesses, however, mutual funds are typically operated on a day-to-day basis by a third party – a mutual fund company. Being separate and distinct from the funds which it advises, a fund company has a primary responsibility and loyalty to its own shareholders. For instance, each publicly traded mutual fund company has a primary responsibility to its public shareholders above any duties to the investors in the many funds it manages.

Certainly, the mutual fund industry is competitive. There are thousands of funds and hundreds of fund companies. They disclose costs to the considerable extent required by law. Each fund company also prefers that the funds they manage do well relative to other funds. That does not mean, however, that the mutual fund industry competes on cost.

There are hundreds of casinos at Las Vegas, but that does not mean that you'll find one where the odds are in your favor. Casinos compete on glitz. While they want their customers to always have hope and leave feeling like winners, at the end of the day the house wins. Casinos owe it to their shareholders. Mutual funds compete on a range of services and a hope of earnings performance. They, too, owe their primary duty to their shareholders. In both cases, cost is all too often an afterthought for the customer.

While the Investment Company Act of 1940 and the SEC have addressed this inherent conflict of interest in many ways, it may be appropriate to consider whether the current framework is adequate to the task. In particular, there is significant evidence suggesting that fund directors generally do not actively pursue fee reduction or changing money managers. Public pension plans and corporate retirement plans switch asset managers on a regular basis, either due to fee or performance issues.

- Why don't we ever see reports of 'request for proposals' by mutual funds for their money managers? Fees are the largest controllable cost of a mutual fund.

- Why don't we see reports that at least a handful of funds each year have chosen a new fund advisor? Thousands of mutual funds under-perform the market each year. Numerous ones lose money each year.

To address these short comings, it may be appropriate to consider some sort of requirement that fund directors seek competitive proposals on a periodic basis or prior to renewing advisory contracts. An alternative approach might be to consider requiring fund boards to fully disclose the basis and reasoning for not seeking such competitive proposals. Imagine any other board of directors fulfilling its fiduciary duties without seeking competitive proposals for its principal supply contract.

The current nature of mutual fund governance also has allowed for mutual fund companies to enter into soft dollar arrangements with brokers at the expense of the mutual funds which they manage. One alternative might be an outright ban on such arrangements. Short of a prohibition, would be to require mutual fund fee disclosures to include the amount by which any soft dollar arrangement is picking up costs for the fund company.

With regard to the use of IPO allocations to enhance the performance of incubator and small funds, consideration might be given to requiring the SEC to promulgate new rules to limit such activities.

Tax Deferred Retirement Plans

With over $1.75 trillion held in 401(k) and 403(b) plans, mutual fund companies are very interested in these assets. Nearly 70 percent of these assets, or $1.2 trillion were invested in mutual funds as of year-end 2001.[ix] The government bestows numerous tax advantages to these accounts to promote savings in America. In addition, legislation currently is being considered by the Congress to allow mutual fund companies to offer investment advice to plan participants.

It light of this, it may be appropriate to consider having all 401(k) and 403(b) plans include as investment alternatives a low cost broad market U.S. equity index fund and bond index fund. Major pension plans and other institutional investors are investing passively in increasing amounts. According to Greenwich Associates, by year end 2001, public sector pension plans had fully 57 percent of their domestic equity investments

indexed. Corporate pension plans had nearly one third of their domestic equity investments indexed.

Including such a choice for all workers would simply allow them a low cost index alternative to consider while not limiting choice. Such a provision would give workers a benefit similar to those Congress has provided for all Federal Government workers through the Thrift Savings Plan. It could be particularly appropriate if mutual fund companies are allowed to offer investment advice directly to plan participants, as this new provision would add a potential new conflict of interest in the world of mutual funds.

Conclusion

Thank you. I would be happy to answer any of your questions.

[i] Investment Company Institute. As of year-end 2002, money market funds held $2.3 trillion.
[ii] Morningstar Principia Pro as of December 31, 2002. Search was for all mutual fund share classes charging a sales load, excluding index funds, exchange-traded funds, and institutional funds—3,674 funds in all. The 4.1 percent came from adding the average front-end and back-end load.
[iii] Jaij, Prem C., and Joanna Shuang Wu, "Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows," *Journal of Finance15*, (April 2000): 937.
[iv] Carhart, Mark M., "On Persistence in Mutual Fund Performance," *Journal of Finance 52* (March 1997): 57.
[v] Burks v. Lasker, 441U.S. 471, 484 (1979).
[vi] Brown, Stewart, and John Freeman, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *University of Iowa Journal of Corporation Law*, (August 2001): 609-73.
[vii] Berkowitz, Stephen and Dennis Logue, "Transaction Costs: Much Ado About Everything," *Journal of Portfolio Management* 27 (Winter 2001): 65.
[viii] Investment Company Institute, "Understanding the Role of Mutual Fund Directors" (1999): 16.
[ix] Investment Company Institute and the Employee Benefit Retirement Institute, "The EBRI/ICI Participant-Directed Retirement Plan Data Collection Project" (February 2003)

STATEMENT OF PAUL G. HAAGA, JR.

EXECUTIVE VICE PRESIDENT

CAPITAL RESEARCH AND MANAGEMENT COMPANY

AND

CHAIRMAN

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

"MUTUAL FUND INDUSTRY PRACTICES AND THEIR EFFECT ON INDIVIDUAL INVESTORS"

MARCH 12, 2003

EXECUTIVE SUMMARY

- The last several years have been challenging ones for investors, including mutual fund investors, market conditions and corporate and accounting scandals have shaken investor confidence.

- Throughout these difficult times, the comprehensive regulatory scheme under which mutual funds operate has served the interests of fund investors well.

- The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Every investor must receive a prospectus, which contains key information about a fund to help an investor make an investment decision. This includes information about fund fees and expenses.

- Mutual fund fees and expenses are clearly and prominently disclosed in a standardized, easy-to-read fee table at the front of every fund prospectus. Performance information in mutual fund advertisements must be presented net of fees. Fees also are subject to substantive regulation under the Investment Company Act of 1940 and NASD rules.

- The broad availability of information about mutual fund fees and expenses has helped promote price competition in the industry. Recent government and industry studies support the conclusion that competition is working in the interests of fund investors. Among the findings are that the average total cost of purchasing mutual funds has declined steadily and significantly since 1980, that mutual fund investors benefit from economies of scale, and that the overwhelming majority of investors buy and own funds with lower than average expenses.

- The SEC continues to improve disclosure of mutual fund fees and other costs, as demonstrated by various new and pending disclosure requirements, including proposed expense disclosure in mutual fund shareholder reports, proposed disclosure in fund performance advertisements directing investors to the prospectus for information about fund fees and expenses, and standardized disclosure of after-tax returns.

- In addition to disclosure and substantive regulation of fund fees and expenses, mutual funds are subject to comprehensive regulation under the Investment Company Act that has been effective in protecting investors and helping the industry avoid major scandal. The fact that many of the central tenets of mutual fund regulation – including independent boards, mark-to-market accounting, prohibitions on complex capital structures, prohibitions on self-dealing, and direct oversight by the SEC – are now being extended to other businesses (*e.g.*, through the Sarbanes-Oxley Act of 2002) serves as a strong endorsement of the mutual fund regulatory system.

Table of Contents

I. **Introduction** 1

II. **Benefits of Disclosure and Regulation of Mutual Fund Fees** 3

A. Clear and Prominent Fee Disclosure Is Provided to Investors 3

B. Substantive Regulation of Fees Further Protects Fund Investors 6

C. Transparency of Fee Disclosure Has Helped Foster Competition 9

1. The Market Structure of the Fund Industry Promotes Active Competition 9

2. Mutual Fund Fees Continue to Decline 10

3. Fund Investors Continue to Benefit from Economies of Scale 11

4. Most Investors Buy and Own Lower Cost Funds 12

D. The SEC Continues To Improve Mutual Fund Disclosure 13

1. Shareholder Report Disclosure 13

2. Disclosure in Fund Advertisements 15

3. Disclosure of After-tax Returns 15

4. Disclosure of Brokerage Costs 16

III. **Benefits of a Strong Regulatory Scheme** 17

IV. **Conclusion** 20

I. INTRODUCTION

My name is Paul G. Haaga, Jr. I am Executive Vice President and Chairman of the Executive Committee of Capital Research and Management Company, the investment adviser to the 29 funds in The American Funds Group, with more than $350 billion in assets under management. The American Funds Group is the third largest mutual fund group in the United States and the largest group distributed exclusively through unaffiliated financial intermediaries. I also serve as Chairman of the Board of Governors of the Investment Company Institute, the national association of the American investment company industry, and I appear here today on behalf of the Institute. The Institute's membership includes 8,929 open-end investment companies ("mutual funds"), 553 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.322 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

I am pleased to appear before the Subcommittee today to discuss how Securities and Exchange Commission (SEC) disclosure requirements and substantive regulation have provided mutual fund investors with a sound basis for making informed investment decisions, fostered competition in the mutual fund industry, and shielded the industry from major scandal.

The last two to three years have been challenging ones for all investors, including mutual fund investors. Because mutual funds themselves are investors in the securities markets, they have felt the impact of market downturns. In addition, the egregious corporate

and accounting scandals that have surfaced during this period have broadly impacted investor confidence.

In these difficult times, when so many Americans have entrusted their hard-earned dollars to mutual funds, it is entirely appropriate to conduct this review of mutual fund industry practices and their effect on individual investors. My testimony will describe how fund shareholders benefit from the current system of SEC mutual fund regulation.

First, I will describe mutual fund disclosure requirements, especially the requirements governing disclosure of fund fees and expenses. The availability of clear and prominent fee disclosure has served to create a basis for informed investment decisions. It also has promoted price competition in the industry, which has the beneficial effect of limiting costs to fund shareholders. Recent industry and government studies of mutual fund fees confirm the existence of competition. Moreover, in recent years, the SEC has adopted and proposed changes to further enhance fund disclosures.

Second, I will discuss key elements of the strong system of substantive regulation that has protected funds from the scandals that have shaken investor confidence in corporate America. In fact, in the aftermath of these scandals, many of the central tenets of mutual fund regulation – including independent boards, mark-to-market accounting, prohibitions on complex capital structures, prohibitions on self-dealing, and direct oversight by the SEC – are being extended to other industries through the provisions of the Sarbanes-Oxley Act of 2002 and other regulatory initiatives.

II. BENEFITS OF DISCLOSURE AND REGULATION OF MUTUAL FUND FEES

A. Clear and Prominent Fee Disclosure Is Provided to Investors

The disclosures that mutual funds are required to provide to investors are unmatched by those of any other financial product. Each investor receives a prospectus at or before the time of buying fund shares. The prospectus provides detailed information about a fund's investment objectives and policies, risks, returns, fees and expenses, the fund manager, and how to purchase and redeem shares. In 1998, with strong support from the fund industry, the SEC adopted changes designed to improve the quality and usefulness of information in fund prospectuses in order to promote the primary purpose of the prospectus – to help an investor make an informed investment decision. One of the innovations adopted by the SEC at that time is the requirement for a standardized "risk/return summary" at the beginning of every fund prospectus that lays out concisely and in a specified order information about the fund's investment objectives, strategies, risks and performance, as well as its fees and expenses.[1]

Reflecting their importance as part of the information that investors and their professional advisors should consider when deciding whether to invest in a fund, fund fees and expenses are disclosed in a straightforward, standardized fee table. The fee table presents fund fees in two broad categories: shareholder fees (such as sales charges paid to compensate financial professionals who provide investment advice and other services) and annual fund

[1] At the same time that the SEC proposed these changes to fund prospectuses, it also proposed a rule, which the Institute supported, designed to prevent misleading fund names. The SEC adopted the "fund name rule" in 2001. It requires any fund whose name suggests that the fund invests in certain investments, industries, countries or geographic regions to have a policy of investing, under normal circumstances, at least 80 percent of its assets in a manner consistent with its name.

operating expenses. The fee table shows annual fund operating expenses broken down into specified categories. These include, for example, the "management fee" that the fund's investment adviser charges to manage the fund and the "distribution (12b-1) fee," if any, that the fund pays to cover costs such as compensating broker-dealers, financial planners and other financial professionals for services they provide directly to investors. Each type of annual operating expense is expressed as a percentage of the fund's average net assets. The fee table also shows total annual fund operating expenses as a percentage of average net assets (sometimes referred to as a fund's "expense ratio").[2]

One distinction between shareholder fees and annual fund operating expenses is that shareholder fees are paid directly by investors, whereas annual fund operating expenses are paid out of the fund's assets (and, thus, indirectly by investors) to cover the ongoing costs of running the fund and other services. Notably, investors often have the option of paying for the assistance and ongoing services of their financial advisers, including administrative services related to maintaining shareholder accounts, in more than one way. These payment options could include a direct fee (*i.e.*, a sales charge), a payment made from the fund's assets over time (*i.e.*, a 12b-1 fee), or a combination of both. Most investors use these services; thus, most funds have sales charges and/or ongoing fees to cover these costs. Indeed, Institute data show that the vast majority (approximately 80 to 85 percent) of mutual fund purchases are made by investors through financial intermediaries, including both financial advisers and employer-

[2] A variety of other readily available sources of information about mutual fund fees supplement the SEC's fee disclosure requirements. These sources include brokers and financial advisers, newsletters, newspapers and magazines. They also include the SEC itself, which in recent years has developed and made available on its website (www.sec.gov) both an interactive mutual fund cost calculator designed to assist investors in comparing the costs of different funds and other educational materials about investing in mutual funds. The Institute and many individual fund groups also offer educational resources and tools for investors to help them better understand fees and expenses as well as other important aspects of mutual fund investing.

sponsored retirement plans.[3] In other words, in most cases, investors are receiving professional advice or other services from financial intermediaries when investing in mutual funds. To provide investors with a choice of how to pay for these services, many funds offer various classes of shares that provide a variety of different payment options.[4]

The American Funds Group provides a good example of this. Our funds are sold exclusively through third parties, primarily retail broker-dealers. We have adopted a multiple class structure that, by providing choices, seeks to satisfy the different needs of the different types of customers we serve. The overall expenses of our share classes vary based largely on two important factors: (1) the level of compensation paid by the fund on behalf of its shareholders to financial intermediaries; and (2) the level of administrative services supported by the share class.[5]

In addition to listing a fund's fees and expenses, the prospectus fee table includes an example that illustrates the effect of fund expenses on a hypothetical investment over time. The example is designed to enable investors to readily compare the costs of two or more funds because the invested amount and time periods are standardized. The total is an "all-in" figure,

---

[3] *See* Investment Company Institute, 2002 Mutual Fund Fact Book, at 33.

[4] In a multiple class structure, each class of shares invests in the same portfolio of securities. Different classes may be sold through different distribution arrangements (*e.g.*, retail broker-dealers, employer-sponsored retirement plans, etc.) and may have different expense levels that reflect their customization.

[5] For example, we offer five share classes designed for use exclusively by retirement plans. These share classes have a broad spectrum of expense levels. The expense differences reflect the fact that some retirement plan sponsors wish to have the fund pay for all expenses of financial intermediaries and plan administration, while others prefer to pay most of these expenses directly and outside of the fund.

expressed as a single dollar amount, that takes into account both sales charges and annual operating expenses.[6]

The required disclosures of mutual fund fees are reinforced by SEC rules governing mutual fund performance advertising. Under current SEC rules, funds that advertise performance information must provide standardized total return data for prescribed periods. Importantly, all standardized performance numbers must be presented net of fees. Thus, when investors review and compare fund performance data, the effect of all fees has already been taken into account.

Taken together, the foregoing disclosure requirements provide investors and their professional advisers with the information needed to make decisions about the value that a particular fund can offer.

B. Substantive Regulation of Fees Further Protects Fund Investors

In addition to the wealth of information about fees and expenses that is available to mutual fund investors and their professional advisors, there are a number of substantive regulatory protections that apply to mutual fund fees.

First, NASD rules place limits on mutual fund sales charges and 12b-1 fees.[7]

---

[6] As discussed in Section II.D below, the SEC has proposed to require similar dollar amount disclosure in fund shareholder reports. The Institute supports that proposal.

[7] *See* NASD Conduct Rule 2830. NASD rules limit total front-end and/or deferred sales charges to no more than 8.5% of the offering price, although most funds charge far less than the maximum. The rules also limit 12b-1 fees. These fees are limited to a maximum of 1.00 percent of the fund's average net assets per year, which may include a service

Second, fund boards of directors oversee all expenses and have specific review, approval and oversight responsibilities with respect to the most significant components of ongoing fund expenses – the investment advisory fee and any 12b-1 fee.[8]

For example, both the board as a whole and a majority of the fund's independent directors must review and approve any investment advisory contract entered into by a fund on an annual basis, after an initial term of no more than two years. Fund directors are required to request, and the adviser is obligated to provide, information reasonably necessary to review the terms of the contract, including the advisory fee.[9] My firm, Capital Research and Management Company, prepares extensive information for this purpose and provides it to the directors of The American Funds and their independent legal counsel approximately two weeks in advance of a meeting of the contracts committee of independent directors that is convened for the purpose of considering renewal of the investment advisory contract, the 12b-1 plan (discussed further below) and other key agreements between the funds and the investment management

---

fee of up to 0.25 percent to compensate intermediaries for providing services or maintaining shareholder accounts. NASD rules also subject the aggregate amount of 12b-1 fees to a lifetime cap, based upon a percentage of fund sales.

In addition to these fee limits, NASD rules impose suitability requirements on broker-dealers with respect to securities that they recommend, including mutual funds. The NASD has provided guidance reminding its members that, in determining the suitability of a particular fund, a member should consider the fund's expense ratio and sales charges as well as its investment objectives. The NASD also has issued specific guidance concerning the application of suitability principles to sales of mutual funds that offer multiple classes. *See, e.g.*, NASD Regulation, Inc., "Suitability Issues for Multi-Class Mutual Funds," Regulatory & Compliance Alert, Summer 2000.

[8] As discussed further in Section III below, significant new SEC fund governance requirements designed to enhance board independence and effectiveness have recently gone into effect.

[9] While fund directors have a responsibility to make sure that advisory fees are reasonable in light of all relevant facts and circumstances, they are not required to engage in a competitive bidding process or to award the advisory contract to the adviser offering the lowest rates. Either of these approaches would, inappropriately, ignore the fact that the fund's shareholders have chosen the fund and the fund family in which they wish to invest. In the words of former SEC Chairman Arthur Levitt, "Directors don't have to guarantee that a fund pays the lowest rates. But they do have to make sure that fees fall within a reasonable band." Remarks by Chairman Arthur Levitt, U.S. Securities and Exchange Commission, Investment Company Institute, Washington, D.C. (May 15, 1998).

organization. Every committee meeting includes an executive session involving the independent directors and their legal counsel outside the presence of fund management.

A fund's adviser has a fiduciary duty with respect to the receipt of compensation from the fund.[10] The SEC and fund shareholders may bring suit against the adviser for breach of this duty.[11]

Pursuant to Rule 12b-1 under the Investment Company Act, any payments by a fund for distribution-related expenses must be in accordance with a written plan approved annually by the fund's board of directors, including a majority of the independent directors. The fund's directors must review, at least quarterly, the amounts spent under a 12b-1 plan and the reasons for the expenditures.

In addition to the specific limits on fund fees and the board review, approval and oversight requirements described above, another level of investor protection is provided through requirements that shareholders must approve any material changes to the advisory contract (including any proposed fee increase) and any material increase in a fund's 12b-1 fee. Thus, funds cannot unilaterally raise these fees, nor may the board alone approve a fee increase.

---

[10] Section 36(b) of the Investment Company Act of 1940. A mutual fund also enters into a number of contracts with other service providers, such as the fund's principal underwriter, administrator, custodian, and transfer agent. As part of its overall responsibilities, the board of directors oversees the performance of these service providers. If the service provider is the investment adviser or an affiliate of the adviser, the fund board must review and approve the contract with the service provider to ensure that any compensation paid thereunder meets the standards of Section 36(b).

[11] *See, e.g.*, Kalish v. Franklin Advisers, Inc., 928 F.2d 590 (2d Cir. 1991); Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).

C. Transparency of Fee Disclosure Has Helped Foster Competition

The broad availability of information about mutual fund fees and expenses has helped promote competition in the industry. Individual investors, as well as the intermediaries who assist investors in making their investment decisions, have access to and use this information. When the Institute testified on price competition in the fund industry in 1998, a central theme of the Institute's testimony was that competition in the mutual fund industry is working effectively in the interests of investors.[12] As evidence of this, we noted: (1) that mutual funds compete for investor dollars; (2) that there are low barriers to entry into the fund business; (3) that the industry is not concentrated; (4) that the total costs of investing in mutual funds are declining; (5) that mutual fund investors are benefiting from economies of scale; and (6) that a substantial majority of fund shareholders own equity funds that charge lower fees than the industry average. Each of these points remains valid today and several have been reinforced by developments since 1998.

1. The Market Structure of the Fund Industry Promotes Active Competition. In its 2000 report on mutual fund fees,[13] the United States General Accounting Office (GAO) described the mutual fund industry as one that features a large number of competitors, low barriers to entry, and product differentiation on the basis of performance, quality and services. The GAO

[12] Statement of Matthew P. Fink, President, Investment Company Institute, before the Subcommittee on Finance and Hazardous Materials of the House Committee on Commerce on "Improving Price Competition for Mutual Funds and Bonds," September 29, 1998.

[13] United States General Accounting Office, "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition" (June 2000) ("GAO Report").

Report noted that both the number of funds and the number of fund families rose significantly during the period of 1984 to 1998 and that the industry was not concentrated.[14]

2. Mutual Fund Fees Continue to Decline. The Institute's 1998 testimony discussed several studies indicating that the total purchase cost of investing for mutual fund shareholders had steadily declined over time.[15] Additional studies of trends in mutual fund fees have been conducted more recently. These studies all reach the same conclusion: total costs of purchasing mutual fund shares have continued to fall.

According to Institute research, the average total cost that investors incurred when purchasing mutual funds[16] has declined steadily and significantly since 1980. From 1980 to 2001, the total cost of equity funds fell by 43 percent, the total cost of bond funds decreased by 41 percent and the total cost of money market funds decreased by 35 percent.[17]

---

[14] GAO Report at 58-59.

[15] These studies included: (1) Erik R. Sirri and Peter Tufano, "Competition and Change in the Mutual Fund Industry," *in Financial Services: Perspectives and Challenges*, edited by Samuel L. Hayes, III, Cambridge, MA, HBS Press, 1993; 92) Steve S. Savage, "Perspective Amid the Debate Over Mutual Fund Expenses," *AIA Investor News*, published by the American Investors Alliance, February 1993; (3) Lipper Analytical Services, Inc., "The Third White Paper," September 1997; and (4) "Advisory Fee Contracts," *Strategic Insight Overview*, May 1998, p.ii.

[16] To properly measure the total cost of investing in mutual funds, it is important to consider both (1) the sales charges paid by investors directly to compensate financial professionals who provide investment advice and other services, and (2) the annual operating expenses that are paid out of the fund's assets to cover the costs of running a fund and other services. Unlike annual operating expenses, sales charges are one-time charges. Thus, to measure total shareholder cost accurately, it is necessary to "annualize" the sales charge, *i.e.*, convert it into the equivalent of an annual payment paid by the investor over the life of his or her investment.

[17] *See* Investment Company Institute, "Total Shareholder Cost of Mutual Funds: An Update," *Fundamentals*, September 2002, available at http://www.ici.org/pdf/fm-v11n4.pdf.

The SEC's Division of Investment Management published its own study of mutual fund fees in 2000.[18] The SEC looked at both expense ratio trends and total ownership costs. According to the SEC study, the weighted average expense ratio for all fund classes declined in three out of the last four years that the SEC studied (from 0.99% in 1995 to 0.94% in 1999). While the SEC found an increase in the weighted average expense ratio from 0.73% in 1979 to 0.94% in 1999, it explained that this increase was due to the shift from use of front-end sales charges (which are not included in a fund's expense ratio) to finance distribution, to the use of 12b-1 fees (which are included in the fund's expense ratio). When examining the total ownership costs of "load classes,"[19] the SEC found a decline of 18% between 1979 and 1999.

3. Fund Investors Continue to Benefit from Economies of Scale. Some critics have suggested that the mutual fund industry has not passed economies of scale on to investors. These critics usually rely upon a fundamental misconception – that economies accrue to an *industry* that has grown. Economies do not accrue to an industry but rather only to individual funds or fund families as they grow. In fact, evidence shows that mutual fund investors have benefited from economies of scale.[20] Institute research shows that the expense ratios of large equity funds were lower than those for smaller funds and that expense ratios declined as funds grew.[21]

---

[18] Division of Investment Management, U.S. Securities and Exchange Commission, "Report on Mutual Fund Fees and Expenses" (December 2000).

[19] The SEC defined "load classes" as classes with 12b-1 fees higher than 25 basis points, classes with 12b-1 fees and contingent deferred sales charges, and classes with traditional front-end sales charges.

[20] The term "economies of scale" refers to the expectation that a growing fund should be able to spread certain fixed costs across a larger asset base, resulting in a declining expense ratio. In fact, the fee structures of many funds have been specifically designed to pass along economies of scale by means of management fee "breakpoints," which refer to a specific level of asset growth, and provide that when this level is achieved, the management fee rate will be reduced by a predetermined amount (*e.g.*, 5 or 10 percent).

[21] John D. Rea, Brian K. Reid, and Kimberlee W. Millar, "Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds, *Perspective*, Vol. 5, No. 5, December 1999.

The findings in the GAO Report are consistent with the Institute's research. For example, the GAO found that between 1990 and 1998, 85 percent of the equity funds included in its study reduced their expense ratios, with an average decline of 20 percent.[22] Another more recent empirical study of mutual fund advisory contracts provides further support for the proposition that mutual fund investors are benefiting from economies of scale. This study found that fee rates in mutual fund advisory contracts are lower for advisers of large funds and members of large fund families, leading the author to conclude that these results "are consistent with economies of scale being passed along to investors – suggesting a competitive environment."[23]

My own experience backs this up. Like many other fund groups, The American Funds have management fee schedules that provide a series of breakpoints at specified asset levels. As a result, our funds' shareholders have benefited greatly from economies of scale. For example, as a result of the amount of assets in our oldest and largest fund, Investment Company of America, the current advisory fee is .24%.

4. Most Investors Buy and Own Lower Cost Funds. In 1998, the Institute testified that the overwhelming majority of both shareholders' equity fund accounts and equity fund assets were in mutual funds that charged annual fees below the simple average. More recent Institute data indicate that this is still true. In fact, in 2001, 79% of equity fund accounts and 87% of

---

[22] The GAO examined expense ratios, asset growth rates, and related data for the 46 largest equity funds and 31 largest bond funds as of December 31, 1998 that had been in existence since January 1, 1990.

[23] Daniel N. Deli, *"Mutual Fund Advisory Contracts: An Empirical Investigation,"* The Journal of Finance, Vol. VII, No. 1, Feb. 2002, at 110.

equity fund assets were in share classes with a below average expense ratio. Institute research also shows that the percentage of new sales attributable to share classes with a lower than average expense ratio was at least 80% in each year from 1997 through 2001, when it reached 86%.[24]

D. The SEC Continues to Improve Mutual Fund Disclosure

As discussed above, existing mutual fund fee disclosure requirements provide a high degree of transparency that has played a significant role in fostering competition in the mutual fund industry. The SEC continually seeks ways to further improve disclosure of mutual fund fees and other costs, as evidenced by various new and pending SEC disclosure requirements.

1. Shareholder Report Disclosure. Mutual funds are required to furnish to shareholders on a semi-annual basis reports containing the fund's financial statements and additional financial and other information. The SEC recently proposed changes to simplify and improve the disclosure in fund shareholder reports. Among other things, the proposals would allow mutual funds to provide summary portfolio schedules and require funds to provide graphic presentations of their portfolio holdings. The Institute strongly supports most of the proposed changes, which build on earlier SEC disclosure initiatives such as fund prospectus simplification.[25]

---

[24] The experience of bond funds has been similar: 74% of bond fund accounts and 85% of bond fund assets were in share classes with below average expense ratios in 2001. The percentage of new sales of bond funds attributable to bond fund share classes with lower than average expenses increased from 79% in 1997 to 85% in 2001.

[25] *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated February 14, 2003.

As part of its shareholder report disclosure improvement initiative, the SEC has proposed to require new disclosure concerning fund expenses in shareholder reports. Specifically, the SEC has proposed that fund shareholder reports disclose the cost in dollars of a $10,000 investment in the fund, based on the fund's actual expenses and return for the reporting period. The proposed disclosure is intended to enhance investor understanding of ongoing fund expenses and allow investors to estimate the costs they bore over the reporting period.

The Institute supports this proposal. It should enhance investors' awareness of the importance of fees by reminding them about the impact of expenses on their investment return and will also assist them in comparing the expenses of different funds. The proposed disclosure would complement the extensive fee and expense disclosure that funds currently provide.

In making its proposal, the SEC noted that it had considered an alternative approach that would require every quarterly account statement delivered to an investor to disclose the actual dollar amount of fees paid with respect to each mutual fund held by that investor during the last quarter. The SEC expressed concerns about the cost and logistical complexity of such a requirement. For example, in many cases, fund shares are held by broker-dealers, financial advisers, and other third-party financial intermediaries. In order to calculate and timely report personalized expense information for each fund held in an account each quarter, not only funds but also each intermediary would have to implement new systems, which would be extremely burdensome.[26] Based on these concerns, the SEC determined not to propose such an approach.[27]

---

[26] The American Funds, for example, are sold through approximately 2,000 dealer firms.

[27] An ICI survey of various industry participants conducted in late 2000 confirmed that the costs and burdens of providing individualized expense disclosure on quarterly account statements would be substantial. ICI Survey on GAO Report on Mutual Fund Fees (January 31, 2001).

Individual expense disclosure in account statements also would have other disadvantages. For example, it would not provide any context for an investor to assess the expenses paid in a meaningful way or to make comparisons with different funds. If an account statement reflected investments in several different funds, it is likely that the amount invested in each one would be different, thus making it difficult to make a fair comparison. The SEC's proposed approach uses a standardized investment amount ($10,000), which is specifically designed to facilitate comparisons. Also, account statement disclosure of fund expenses could be misleading because there could be other investments reflected on the same statement that would not include similar disclosure. This could create the mistaken impression that mutual funds are the only type of investment that involves costs, which might lead to ill-informed investment decisions.

2. Disclosure in Fund Advertisements. As discussed above, standardized quotations of fund performance are calculated in a manner that takes fund fees and expenses into account. The SEC has proposed amendments to the rules governing fund advertisements. Among other things, the proposed amendments would require a legend in fund performance advertisements to direct investors to additional information about fees and expenses in fund prospectuses. This proposed change will call further attention to fund fees and expenses and their impact on returns.

3. Disclosure of After-tax Returns. As part of the SEC's continuing efforts to improve mutual fund disclosure of costs, in early 2001, the SEC adopted rules requiring most mutual

funds to disclose in their prospectuses returns on an after-tax basis.[28] This disclosure is presented in a standardized format and included as part of the risk/return summary required at the front of the prospectus. Significantly, to our knowledge, no other financial product is subject to a similar disclosure requirement. Nevertheless, the Institute generally supported the rules because we agree that it is relevant for investors to understand the impact that taxes can have on returns.[29]

4. **Disclosure of Brokerage Costs.** Questions have arisen concerning the disclosure of brokerage costs (commissions) that a fund pays in connection with buying or selling portfolio securities. Information about brokerage commissions paid by mutual funds is included in a fund's Statement of Additional Information, which is available to investors for no charge upon request.[30] The SEC previously required disclosure of average commission payments in fund prospectuses, but eliminated this requirement as part of its 1998 prospectus simplification initiative.[31]

The industry would welcome ideas for ways to better disclose these costs. One suggestion that has been raised – requiring that they be included in the fund's expense ratio –

---

[28] Certain types of funds, such as money market funds and funds used as investment options for 401(k) plans and other types of retirement plans, are exempted from these requirements.

[29] We continue to have concerns with some of the specific aspects of the rule, however. The most significant concern is that the rules require funds to use the highest marginal tax rate in computing after-tax returns. This rate is much higher than the rate applicable to the majority of mutual fund shareholders. We believe that using the rate applicable to the average fund investor would provide more useful information by presenting a more realistic measure of after-tax returns.

[30] Funds also include this information in Form N-SAR, which is filed with the SEC. (Both documents are available on the SEC's EDGAR system.)

[31] In eliminating the requirement, the SEC stated that "a fund prospectus appears not to be the most appropriate document through which to make this information public." SEC Release No. IC-23064 (March 13, 1998), 63 Fed. Reg. 13916, 13936 (March 23, 1998).

would not improve disclosure of brokerage costs. There are several reasons for this. For example, including brokerage commissions in a fund's expense ratio could confuse investors, distort expense ratios and make fair comparisons across funds more difficult, because the expense ratio would include commissions paid for securities that trade on an agency basis but would *not* include the spread for securities traded on a principal basis. As a result, it might appear that a fund that holds securities that trade on a principal basis would have lower trading costs and lower overall expenses than a fund that pays commissions, when this might not be the case. Other components of trading costs (*e.g.*, market impact) also could not be included in the expense ratio. By including *some*, but not all costs associated with trading, the expense ratio would no longer serve its primary function – allowing investors and others to compare ongoing fund expenses in a consistent manner. Finally, the level of brokerage costs can fluctuate significantly, sometimes as the result of a one-time occurrence, such as a change in the fund's portfolio securities in connection with the assignment of a new portfolio manager. This could lead to volatility in the fund's expense ratio that may confuse investors by appearing to indicate changes in the cost of providing fund services to investors.

III. BENEFITS OF A STRONG REGULATORY SCHEME

The disclosure and substantive regulatory requirements governing fund fees and expenses and the other disclosure requirements discussed above represent just some of the ways in which mutual fund regulation informs and protects investors. Mutual funds are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for over 60 years. Their operations are regulated under all four of the major federal securities laws, including the Securities Act of 1933, the Securities Exchange Act of 1934,

the Investment Advisers Act of 1940 and, most importantly, the Investment Company Act of 1940.

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) insure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or restrict forms of self-dealing; (4) prohibit unfair and unsound capital structures; and (5) insure fair valuation of fund purchases and redemptions.

The strict regulation that implements these objectives has allowed the industry to garner and maintain the confidence of investors and also has kept the industry free of the types of problems that have surfaced in other businesses in the recent past. An examination of several of the regulatory measures that have been adopted or are under consideration to address problems that led to the massive corporate and accounting scandals of the past several years provides a strong endorsement for the system under which mutual funds already operate.[32]

---

[32] Mutual funds also are subject to most of the requirements that apply to corporate issuers under the Sarbanes-Oxley Act of 2002, including the following: (1) mutual fund shareholder reports must be certified by the fund's principal executive and principal financial officers; (2) mutual funds must disclose whether their audit committee includes at least one member who is an "audit committee financial expert," and if not, why not; (3) mutual funds must disclose whether they have adopted a code of ethics that covers specified fund officers and other personnel and if not, why not; (4) mutual funds must comply with the new auditor independence requirements, including the requirement to periodically rotate auditors; and (5) legal counsel to mutual funds (which the SEC has interpreted to include legal counsel to the fund's investment adviser, for this purpose) must comply with new requirements governing attorney conduct. Congress excluded mutual funds from some of the Act's provisions where existing law already prohibits the conduct in question. For example, because Section 17(a) of the Investment Company Act prohibits most transactions with affiliates, mutual funds were exempted from Section 402 of the Sarbanes-Oxley Act, dealing with issuer loans to insiders.

For example, under the Investment Company Act, mutual funds – unlike any other financial product – are governed by a board of directors that is required to have at least a certain percentage of directors who are independent from fund management. In early 2001, the SEC adopted new requirements designed to enhance the independence and effectiveness of independent fund directors, and to "reaffirm the important role that independent directors play in protecting fund investors."[33] As a result, funds that rely on any of several key exemptive rules under the Investment Company Act (which includes the vast majority of funds) are subject to the following requirements: (1) independent directors must constitute a majority of their boards of directors; (2) independent directors must select and nominate other independent directors; and (3) any legal counsel for the independent directors must be an "independent legal counsel" as defined by the SEC.[34]

Recognizing the significant role that independent directors can play in protecting investors, the New York Stock Exchange and other self-regulatory organizations are considering adopting board independence requirements for listed companies.[35]

Fundamental provisions of the Investment Company Act – affiliated transaction prohibitions, restrictions on capital structure and daily mark-to-market accounting – contribute greatly to the transparency of mutual fund operations. Perhaps more importantly, they prevent

---

[33] SEC Release No. IC-24816 (January 2, 2001), 66 Fed. Reg. 3734 (January 16, 2001).

[34] Even before the SEC issued its fund governance proposals, the Institute formed an industry Advisory Group, on which I served, that issued a report recommending that fund directors consider adopting a series of fifteen "best practices" – which go beyond legal requirements – to enhance the independence of independent directors and the effectiveness of fund boards as a whole. Investment Company Institute, Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness (June 24, 1999).

[35] *See, e.g.*, Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee (2002).

the types of conduct and practices of corporate issuers (*e.g.*, loans to insiders or "creative" accounting practices) that have caused millions of Americans to lose not only significant amounts of money but also their confidence in the capital markets.

The extensive regulatory scheme that applies to mutual funds has been effective in protecting investors and helping the industry avoid major scandal due, in large part, to another important aspect of mutual fund regulation – direct SEC oversight and regular examinations of funds. The Institute has always strongly supported adequate funding of the SEC to ensure that it can fulfill these roles effectively, and we are pleased that the SEC's latest budget increase recognizes the importance of a strong, well-funded SEC.[36] We note that Section 408 of the Sarbanes-Oxley Act, which provides for regular and systematic SEC review of certain disclosures made by corporate issuers, affirms the value of direct SEC oversight and regular examinations.

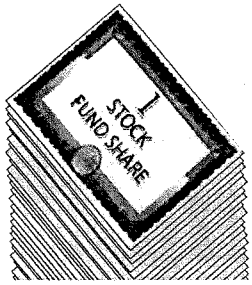
IV. CONCLUSION

In these challenging times that we all face – where public confidence has been shaken and weak market performance continues – it is clear that investors have benefited from the stringent regulation of mutual funds. The disclosure and substantive regulatory requirements imposed upon mutual funds have enhanced competition and helped the industry avoid major scandal.

---

[36] Congress recently passed a spending bill for fiscal year 2003 that earmarks $716 million for the SEC, an increase of approximately 47 percent above the amount the SEC spent in fiscal 2002. The SEC has announced plans to make significant additions to its examination staff and restructure its current mutual fund examination process.

Most Investors Are Buying Lower Cost Stock Funds

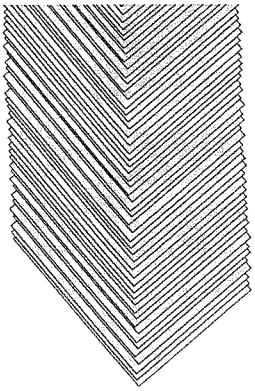


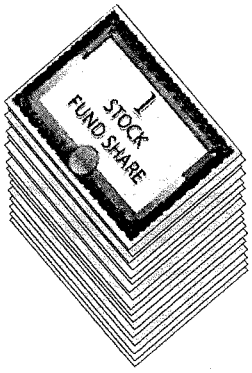
Investments in Stock Funds With BELOW-AVERAGE EXPENSE RATIOS

83%

Investments in Stock Funds With AVERAGE or ABOVE-AVERAGE EXPENSE RATIOS

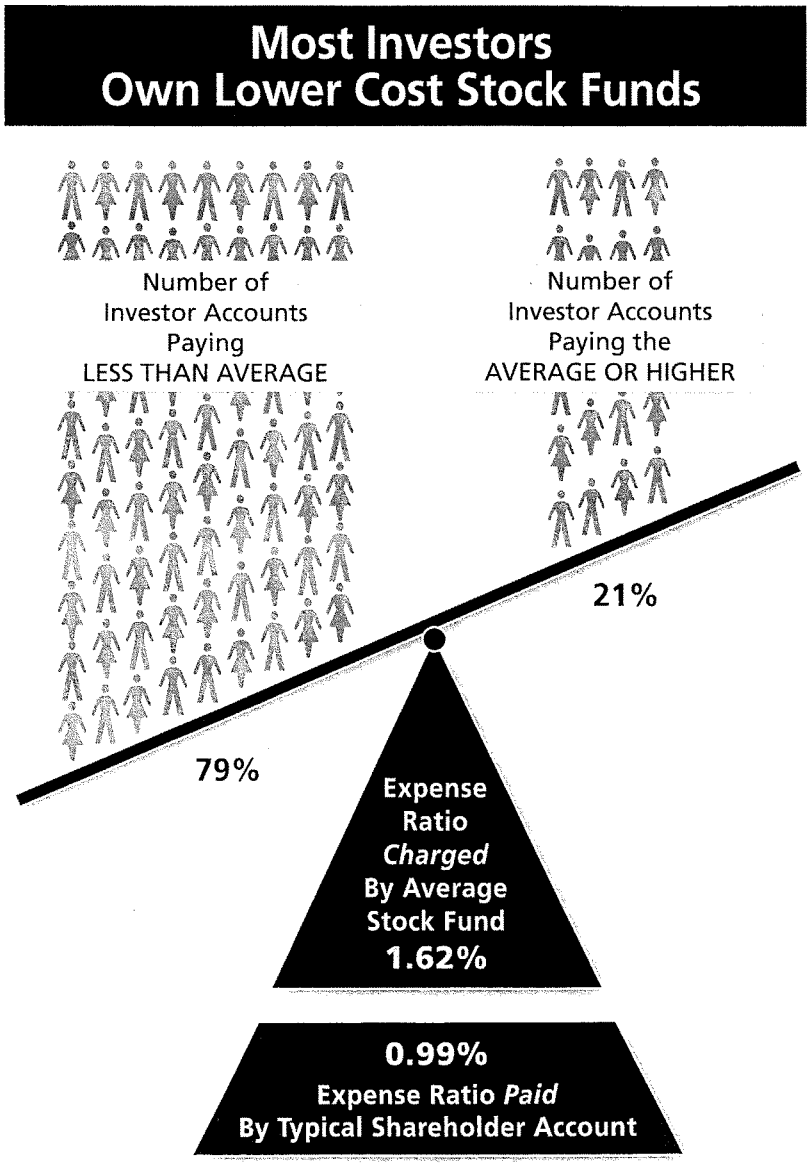
17%





Total Sales of All Stock Funds
1997–2001

Average Stock Fund Expense Ratio – 1.62%


Most Investors
Own Lower Cost Stock Funds
Number of
Investor Accounts
Paying
LESS THAN AVERAGE
Number of
Investor Accounts
Paying the
AVERAGE OR HIGHER
21%
79%
Expense
Ratio
Charged
By Average
Stock Fund
1.62%
0.99%
Expense Ratio Paid
By Typical Shareholder Account

Testimony Concerning "Mutual Fund Industry Practices and their Effect on Individual Investors"

by John Montgomery, Bridgeway Funds

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 12, 2003

Introduction

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee,

After three years of negative returns, quotes like the following reflect the backlash by shareholders, the media, and regulators:

> "Mutual funds exist in a culture that thrives on hype and withholds important information in a cutthroat business that regularly misleads investors." [1]

While I hardly think it reflects the environment at Bridgeway Funds and while I believe the mutual fund industry in aggregate is definitely on the "cleaner end of the spectrum" within the investment community, major criticism *is* well deserved. As an industry we can do better; indeed, we *must* do better if we are to serve the long-term needs of our country's smaller investors. When the stock market was rising 10 to 30% per year in the 90's, no one looked "under the hood" of their mutual funds. Now that many people have experienced doubled digit declines three years in a row, they *are* looking, and they don't like some of what they see—and especially some of what they *don't* see and can't find. Along with the malaise caused by Enron, Tyco, and Global Crossing, investors are feeling a crisis of confidence.

I believe that access to crucial information so that individual investors and financial intermediaries can make informed decisions is a strong component of free enterprise. Full disclosure ensures fair competition and creates a playing field that is level enough for all investors to take part in the capital markets. Efficient markets cannot exist in a vacuum, lacking key information. Unfortunately, much of that information is not available in our industry. To be sure, we (specifically, legislators, regulators, audit firms, and industry practitioners together) have made progress in recent years with the "plain English" prospectus, simple and standardized fee tables, better standards for performance evaluation, disclosure of the effect of taxes on returns, and *much* more detailed information available through the Internet. We have taken steps to hold financial fiduciaries more accountable. There are several initiatives "in the works" to make even more information available. Although we are moving in the right direction, I fear that we will spend resources in areas where we will not get the maximum benefit for individual shareholders. In this testimony, I will discuss thirteen areas for improved disclosure, including the difficulty of implementation and potential benefits.

Background

Since Bridgeway is not a household name, I would like to tell you about my background and about the firm I founded almost ten years ago.

I have undergraduate degrees from Swarthmore College in philosophy and in engineering, and graduate degrees from MIT in engineering and from Harvard in business administration. I have worked in academia, a short time in the federal government, in quasi-governmental operating agencies (urban mass transit), and for the last ten years in the mutual fund industry. Six of my years in the transportation industry were in budget and financial management, feasibility studies, and efficiency studies. I spent six years applying numerical methods to stock market investing as a hobby. Then at the end of 1991, I left the transportation industry to refine my quantitative models, to determine the feasibility of starting a mutual fund company, and to write a business plan for Bridgeway. Research is one of my passions. I love trying to make products and systems work better to support people's needs.

In 1992, what I found as an "outsider" researching the mutual fund industry was initially shocking, but on reflection not so surprising. At that time, the industry had already experienced enough years of steady growth to become overly complacent with respect to costs and shareholder interests. I had seen this

---

[1] "Is Your Fund Manager Worth $5 Million?" CBS MarketWatch, March 6, 2003, p. 1.

happen in the oil industry in my hometown of Houston in the 1970's. The tendency in a boom era, whether in private enterprise, academia, or even government, is to lose track of the importance of efficiency and the importance of taking care of clients, constituents, and stakeholders. That excess was "wrung out" of oil industry participants in the downturn of the mid 80's. When I moved back to Houston in 1985, I watched the aftermath of oil prices falling from $40 to $10 a barrel on the spot market. It was terribly painful. In 1992, I recognized the signs of excess in the fund industry, and I saw it as a market opportunity to "build a better mousetrap" by focusing on investment performance (through the discipline of a quantitative investment process), and by focusing on costs and an extreme attention to shareholder interests. What I did not realize in 1992 was that the industry would experience another seven years of growth before, like the oil industry, being put "through the wringer" of the most protracted bear market since before World War II.

Bridgeway Capital Management, Inc. was founded in July, 1993 as the adviser to the Bridgeway family of equity mutual funds. The firm has a unique participative and family-like culture. We ascribe to four business values: integrity, investment performance, cost efficiency, and friendly service. The entire staff takes part in Bridgeway's success through our employee stock ownership program and through ownership in the Bridgeway mutual funds. The highest compensated staff member can make no more than seven times the lowest compensated member. Bridgeway is a pioneer in minimizing conflicts of interest: we have no affiliated brokerage or service companies, engage in no soft dollar commissions, rely heavily on performance-based fees, and prohibit portfolio managers from investing in equity securities directly. Bridgeway uses its lean cost structure to close small company funds at low levels, to offer two funds that would not be economically viable at most firms, and to offer some products with lean expense structures. (Bridgeway Ultra-Large 35 Index Portfolio has the lowest expense ratio of any publicly available retail fund in America.) We believe these are among the characteristics that have helped distinguish the advisor and that influence the longer-term performance of our funds.

Disclosure

By uniform, standardized, and improved disclosure, we can spur competition in the mutual fund industry and significantly improve investors' returns over time. Here are thirteen areas for potentially improved disclosure:

1. Disclosure of proxy voting.

I am in favor of the legislative initiatives that would require mutual funds to disclose how they vote on company proxies. Shining the light on these actions will encourage fund companies to better exercise their responsibility as fiduciaries and as company owners. At the most basic level, I believe that shareholders have the right to know how we vote. The Internet provides a reasonably cost effective way to disseminate this information, and the industry will find ways to make the cost more efficient over time. On the other hand, proxy vote information is not something individual shareholders desire. Based on a non-statistically significant sample, the vast majority of Bridgeway's shareholders do not care about this information and would not use it if it were available. Thus, while the additional disclosure may help our capitalist system overall (which is why I support it), I believe that only a tiny faction of shareholders will use the information in choosing funds.

2. More frequent (quarterly) disclosure of fund holdings.

At "a gut level," I am in favor of more frequent disclosure. I believe that shareholders have a right to know. However, I do not believe that it is in shareholders' best financial interest overall, and for this reason I am against it. My reasoning is threefold. First, it will cost some money. One estimate of the cost is "only" roughly one basis point of cost. At Bridgeway, we work terribly hard to squeeze the next basis point of cost out of our funds; this requirement works in the opposite direction, increasing costs. Second, to the degree that shareholders do make use of the information, it may increase their selling and buying of funds, which will undoubtedly lead to lower investor returns. There is a growing body of evidence that increased trading of almost all kinds leads to lower returns in aggregate due to transaction costs. Third, the people in the best position to make use of the information are professional traders who would use it to front run some larger mutual funds. There is already significant attention paid to the buying and selling of

company shares at some of our larger fund companies. In spite of the fact that most investment firms complete trades of individual companies within the lag period discussed, there are still trends that are likely tradable and that are easier to discern with more frequent disclosure. In my opinion, this is not the kind of information that will lead to improved competition or higher returns.

3. Disclosure of commission costs.

Brokerage commission expense is disclosed by mutual funds, but the disclosure is not in a format that facilitates comparison of the efficiency among funds. "Commission cost per average net assets," is a simple mathematical calculation, which funds could report in the financial highlights table of a fund prospectus, semi-annual, and annual report at virtually no additional cost. In fact, Bridgeway tried to disclose this information in the financial highlights table of our first plain English prospectus, but the SEC required us to delete it because it was non-standard information. They have a good point; it is really only helpful if all funds report it. The best argument against this disclosure is that total trading cost (see section five below) is a much more important and relevant number. Indeed, it is theoretically possible to decrease commission cost to the detriment of total trading cost, so that disclosure of only one component (commissions) could be counterproductive. My own opinion is that the commission cost structure of our industry is so broken and riddled with conflict of interest that disclosure of even this one element would be an improvement.

4. Disclosure of soft dollar commissions.

Apart from affiliated brokerage and directed brokerage, the practice of soft dollar commissions is one of the worst examples of undisclosed conflicts of interest in the mutual fund industry. The term "soft dollar commissions" refers to an agreement between a broker and an investment adviser, by which the broker supplies a variety of products or services from research to software, hardware, data, or other services in return for a certain volume of business to the broker. The problem with this legal arrangement is that the adviser receives the immediate benefit, while the shareholder pays. There is inadequate incentive for the adviser to keep trading costs low. Some would argue that ultimately, the shareholder would pay these appropriate expenses anyway, that they are disclosed in the adviser's Form ADV to clients, and that they are adequately reviewed by fund boards of directors. I would argue that shareholders should only pay these expenses through the management fee. After all, via the management contract, the shareholder hires the adviser to manage the portfolio, which includes stock-picking tools. I also believe that the level of information typically disclosed in the Form ADV is far from adequate and that the conflict of interest is simply too great to handle by disclosure and review. A confirmation of this situation is the response of vendors when we tell them that Bridgeway will be paying with "hard dollars." I had one software salesman look at me incredulously and say, "Why on earth would you pay for this with your own money when you could pay for it with soft dollars?" In other words, why not use someone else's money to pay and just not worry about it? The answer is that it is not in our shareholders' best interest—Bridgeway's first criterion for evaluating the appropriateness of a course of action. The bottom line: Congress should *not* work to improve disclosure of soft dollars; it should simply stop the practice altogether. Ultimately, this will improve the quality of decisions made on things soft dollars buy, save shareholders some money, and greatly reduce the time that advisers, auditors, regulators, and lawyers spend trying to document the fairness of a firm's practice. As a fellow Texan said, "If you see a snake, just kill it—don't appoint a committee on snakes." This is one snake we just need to kill.

5. Disclosure of total trading cost, "the other operating expense ratio."

The simple math on the importance of trading costs is eye opening. Trading costs are the total cost of buying or selling a position in a security. The problems with trading costs are that they are so difficult to measure and that they are transparent to the individual shareholder. (Trading costs are capitalized in accordance with generally accepted accounting principles and included with the purchase price of securities held.) The first part, commission costs, is definitive and easy to measure, but it is the smallest part of the pie, or as Plexus Corporation likes to put it, "the tip of the iceberg." The second part is "impact cost," or the unfavorable market impact a buyer or seller has on the market price of a security. Thus, if I am buying 100,000 shares of a given company, my purchases themselves will push up the price of the stock, so that

the last shares I purchase are typically more expensive than the first ones. The third part is opportunity cost. As a trader, I can minimize the magnitude of the impact cost by stretching out my trading over a longer time period. However, if my purchase idea is a good one, I run the risk of someone else getting there first and driving up the price before I can establish even a partial position.

Appendix One illustrates the dynamics of the components of trading cost with a specific example. What does the larger picture look like for the whole industry? If we take an average trading cost of roughly 1% (probably conservative) for a fund investing in larger companies, but a turnover of 100% (turnover of 100% means the fund buys and sells the equivalent of the entire fund in one year's time), the total trading cost would be 1% for purchases plus 1% for sells or 2% of the value of the funds in a year. This is significantly more than the entire operating expense ratio of such funds. For small company funds, the trading costs are roughly twice this high. Thus, to "beat the market," the portfolio manager of an actively managed large company fund must add back value equal to the operating expense ratio (say 1.4% on average) plus 2% in trading cost. This is a *huge* performance hurdle to overcome and highlights the need for *some* way to provide shareholders with information on its magnitude. While the numbers are difficult to measure, I believe that the state of the art on trading cost measurement has reached the point where the mutual fund industry should commit to disclosing some basic information to shareholders. I defer to Wayne Wagner of Plexus on this point, since it is the core of his company's business. In Bridgeway's case, the adviser pays "hard dollars" to Plexus twice annually for such an independent review. We make their report available to our Fund board of directors, but not to the investing public, for competitive reasons. However, if all funds disclosed such data, we would be willing and happy to do so.

6. Better access to mutual fund prospectus and statement of additional information disclosure

While we have made tremendous strides in the usefulness of prospectuses over the last few years, we have yet to make it easy to locate these documents. Based on my search of seven fund companies that have products I respect, only four had prospectuses available within three "clicks" of their home page. At two sites, I was unable to find prospectuses online after 10 clicks. Only two sites had statements of additional information available online. Visiting the SEC.gov website, you may get lucky: searching for a specific Bridgeway fund will get you to the right Edgar filings, since we have only one prospectus for all our funds. Type in the specific name of a fund at a large fund company, however, and you may be searching a long time for the corresponding legal name of the fund. Why not just cross reference all funds by specific name and ticker symbol? Once you do find the correct filing, it is listed as "post-effective amendment (Rule 485(b))." How many individual investors understand this to be the prospectus or the document they need to read before investing?

7. Standardized industry expense, performance, and operating information

When I worked in the urban mass transportation industry, there was uniform data on system expenses, passengers, and other very helpful operating data with enough detail to establish some best industry practices. Twenty years later, there is no similar, easily accessible database for the mutual fund industry. When we want such information, we have to rely on increasingly expensive data from one of the rating agencies or gather the information manually from prospectuses, annual reports, and other Edgar filings. Some information is in the Edgar system, but it is not downloadable, expense categories are not standardized, and it is *terribly* time intensive to access information across fund families. The federal government is in the strongest position to take the lead on this. I envision information like that submitted by fund companies on Form NSAR, but with standardized, detailed expense and revenue items and Internet access in a database format. Standard reports and comparisons could also be made available on the SEC web site.

8. Disclosure of fund marketplace costs

A problem that has been on the horizon and is now getting bigger is the increasing cross subsidization resulting from mutual fund marketplaces, the "one stop shopping" brokerage houses that offer funds from many fund families. True, these marketplaces have been a boon to the industry. In fact, at some fund families, a majority of shareholders have their accounts at these marketplaces. The problem is that some of

the largest marketplaces are raising fees charged to funds ("invisible" to shareholders) up to a 0.40% per year, while others charge nothing for essentially the same services. Mutual funds cannot pass the specific fee to shareholders for their chosen market place. We must penalize the shareholders that use the lower-cost alternatives by spreading the costs across all accounts. For the marketplaces, there is little incentive on their part to keep these costs low, if they believe they will be passed on and spread across a larger base of shareholders at all other marketplaces, and if their own customers do not see the fee increase. Thus, costs associated with shareholders of an expensive marketplace are paid equally by all shareholders, and this is neither transparent nor disclosed to shareholders at all. Therefore, shareholders cannot consider true services and costs in making decisions.

One solution is for the fund managements to "just say no." However, the ubiquitous marketplaces wield much power in the negotiation with funds, and "just saying no" is not likely to happen on a large scale. The fund marketplaces are likely to be able to extract increasing fees (or from the marketplace viewpoint, charge fair fees for a high level of service and distribution). My proposal is twofold. First, we require the marketplaces to disclose to shareholders the average fees they are charging mutual fund companies to participate in their marketplaces. Second, we require funds to disclose in the prospectus the fee rate paid to any fund marketplaces that represent more than 2% of outstanding shares for a given fund. Then at least these fees would be transparent and shareholders could also set their own limits or "vote with their feet."

9. Disclosure of manager salaries

When we invest in individual companies, we have the right to know the compensation of the company leaders. When we invest in mutual funds, we are in the dark. At Bridgeway we believe that investors should know the actual compensation and structure of that compensation as it relates to the fund's management. To the best of my knowledge, Bridgeway is the only mutual fund company that voluntarily discloses portfolio manager pay in its statement of additional information. The argument against this disclosure is that net profit for shareholders of a publicly held corporation is net of executive compensation, which can be a significant portion of total expenses. In the case of mutual funds, manager compensation can rise and fall, but it does not affect the management fee actually paid by the fund. While this is true, I still think compensation structure and level may strongly affect portfolio manager incentives and the decisions he or she makes on behalf of a fund. Our industry's refusal to disclose it contributes to the aura of "withholding important information" and "misleading shareholders" that some shareholders perceive in the current environment. This is the time for the industry to step up to the plate and disclose pay for portfolio managers and corporate senior managers.

10. Disclosure of adviser policy on portfolio manager investing in securities in which the fund may invest

A portfolio manager's investment in securities that his or her fund could also own is one of the clearest conflicts of interest. The SEC has cracked down on the worst cases of abuse involving "front running," a manager buying a stock and then investing his or her fund in it, to run up the price and benefit personally. I suppose this abuse just does not exist any more. However, many advisers allow their managers to own stocks directly within certain guidelines of timing buys and sells. Imagine the portfolio manager of a small company fund who finds a stock with limited liquidity. He could buy the stock for the fund or skip the fund and purchase it directly. Most advisers' codes of ethics would not preclude this. But as a shareholder, I want to know that the best ideas of the portfolio manager are going into my fund. The best way to avoid this conflict is to preclude managers from owning securities directly that their fund could also own – or disclose the policy.

11. Disclosure of portfolio manager holdings of the fund(s) he or she manages

Funds are currently required to disclose fund ownership by officers and directors, but not individual portfolio managers. As a shareholder, I would really like to know, "Is the portfolio manager eating his own cooking?" This disclosure would be easy to do.

12. Board disclosure

Over the years, I have examined the record of some of the consistently worst-performing funds and wondered, "Where *are* their boards of directors?" Unlike the boards of privately held firms, non-profit organizations, or even publicly traded companies with multiple constituencies, a mutual fund's board really exists *only* to protect the interest of its shareholders. Nevertheless, five mutual funds declined by more than 20% per year over the last five years; three of these had dismal returns for the four or five years before this. The average expense ratio of these five funds is 11.5%, more than the entire average annual return of the stock market. How can these funds hope to make *any* return for shareholders? Why doesn't someone put them out of their misery?

Each year the independent members of a fund's board must approve a management contract or continuation of a management contract with an adviser. They are required to consider such aspects as performance returns versus peers, returns versus market, cumulative returns, operating expenses and usage of such expenses. Most fund boards will document this evaluation in the minutes of their meeting. Why not disclose the basis for every fund board's decision to renew the management contract in the statement of additional information? As a shareholder of another fund family's bond fund (Bridgeway offers no bond funds), I would like to know what the board thinks and how it arrived at its decision. In addition, we should look for ways to make the boards take more responsibility for relative performance. Some of my preliminary thoughts include: Why not make the board put the management contract up for bid if the current advisor shows repeated underperformance? For example, if the advisor is in the bottom quartile for five of six years, or if the advisor is in the bottom quartile for three of four years and has a net expense ratio in the bottom 10%, mandate that the contract is opened to competitive bids. This type of requirement combined with the disclosure I just mentioned would do much to make the board more accountable to the shareholders.

13. 12b-1 Disclosure

Section 12b-1 of the Investment Company Act of 1940 was written to provide a way for fund shareholders to foot the bill for advertising, marketing, and distribution costs. The theory was to curtail abuses and to help grow fund assets so that costs would be spread over a larger base. Some forms of abuse have undoubtedly been curtailed under the plan, but I believe it has been largely ineffective in the latter goal. If advisers benefit from some increased assets, but shareholders foot the bill, there is an incentive to overspend on distribution costs. At any rate, fund boards of directors review these costs in detail quarterly, and presumably talk about their effectiveness in raising assets or improving quality of service. This kind of information should also be made available to shareholders. Shining more light on the evaluation process should hold boards and management companies to a high standard.

Addendum—Chasing past performance

I have one final issue that concerns education rather than disclosure.

One of the saddest things about the investment community is that practically the whole system feeds a buy high, sell low mentality. Investors focus on historical three year, (more often) one year, or even shorter timeframes. Journalists write most frequently about managers who have performed the best over these same time periods. Many brokers push the same recent "winners." Investment management firms pour their advertising budgets and sales pitches into the products that have performed the best recently. Rating agencies rate funds statistically, only to fall into the same trap when it is time to recommend specific funds. Each party can claim that it is not their fault. For example, investors can blame the management firms or brokers that pushed a product or a specific article touting a product, or a barrage of sales literature. Journalists ultimately have to write about what sells. (Long-term performance doesn't change much daily or even monthly and issues such as disclosure get pretty boring after a couple of articles.) Management firms aren't going to spend advertising dollars on recently poorer performing funds that no one would buy.

Let me illustrate this point with a couple of thought-provoking studies on the damage of "chasing the hot fund" that have been completed over the last 10 years. Morningstar studied 199 no-load growth mutual

funds over the period 1989-1994. Their findings showed that while the average annual return for these funds over this period was 12.0%, the average mutual fund investor received a return of just 2.0%. How can this be? Over this same time period the average mutual fund investor only held a particular fund for 21 months as they jumped in and out, or across funds. This market timing cost them 10% return. Another popular study done by Dalbar on investors in equity mutual funds from 1984-1996 found that investors on average earned 10% less than the funds over the same period. Their conclusions were the same. As people tried to hop to the hottest fund they basically destroyed value. These are only two of the many studies that have shown that chasing the rear-view mirror performance is not a good strategy.

An analysis that I did with Bridgeway portfolios tells the same story. Simply invest each year in the Bridgeway portfolio that has done the poorest over the previous three-year period. The results are pretty interesting. If you followed this strategy starting five years ago (the first year we had a three-year record), $10,000 would have turned in to $21,521. If you followed the opposite strategy, investing in our fund with the *best* trailing three-year record, $10,000 would have turned into $10,732. Now, this is an interesting exercise that demonstrates the perils of chasing recent hot performance. It is not statistically significant—five years is not enough data upon which to base an investment strategy—and I still recommend choosing funds in accordance with your investment needs.

Nevertheless, it is our human nature to invest after recent strong performance (buy high), then sell when things pull back (sell low). How can investors avoid it? By keeping a long-term perspective, setting an asset allocation or financial plan commensurate with risk tolerance and investing time horizons, and then sticking with it. This will take a tremendous education effort on the part of fund companies, the media, and government if we have any hope of improving the situation.

Conclusion

If mutual funds are going to address increasing public distrust in the environment of a bear market, if we are going to continue to play a major role in giving access to the wealth of this nation through security ownership, we are going to have to earn it. We need to pursue the interests of individual shareholders relentlessly, and we need to ensure that adequate information is available for shareholders and their advisors to make informed decisions.

Finally, I want to thank the Committee for the opportunity to testify this morning. I would be happy to entertain any questions you may have.

Appendix One

Illustration of the Components of Trading Cost

This appendix illustrates the components of trading cost with a specific example, the purchase of 100,000 shares of XYZ Company. After identifying the purchase, one of Bridgeway's trading staff tells me the bid (the price at which a broker or market maker is willing to buy some shares of stock from me) is $29.95 and the ask (the price at which a broker or market maker is willing to sell some shares of stock to me) is $30.05. For the sake of argument, let's say the real "worth" of the stock is half way between, or $30.00. The trader also says that the "size" on the ask is 2,000 shares, which means that the total number of shares advertised at $30.05 is only 2,000 shares. So, if I act fast enough, I know I could buy 2,000 shares for $30.05. The total trading cost for these 2,000 shares would be $0.05 per share for commission (roughly the average industry commission; Bridgeway's actual commission cost is lower) plus $0.05 per share for the difference between the ask and the stock's true worth. My total trading cost would be $0.10 divided by $30 or 0.33% of the trade. I would be very happy with this, except that I have 98,000 more shares to buy and there may be no more shares available to buy at $30.05. Since the broker knows I usually buy a lot more than 2,000 shares, he or she may raise the ask much more than a couple of pennies. So I have two major alternative trading strategies. I can disclose the full size of the trade to the broker and let him or her bid on it. This is where significant negotiation goes on. We may agree on a price for all 100,000 shares of $30.25; then I know my trade is completed and I won't miss out because of an overall increasing market or because another large buyer enters the market and drives up the price of XYZ company. The total trading cost of the trade would then be $0.05 commission plus $0.25 (the difference between the actual price and what XYZ is worth) divided by $30 or 1% of the value of the trade. Depending on the liquidity of the stock (how many buyers and sellers there are at what level of volume), this might be a very attractive price. On the other hand, I could hope that I could establish this position over the next few days for an average price closer to $30.00. I might buy 2,000 shares now, advertise (offer to sell) 5,000 more at only $29.98 and take a "wait and see" stance. If the market declined at some point over the next few days, I would have likely bought the additional 5,000 shares and now I might get more aggressive, buying more shares at a lower price. Let's say that the maximum price I'm willing to pay for XYZ Company is $31.00. Let's further assume over the next three days I have accumulated 60,000 shares of stock with an average price of $29.98. I'm very happy, except that now the DOW average rises 200 points, the new bid and ask of XYZ Company is over my limit of $31.00/share and the stock never comes back in to my buying range. Let's say a month from now the average between the bid and ask is $32.00/share. I own 60,000 shares at a cost of only $30.03 (purchase price plus commission), for a nice one month unrealized gain of 6.6%. However, the opportunity cost of not executing the full 100,000 share order is $32.00 minus $30.00 times the other 40,000 shares equals a whopping 6.3% on these shares. Then the total trading cost on my full 100,000 share order would be $0.05 commission minus $0.02 I saved for my patience getting a better price times 60,000 shares plus 40,000 shares times $2.00 (my opportunity cost) divided by 100,000 shares. Doing the math we get a total trading cost of $81,800 or 2.73% of the value of the trade. If we stop the analysis at just one month, I would have come out ahead in the first trading strategy, getting the trade done more quickly.

Testimony of
Wayne H. Wagner
Chairman, Plexus Group
Senior Vice President, JPMorgan Chase & Co.
(wwagner@plexusgroup.com)

House Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 12, 2003

Thank you for the opportunity to present my thoughts to the committee.

Today I will present some ideas relating to transaction costs. They will have a bearing on such questions as whether transaction costs are significant to investors, whether investors could make better choices if they knew more about them, and whether markets could be better organized to minimize the effect of transaction costs on institutional performance.

Let me explain how I have come to the evidence I am about to present. I first became concerned about transaction costs in the early 70's while devising operating procedures for running index funds. As Mr. Bogle can attest, index funds have no ability to recover costs through research, and understanding how to minimize them is crucial to the success of indexing. In 1990, my firm, Plexus Group, began to focus exclusively on consulting with money managers, plan sponsors, brokers and exchanges to help them understand and control the costs, leading hopefully to better performance. Today we analyze trading decisions that cover approximately 25% of exchange volume worldwide. Under our new affiliation with JPMorgan we are expanding the study of transaction costs into a broader charter of Equity Research, Trading and Settlement, or the full Supply Chain that brokers provide to money managers.

Let's begin at the bottom line: transaction costs hurt performance. They immediately reduce the assets of the investor. They impede the ability of investors to capture the fruits of research. They reduce liquidity by making fewer ideas actionable. Finally, they interfere with the informed pricing of financial assets and the ability of firms to efficiently raise capital for investment. Congress and the Securities and Exchange Commission have repeatedly recognized the deleterious effects of costs and acted many times to create movement toward lower costs.

It is impossible to argue that uninformed investors are better investors. As long as the information is not misinformation, more information is preferred over less. To be usable, cost information must (1) be put forth in a form that can be understood by the recipient; (2) accurately measure the magnitude of the cost,

and (3) respect proprietary information that might harm the interests of the investors.

I will explain all three of these criteria.

Institutional Transaction Costs

The work of Plexus Group shows the significance of transaction costs. We measure average costs exceeding 1.5%, or 45¢ for the average $30 share that institutions are buying and selling. A round-trip costs double that, or 3%, certainly large enough to adversely affect returns in a world where 100% annual turnover is common. I personally believe that total transaction cost is the largest cost borne by investors over time, in most cases being a larger drag on performance than management and administrative fees. Yet these figures are never disclosed, and often are dismissed by a manager as merely "part of the process."

This number may seem extraordinarily large to you in a world where 5¢ commissions are common and where retail trades can be executed for under ten dollars apiece. The truth is that institutional trading is very different from retail trading. Yet we should never forget that the "end investor" is in fact the public, through their retirement plans and mutual funds.

To a retail investor, the market may seem like a vending machine: put in your coins, push the button and out pops your selection. Institutional trading is much more difficult because a large portion of the dollar trading is done in remarkably few and extraordinarily large trades. Imagine buying 400,000 cans from a vending machine!

The best way to illustrate this is via a study of the nature of institutional trading recently completed at Plexus Group. In this study we divided our entire trade universe into five groups, with each group representing the same number of dollars traded. The first group represented the smallest orders; the fifth group the largest orders. For simplicity, the three middle groups are not presented. The table below summarizes the results of that study.

Group	Percent Of Dollars Traded	Number of Orders	Percent Of Orders	Median Order Size In Shares	Average Dollars Traded / Order	Median Percent Of Day's Volume	Median Trading Cost
Smallest Trades	20%	801,538	92.5%	2,000	$53 thou	0.4%	0.28%
Largest Trades	20%	2,512	0.27%	2,000,000	$77 mil	52.6%	1.07%

Remember that each group represents the same number of trading dollars, and is thus of equal interest to investors. The small-trade group is not all that

different from retail trading. But most institutional activity occurs in non-retail sized block trades. Because of the potential impact of these trades, institutional traders carefully orchestrate the execution of these orders.

These large trades represent major portfolio commitments that cannot be traded vending-machine style. They must be metered into the market slowly enough to allow the market to absorb the shock and recover. In the process, costs are generated in the form of commissions, impact, delay-induced search costs, and missed opportunities. We represent this cost structure as an iceberg, shown in the exhibit.

These costs are measured by a technique known as implementation shortfall, which compares the return on the trade on a costless and a fully-costed basis. Academicians widely agree that this is the most comprehensive trade cost measure. Several commercial services can produce these numbers. The mathematics are simple enough; managers can compute them easily. While all cost measures are volatile on individual trades, when aggregated together over total trading activity they provide insights on a big-picture level.

A trade is not an event, it is a process; a series of linked activities involving a portfolio manager selecting securities, his or her trader placing instructions with brokers, and the brokers executing the trades using exchange facilities. While there are other popular measurement techniques, they do not show the complete process. They only measure some of the components and can be misleading. Take for example a 'transaction cost" measure consisting only of commissions paid. Plexus measures total costs at roughly ten times the commission cost! Thus reducing commissions while ignoring the bulk of the cost will not truly benefit investors.

Worse, it may actually harm investors. Commissions buy research, execution, clearing, and other services valuable to managers. A higher commission may buy higher quality execution services better suited to these complex and bulky trades. Thus disclosure of partial costs may mislead investors and create pressures for the manager to reduce commissions, even though that may be ineffective, or even perverse, to truly reducing costs to investors.

Is information on transaction costs valuable to investors?

We believe that cost information, properly conveyed, can help investors assess the skills and business practices of their managers. Simpler measures are a partial solution, but carry a risk of misleading the investors. As Albert Einstein famously said, "We should keep things as simple as possible – but no simpler."

Consider how an individual could use these numbers. We presume such information would become part of the standard fund description services like Morningstar, Lipper, and Value Line. Perhaps it could be communicated better if coded into categories of Very High, High, Average, Low and Very Low Cost. High

turnover levels combined with high turnover costs would forewarn investors that a manager's performance is dependent on very high quality of stock picking to pay the very high transaction cost.

From my knowledge, these recommended disclosures are wholly consistent with the recommendations of the AIMR Trade Management Guidelines, statements put forth by the SEC, and the Myners Report and the Pension Fund Disclosure Code put forth by the Investment Management Association/National Association of Pension Funds in the U.K.

Here's the good news: these costs can be managed, and potentially reduced by a significant amount. How much? A recent study by Plexus Group shows that our clients were able to reduce their transaction costs on average by 40% with two years of concentrated effort. How much is that worth?

Let's work through some possibilities. Start with a $10 billion fund with 100% turnover per year. Neither of these assumptions are outlandish. Assuming a 1.5% cost, double it for buys and sells, and transaction costs amount to $300 million per year. If it's possible to save 40% of that, savings of $120 million would be available *per year*. This total is larger than that consumed by a 1% investment management fee, and it is enormous compared to the cost of monitoring and reporting them. Extrapolating the example above to the $2 trillion in equity mutual funds leads to a potential savings of $24 billion per year, triple the income of Wal-Mart, the largest US company.

As a lawmaker, I would be interested in the cost to investors and the cost to the economy. Many of the best mutual fund companies have pursued trade cost-reduction programs to the benefit of the investors. While disclosure does not in itself save money, it creates an incentive for each mutual fund to focus on the potential for cost savings.

Shareholders, perhaps saving for retirement, will be the big winners.

Should managers divulge their trading?

Another question recently discussed in the press is whether managers should be required to disclose their trading activity in the same manner in which they disclose fund holdings. When thinking about this idea, it is important to remember that the large institutional orders cannot be completed in a day. It has been said that "unfilled trading interest is the most valuable commodity on Wall Street." Thus it would not be beneficial to the clients of money managers to have this information disclosed before the trade is complete.

I would recommend, should you choose to require that this information be divulged, that it be published no more frequently than quarterly, and delayed sufficiently after the quarter to preserve the confidentiality of quarter-end trades.

I believe that an important part of this disclosure would be to disclose their quarterly total commission expenditures, to whom the commissions are paid, and the services they acquired. This was one of the key recommendations of the AIMR Trade Management Guidelines taskforce.

Best Execution

To quote Einstein again, "The important thing is to keep the important thing the important thing." The important thing about institutional securities transactions is Best Execution. The AIMR Trade Management Guidelines[1] have defined Best Execution simply and very well:

> . . . the trading process Firms apply that seeks to maximize the value of a client's portfolio within the client's stated objectives and constraints.

The guidelines draw a parallel to the concept of prudence as it applies to investment management:

> "Prudence addresses the appropriateness of holding certain securities, while Best Execution addresses the appropriateness of the methods by which securities are acquired or disposed. Securities selection seeks to add value by evaluating future prospects; Best Execution seeks to add value by reducing frictional trading costs. These two activities go hand in hand in achieving better investment performance and in meeting standards of prudent fiduciary behavior.

The guidelines recognize that Best Execution:

- is intrinsically tied to portfolio-decision value and cannot be valued independently,
- is a prospective, statistical and qualitative concept that cannot be known with certainty *ex ante*,
- has aspects that may be measured and analyzed over time on an *ex-post* basis, even though such measurement on a trade-by-trade basis may not be meaningful in isolation; and
- is interwoven into complicated, repetitive, and continuing practices and relationships.

The investment management industry has put forth these principles to guide the parctice of institutional trading. In my opinion, they can serve as the underpinnings for the Committee as it considers related issues.

---

[1] AIMR Trade Management Guidelines, © 2002, Association for Investment Management and Research

Are our markets delivering the services large investors need?

The average trade on both NASDAQ and the New York Stock Exchange is around 1700 shares. Plexus data shows the average institutional order is 44,660 shares. For institutional trades to squeeze through the market, they must be ground down to a size that can be accommodated in the market. In the process, the time to complete the order necessarily lengthens. This creates opportunities for market insiders and middlemen to make money through unnecessary interpositioning and parasitical front-running. The resulting delay and impact costs reduce investment performance.

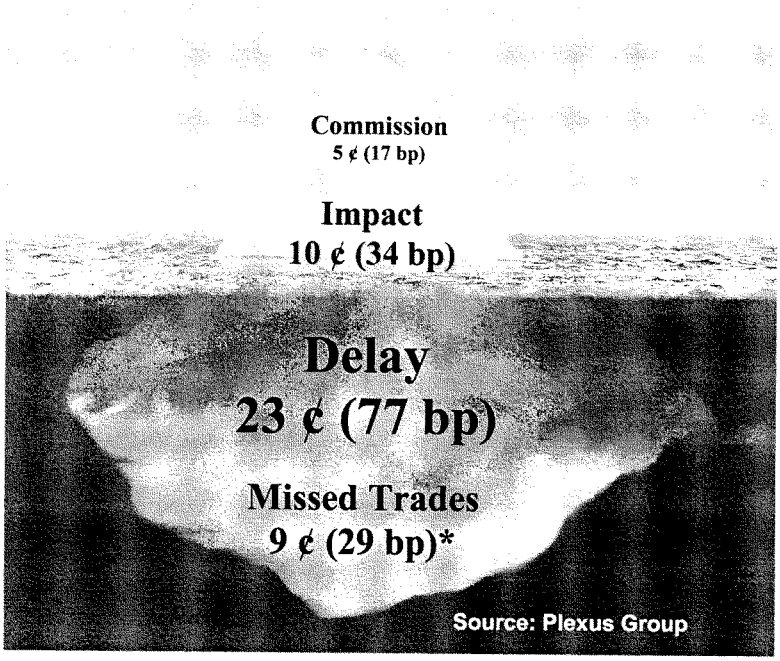
This is not a new problem, and many new market solutions have led to great benefits to investors. This level of innovation needs to continue to be encouraged. The best market for small investor trades may not serve very well those same small investors who invest via mutual funds and other commingled investments. Facilities where large buyers can meet large sellers without leakage will benefit all investors.

The best professional managers do what they can to operate within market constraints. However, without disclosure requirements, the end investor cannot assess whether his or her manager operates an effective measurement and management process.

Recommendations

- Managers should disclose quarterly their trading costs. Anything less is potentially misinformation.
- Managers should disclose quarterly their total commission expenditures, to whom they are paid, the services they acquired, and any potential conflicts of interest.
- Managers should disclose their trading activity on a delayed quarterly basis.
- Best Execution, as defined by the AIMR, is the guiding principle when considering rules and regulations that influence securities transactions.
- Congress and the SEC should continue to press for market innovation, especially innovations that facilitate large buyers meeting large sellers without revealing valuable information on pending trades.

EXHIBIT
The Iceberg of Transaction Costs



Visible to the market:

Commission:	Paid to broker for executing and clearing trade
Impact:	Effect of trading pressure on market price

Hidden costs: (Not visible to the market)

Delay:	Search costs: Waiting for price or liquidity
Missed trades:	Opportunity cost of failure to trade

All costs hurt performance.

Group	Percent Of Dollars Traded	Number of Orders	Percent Of Orders	Median Order Size In Shares	Average Dollars Traded / Order	Median Percent Of Day's Volume	Median Trading Cost
Smallest Trades	20%	801,538	92.5%	2,000	$53 thou	0.4%	0.28%
Largest Trades	20%	2,512	0.27%	2,000,000	$77 mil	52.6%	1.07%

Source: Plexus Group, 2003

Statement for the Record

on

"Mutual Fund Industry Practices And Their Effect On Investors"

before the

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 12, 2003

Introduction

Fidelity Investments commends Chairmen Oxley and Baker, Ranking Members Frank and Kanjorski and other distinguished Members of the Subcommittee for their review of mutual fund industry practices. We are pleased to have this opportunity to address the issue of fees and disclosures in the mutual fund industry. Given that nearly half of the nation's households (54.2 million) own shares of mutual funds, this is an issue that deserves to be addressed openly, fully and fairly.

Fidelity Investments is one of the largest providers of financial services in the United States, with managed assets of $759.6 billion at the end of January 2003. Fidelity provides investment management, retirement planning and brokerage services to 18 million Americans, directly or through financial intermediaries. Fidelity Investments is the largest mutual fund company in the United States, managing the investments of 286 U.S. mutual funds, and is the No. 1 provider of workplace retirement savings plans in the country. Fidelity employs more than 28,000 people in various locations throughout the United States.

The U.S. Mutual Fund Industry is Highly Competitive

Over the past generation, America's mutual fund industry has played a leading role in enabling the majority of American households to become investors in our securities markets through stock, bond and money market funds. During the decade of the 1990s, helped by popular investor education and a strong bull market for U.S. stocks, total customer assets managed by our nation's mutual fund industry grew from $1 trillion to almost $7 trillion. Similarly, the number of Americans who own shares of mutual funds rose from approximately 40 million in 1990 to nearly 95 million today.

Along the way, the American mutual fund industry democratized securities investing in this country, bringing to working families across America professional money management skills, broad diversification and a range of services once enjoyed only by wealthy investors. The industry also has become fiercely competitive, with more than 600 firms offering over 8,000 different mutual funds (or classes of funds) that compete for customer assets based on the strength of their investment performance, shareholder services and cost.

No single company or group of companies dominates the U.S. mutual fund market and the costs of entry into the market are low. One important result of industry competition and growth, as borne out in studies undertaken by the General Accounting Office and Securities and Exchange Commission completed in 2000, is that average mutual fund fees have been declining for many years, and that economies of scale realized over the years through asset growth have played an important part in reducing fund expenses for the industry.

As the Investment Company Institute has reported, when expenses paid by mutual fund investors and by funds themselves are together taken into account, since 1980, the average cost of equity mutual funds has decreased 43%, bond fund costs have decreased 41% and money market fund costs have decreased 34%.[1] This has occurred alongside the introduction of a host of new services and conveniences for investors, as well as dramatic growth of new types of investment products and choices for investors, such as international and asset allocation funds that are generally more costly to manage.

At Fidelity, we offer customers a basic value proposition: above-average investment performance and service, and below-average fees. Fidelity's mutual fund fees are consistently below industry medians. Morningstar, Inc., a leading mutual fund research firm, has referred to Fidelity as one of three "low-cost shops" that "deserve credit for keeping their expenses down,"[2] a point the SEC also noted in its December 2000 report on mutual fund fees and expenses. Along with being low-cost, Fidelity offers high performance. For example, for the year ended December 31, 2002, Fidelity funds beat 70% of their Lipper Inc. peers, on an asset-weighted basis, compared with 66% for the previous year, while for the three-year period ended December 31, 2002, Fidelity's funds beat 64% of their peers, besting the 61% three-year performance figure as of the end of 2001. Similar performance, putting Fidelity funds in the top two quartiles of performance against peers, was recorded for each of the past 10 years.[3]

Generally, the fee for managing funds is reduced as fund assets increase. At Fidelity, many of our investors also benefit from our "group fee" structure. Under this plan, as overall managed assets at Fidelity in a group increase, the group fee rate declines. This way, Fidelity funds pass along the benefits of economies of scale to our shareholders. Of course, if fund assets decline, our management fees will rise, measured as a percentage of assets.

Fidelity also is proud to be among the minority of U.S. mutual fund companies that adjust the level of management fees for many equity funds, up or down, determined by the extent to which a fund's investment performance over a rolling 36-month period exceeds or lags behind the performance of a benchmark group of securities over the same period. This performance adjustment ties management fees to fund performance so that when a fund beats its benchmark, we receive higher fees, and when the fund trails its benchmark, our fees are lower. Either way, our investors benefit.

However, not even low fees, group rates and performance adjustments can offer protection against prolonged downturns that are part of the natural cycle in the stock markets -- such as those we have seen for the past three years in a row. Many investors have been disappointed at investment returns during this period. Mutual fund fees are based upon the costs of building and maintaining an investment research organization, the range and quality of services offered to

investors, and the expense of transactions necessary to carry out the functions of the fund. Fees cannot be blamed for lower returns in a down market any more than they can be cited when there are higher returns in an up market.

During this bear market, the core value proposition of mutual funds -- diversification of investments and professional money management at a reasonable cost -- has been validated. Roughly half of the $8 trillion in lost equity market capitalization from February 2000 to September 2002 was concentrated in just 25 stocks[4] -- a very powerful argument for the diversification that is intrinsic to mutual funds.

In fact, while most U.S. stock funds have suffered losses during the bear market since the year 2000, mutual fund investors' losses have, overall, been lower than losses among holders of individual securities. This is particularly true for holdings that were concentrated in some of the hottest stocks of the recent market bubble. The ICI reported the results of a Morningstar study[5] that contrasted the percentage of individual stocks that lost more than 66% of their value in the year 2001, to the number of equity mutual funds that suffered the same losses. Results showed that while no less than 20% of *individual* U.S. stocks -- one in five -- experienced that sort of loss, among U.S. *equity mutual funds*, just 1% had losses that deep.

This would suggest that the benefit of investment diversification is a more important determinant of fund investors' results than the level of fees. Of course, it also is important to test the fairness of fees being charged to mutual fund shareholders. However, the core question for mutual fund investors is broader: *Are mutual fund investors receiving fair value in return for the fees they pay?*

In the intensely competitive world of mutual funds, "value" is measured two ways: the investment performance of the mutual fund, and the value added by the administrative, recordkeeping and other services an investment company provides to its customers. For some funds, these services are provided only by the fund company. For most funds, however, these services are paid for by the fund, but provided through a broker, advisor or other financial professional selected by the investor.

The investment return of a mutual fund is an objective, empirical fact that fund companies are required to make public every business day. Investors can follow the performance of their funds on a daily basis by checking the Net Asset Values (NAVs) of mutual funds published in their newspapers or online. The key word here is "net," because the reported returns must, by law, be calculated *after* deducting all fees and expenses, including trading costs. What investors see, then, is what they get.

This daily focus on investment performance, net of fees and expenses, compels mutual fund companies to align their investors' economic interests with their

own. The logic is simple, and very powerful: *Fund companies that deliver competitive performance tend to attract more investment – and, by this increase in asset size, earn greater fees over time. Fund companies that don't perform well tend to lose assets – and the fees that go with them.* It is hard to imagine any incentive structure that could more closely align the interests of mutual funds and their investors.

Mutual Funds Offer an Array of Beneficial Services

Competition in America's mutual funds industry isn't limited to performance. Investors today are demanding a wide array of choices on how to invest. As a result, mutual fund companies compete to provide a range of products, technology innovation and services. At Fidelity, serving our customers means striving not only to deliver the best investment performance for our funds, but also to provide our customers with an ever-expanding range of services. While services vary from company to company, this trend can be seen in the industry as a whole, leading to increased choice and sophistication of products, greater ease of access, and more comprehensive information and analytical tools available to consumers.

Specific products and services include, but are not limited to, support services that allow customers to process their transactions more efficiently; ready access to high-quality information and highly trained professionals in person, via the telephone or online via a Web site; investment and retirement planning tools and tax information; simplified account statements; ability to rapidly execute fund transactions; and -- perhaps most importantly -- the peace of mind that comes from knowing that investments are managed by a secure institution, regulated by the SEC, and overseen by independent auditors and boards of directors or trustees elected directly by the mutual fund shareholders.

The U.S. Mutual Fund Industry is a Model for Disclosure and Transparency

The U.S. mutual fund industry is one of the most highly regulated, scrutinized and transparent industries in the world. In fact, many of the reforms in the recent Sarbanes-Oxley Bill were modeled after laws that have governed mutual funds since the Investment Company Act of 1940.

By law, funds must publish their results, price their shares daily, offer accurate and empirical comparisons with their relative index benchmarks, and disclose all fees. This information, plus other details on funds, including their performance, their fees, their independent oversight and their investment policies is readily available to customers. For example, the advertisements of mutual funds publicly sold to individuals are highly regulated and show performance comparisons over a number of years. Such comparisons, based on uniform methodologies, allow mutual fund customers to easily compare the price and performance of competing funds. In addition, customers have ready access to more detailed fee, expense and performance information set forth in

mutual fund prospectuses and shareholder reports (each carefully regulated by the SEC); through third-party analytical and ratings services (such as Lipper and Morningstar); and through Internet Web sites, daily newspapers and dozens of periodicals that focus on mutual funds and investing.

Mutual Fund Boards of Directors Protect the Interests of Investors

The Investment Company Act of 1940 requires that U.S. mutual funds be governed by a board of directors. This board is elected by the fund's shareholders and acts in a fiduciary capacity to protect their interests. The majority of this board must be "disinterested," that is, not affiliated with the fund's adviser. The board and the disinterested directors are required to review fund management and distribution/service (12b-1) fees annually, and to consider carefully a range of factors before renewing the adviser's management contract. It is also important to bear in mind that *no increase* in investment management fees can occur without approval by a vote of the fund's shareholders themselves. This shareholder approval requirement, and the right of any shareholder to redeem shares on any business day throughout the year, together impose a cost discipline on the mutual fund industry unlike that governing any other financial services industry in this country.

Conclusion: Mutual Fund Fees are Highly Competitive and Well-Disclosed

Investors in America can chose to invest in more than 8,000 mutual funds offered by over 600 companies. Each fund provides comprehensive public information on its investment performance and its fees and expenses. Each company also provides consumers with information on the various types of related services it offers. Investors, then, are fully informed and free to make their own decisions about whether a fund offers the right combination of investment performance and service that justifies the fee being charged -- or not. As in any competitive, free-trading market, the ultimate power rests -- as it should -- with the judgment and wallets of mutual fund shareholders.

# # #

---

[1] Investment Company Institute Research in Brief, September 2002
[2] Morningstar, Inc.
[3] Lipper Inc. cited FMR Corp. 2002 Annual Report
[4] Fidelity Investments Fund Analysis and Research Group, 10/16/02
[5] Morningstar, Inc., data cited February 15, 2000, *The Wall Street Journal*

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EST
Wednesday,
March 12, 2003

MUTUAL FUNDS

Information on Trends in Fees and Their Related Disclosure

Statement for the Record by
Richard J. Hillman
Director, Financial Markets and
Community Investment

GAO-03-551T

March 2003

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-03-551T, a statement for the record to the Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

MUTUAL FUNDS

Information on Trends in Fees and Their Related Disclosure

Why GAO Did This Study

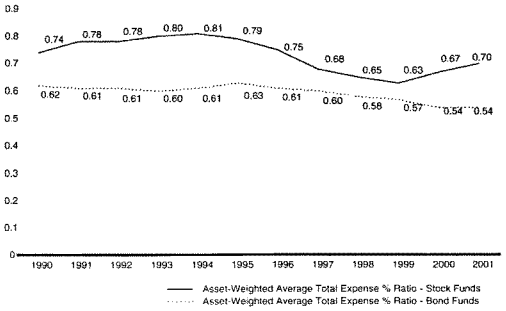
Millions of U.S. households have invested in mutual funds whose value exceeds $6 trillion. The fees and other costs that these investors pay as part of owning mutual funds can significantly affect their investment returns. Recent press reports suggest that mutual fund fees have increased during the market downturn in the last few years. In addition, questions have been raised as to whether the disclosures of these fees and other costs, such as brokerage commissions, are sufficiently transparent. GAO updated its analysis from its June 2000 report, which showed the trends in mutual fund fees from 1990 and 1998 for large funds by collecting data on how these 76 funds' fees changed between 1998 to 2001. GAO also reviewed the Securities and Exchange Commission's recent rule proposal on fee disclosure as well as studies by industry.

What GAO Found

Recent data indicate that mutual fund fees may have increased. Studies by the staff of the Securities and Exchange Commission (SEC) and the Investment Company Institute found that expense ratios for mutual funds overall have increased since 1980. GAO's prior analysis of large mutual funds showed that these funds' average expense ratios generally decreased between 1990 and 1998, but between 1999 and 2001, the average ratio for the large stock funds analyzed has increased somewhat while the average ratio for the large bond funds has continued to decline. The average expense ratio for these large funds overall remains lower than their average in 1990.

SEC is proposing that investors receive additional information about mutual fund fees in the semiannual reports sent to fund shareholders. If adopted, these new disclosures would appear to provide additional useful information to investors and would allow for fees to be compared across funds. However, various alternatives to the disclosures that SEC is proposing could provide information specific to each investor and in a more frequently distributed and relevant document to mutual fund shareholders—the quarterly account statement, which presents information on the actual number and value of each investor's shareholdings. Industry participants have raised concerns that requiring additional disclosures in quarterly statements would be costly and that the additional benefits to investors have not been quantified.

Asset-Weighted Average Expense Ratios for 76 Stock and Bond Funds 1990 - 2001



Sources: GAO (analysis); Morningstar and Lipper (data)

www.gao.gov/cgi-bin/getrpt?GAO-03-551T. To view the full statement, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or hillmanr@gao.gov.

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to provide information on GAO's recent work on mutual fund fees. Millions of U.S. households have invested in mutual funds whose value exceeds $6 trillion. The fees and other costs that these investors pay as part of owning mutual funds can significantly affect their investment returns. Recent press reports suggest that mutual fund fees have increased during the market downturn in the last few years. In addition, questions have been raised as to whether the disclosures of these fees and others costs, such as brokerage commissions, are sufficiently transparent. In a report issued in June 2000, we found that fees for the largest stock and bond mutual funds had declined from 1990 to 1998 but that not all funds had reduced their fees.[1] We also found that mutual funds do not usually compete directly on the basis of their fees, and we recommended that Securities and Exchange Commission (SEC) consider additional disclosures regarding fees to increase investor awareness and to encourage additional price competition among funds.

The operating costs that mutual funds incur are expressed as a percentage of fund assets and called the fund's operating expense ratio. This expense ratio includes the management fee (the amount the fund's investment adviser charges for managing the fund), the fund's other operating expenses (such as fund accounting or mailing expenses), and 12b-1 fees (distribution expenses paid out of fund assets).[2] Moreover, funds incur other costs not included in the expense ratio that also can affect investor returns. For example, funds pay commissions to broker-dealers to execute trades for their fund. This statement responds to your request that we (1) provide updated information on how mutual fund fees have changed since our June 2000 report, (2) discuss how fund fees are currently disclosed and various alternatives for expanding these disclosures, and (3) provide information on how mutual funds' trading costs are disclosed.

To evaluate trends in mutual fund fees, we obtained and analyzed data on the fees and other expenses of 76 mature stock and bond mutual funds from financial research organizations to update analysis presented in our June 2000 report. At the time we conducted the work for our June 2000

[1] U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C.: June 7, 2000).

[2] 12b-1 refers to the specific rules under the Securities Exchange Act that authorized mutual funds to pay for marketing and distribution expenses directly from fund assets.

report, these were the largest funds in existence during the period 1990-1998.[3] Because these funds had grown more than other funds, we expected them to have been subject to the greatest economies of scale, which could have allowed their advisers to reduce the fees they charge investors. For this statement, we obtained information on these funds' assets, expenses, and other information from 1999 to 2001, which was the latest year complete data were available for all these funds. We also reviewed recent studies by regulators and industry associations on trends in mutual fund fees. To describe how fund fees are disclosed and various alternatives for expanding these disclosures, we relied on our prior work on this subject; also we reviewed current SEC rule proposals and comment letters by industry participants and investors.[4] To assess the brokerage commissions mutual funds pay and how these are disclosed, we reviewed SEC rules and studies by academics and others. For each of the topics we addressed in this statement, we also gathered views and relevant documentation from staff at SEC, three mutual fund companies, the Investment Company Institute (ICI), which represents mutual fund companies, and an investor advocate.

In summary, recent studies show that mutual fund fees may be on the rise. Our prior analysis of large mutual funds showed that these funds average expense ratios generally decreased between 1990 and 1998, but between 1999 and 2001, the average ratio for the large stock funds we analyzed has increased somewhat while the average ratio for the large bond funds has continued to decline. The average expense ratio for these 76 funds overall fees remains lower than their average in 1990. However, since 1998, the majority of stock and bond funds we analyzed had higher expense ratios in 2001 than they did in 1998. The decline in assets for many stock funds since 2000 may have contributed to the recent increase in expense ratios because many funds have fee schedules that decrease fees at various increments as fund assets increase.[5] However, when assets decline, less of

[3] For our June 2000 report, we analyzed data for 77 large funds—46 stock funds and 31 bond funds—between 1990 and 1998. However, since we issued that report, one of these funds no longer exists, so our data for 1999 to 2001 presented in this statement included data for 76 funds.

[4] U.S. General Accounting Office, *SEC's Report Provides Useful Information on Mutual Fund Fees and Recommends Improved Fee Disclosure*. GAO-01-655R (Washington, D.C.: May 3, 2001).

[5] For example, a fund's management fee could be 0.35 percent on assets up to $5 billion, 0.30 percent on assets between $5 billion and 10 billion, and 0.27 percent on assets above $10 billion.

these funds' assets are charged the lower fee increments, which increases the expense ratio they report as a percentage of their total assets. Although most of the expense ratios for the large bond funds we analyzed had also increased, the overall average of these funds' ratios had declined because assets for lower-fee funds were growing faster than those of higher-fee funds.

In response to the recommendation in our 2000 report that SEC consider additional disclosures regarding fees, SEC issued proposed rule amendments in December 2002 that would require that mutual funds make additional disclosures of fees to their shareholders. These new disclosures would appear to provide additional useful information to investors and will allow for fees to be compared across funds. However, SEC is proposing that this information be included only in the semiannual shareholder reports, which provides information to all of a mutual fund's investors that is not investor specific. Various alternatives to the disclosures that SEC is proposing were discussed in our prior reports and those of others that could provide information specific to each investor in a more frequently distributed and relevant document to mutual fund shareholders—the quarterly account statement, which presents information on the actual number and value of each investor's shareholdings. However, industry participants have raised concerns that requiring additional disclosures in quarterly statements would be costly and their additional benefits to investors have not been quantified.

Industry participants and others are also debating whether to increase the disclosures that mutual funds are required to make about their trading costs, such as the commissions funds pay to broker-dealers when they trade securities. Currently, funds are required to disclose the amount of brokerage commissions they paid only in reports sent to SEC, which are available to investors only if specifically requested. Although SEC has not proposed any changes to how funds disclose these costs, academics and investor advocates believe that additional disclosures of these expenses would be useful to investors. However, industry participants raised concerns over whether such disclosures would provide information that could be meaningfully compared across funds.

Mutual Fund Fees Appear to Have Risen Recently

Data from others and our own analysis indicates that mutual fund fees may have increased recently. Studies by SEC and ICI found that expense ratios for mutual funds overall have increased since 1980. Our own analysis finds that average expense ratios for large stock funds have

increased since 1998, but those for large bond funds have declined since then.

Recent Studies Indicate that Mutual Fund Expense Ratios Have Increased

Since we issued our report in 2000, the staff at SEC have published a study of mutual fund fees that showed that fund expense ratios have increased.[6] The SEC staff study measured the mutual fund expense ratio of all stock and bond mutual funds between 1979 and 1999. The study used a weighted average of mutual funds in order to give more weight to funds with more assets. Their study found that the average expense ratio for these funds rose from 0.73 percent in 1979 to 0.94 percent in 1999. However, they noted that the increase in mutual fund expense ratios since the 1970s can be attributed primarily to changes in the manner that mutual funds and their shareholders pay for distribution and marketing expenses. Over this period, many funds have decreased or replaced front-end loads, which are not included in a fund's expense ratio with ongoing rule 12b-1 fees, which are included in a fund's expense ratio. Front-end loads are charged to investors as a percentage of the initial investment when they buy shares and are used to compensate financial professionals, such as the investor's broker or financial planner.

Using a different methodology, ICI also published a series of studies that show that, although expense ratios may be rising, the overall cost of investing in mutual funds has decreased. ICI's studies attempt to measure what it calls the "total shareholder cost" of investing in mutual funds by considering both a fund's operating expense ratio and any sales charges, such as loads, investors paid when investing in that fund. To determine the average total cost of investing in funds as a percentage of fund assets, ICI also weights each individual fund's total cost by the fund's sales each year. By using sales to weight each fund's contribution to the overall average, ICI indicates that it is attempting to present the cost and the actual investment choices made by investors purchasing mutual fund shares in particular years. In its latest study using this methodology, ICI reports that the total shareholder costs for equity funds fell from 2.26 percent of fund assets in 1980 to 1.28 percent in 2001, and that the total cost of investing in bond funds declined from 1.53 percent to 0.90 percent during the same period.[7]

[6] U.S. Securities and Exchange Commission Division of Investment Management, *Report on Mutual Fund Fees and Expenses* (Washington, D.C.: December 2000).

[7] Investment Company Institute, *Total Shareholder Cost of Mutual Funds: An Update* (Washington D.C.: September 2002).

According to ICI's study, the primary reason that the total cost of mutual fund investing has declined results from the reduction in sales and other distribution costs paid by mutual fund investors over this period. For example, ICI finds that the average load has fallen from 7.0 percent of the dollar value of investors' purchases to 5.2 percent and sales of shares not subject to such loads have also increased. For example, some funds waive the load for certain investors, such as purchases by retirement plans.

Some industry participants have criticized the ICI's methodology. As we discussed in our June 2000 report, analysts at one industry research organization acknowledged that the ICI data may indicate that the total cost of investing in mutual funds has declined.[8] However, they said that because ICI weighted the fund fees and other charges by sale volumes, the decline ICI reports results mostly from actions taken by investors rather than advisers of mutual funds. These research organization officials noted that ICI acknowledged in its study that about half of the decline in fund costs resulted from investors increasingly purchasing shares in no-load funds.

Although ICI's study shows that the total cost of investing in funds may be declining, it also shows that stock funds' expense ratios have risen. According to ICI's September 2002 study, the average stock fund operating expense ratio has risen from 0.77 percent in 1980 to 0.88 percent in 2001. ICI's study also shows that the average expense ratio of the stock funds it reviewed has continued to rise in recent years from 0.83 in 1998 to 0.88 percent in 2001. ICI attributes this increase to two factors. First, funds with higher expense ratios, such as aggressive growth funds or international stock funds, have been popular lately and increased sales of these funds would increase the overall average. Second, the decline in assets experienced by many stock funds as a result of the market decline since 2000 also means that such funds have fewer assets over which to spread their fixed operating costs and thus their expense ratio would rise as a percentage of their assets.

Recent press reports have also indicated that fees for mutual funds may be increasing. For example, a March 2003 press report presented data from Lipper, Inc., a mutual fund research service, that shows that the median

[8] Morningstar, Inc., *Morningstar.Net Commentary: Revisiting Fund Costs: Up or Down?*, Scott Cooley, (Feb. 19, 1999).

expense ratio for stock funds increased from 1.30 percent in 1998 to 1.46 percent in 2002.

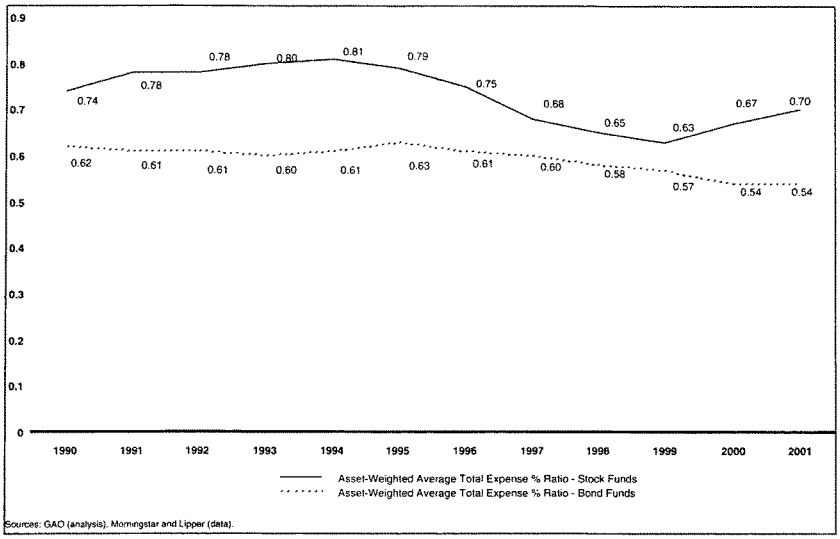
Our Analysis Shows that Average Fees for Large Stock Funds Have Increased Recently, but Fees for Large Bond Funds Have Declined

Although our June 2000 report found that fees for large stock and bond funds had generally declined between 1990 and 1998, analysis of recent years shows that the average expense ratios for large stock funds have risen since 1998 while fees for bond funds have continued to decline. For our June 2000 report, we analyzed the change in expense ratios from 1990 to 1998 for 77 large stock and bond mutual funds, which because of their growth during this period—which collectively averaged over 600 percent—were likely to have experienced economies of scale in their operations that would allow them to reduce their expense ratios. To calculate the average expense ratios on the large mutual funds identified in our previous report, we weighted each fund's expense ratio by its total assets. The resulting asset-weighted average expense ratios represent the fees an average investor would expect to pay on every $100 dollars invested in these funds during this period. Since our 2000 report one of the bond funds was liquidated, so our analysis for this statement presents comparable results for 76 funds.

As shown in figure 1, since 1990, the average expense ratio charged by the large stock funds we analyzed, after generally rising during the mid-1990s, declined the second half of the 1990s and then began rising again. The asset-weighted average expense ratio for these stock funds declined from 0.74 percent in 1990 to 0.70 percent in 2001. However, the average expense ratio of these funds has increased recently by about 8 percent, from 0.65 percent in 1998 to 0.70 percent in 2001. The average expense ratios for the large bond funds also generally declined between 1990 and 2001, from 0.62 percent to 0.54 percent. However, unlike the stock funds, the bond funds have continued to decline since 1998.[9]

[9] For our June 2000 report, the asset-weighted average expense ratios were calculated using each fund's year-end net assets. Consistent with industry practice, we calculated the average expense ratios for our updated analysis using each fund's average net assets for each year. Based on a comparison of 1998 information calculated both ways, the difference does not appear to materially affect the overall trends we identified.

Figure 1: Asset-Weighted Average Expense Ratios for 76 Large Stock and Bond Funds, 1990–2001



Sources: GAO (analysis), Morningstar and Lipper (data).

Various factors may explain the recent rise in stock fund expense ratios. ICI and industry participants attribute recent increases in average expense ratios industrywide to asset declines among stock funds. For example, ICI reported that total assets held by stock funds have declined from over $4 trillion in 1999 to about $3.4 trillion at the end of 2001. The decline in assets for many stock funds may have contributed to the recent increase in expense ratios because many funds have fee schedules that charge lower management fees at various increments as the fund's assets increase. As the assets of a fund with such a declining rate fee schedule increase, these additional assets are assessed a lower-percentage rate fee, which results in the fund reporting a lower total expense ratio overall. However, when assets decline, more of the fund's assets are charged the higher

management fee increments, resulting in an increase in the overall expense ratio of the fund.

However, asset declines and resulting increases in some expense ratios do not explain all of the increases in the average expense ratio for the large stock funds we analyzed because the assets of most of these funds continued to grow. Overall, the total assets in the 46 stock funds we reviewed increased from $835 billion in 1998 to over $1,052 billion in 2001. Individually, 28 of the 46 stock funds experienced asset growth between 1998 and 2001, although most of these funds' assets declined from 2000 to 2001.

The decline in the average expense ratio for bond funds shown in figure 1 appeared to arise from stronger asset growth in lower-fee funds. We divided the 30 bond funds in our analysis into two groups: (1) those funds with expense ratios in 1998 that were higher than the 0.60 percent weighted average ratio for all 30 funds and (2) those funds with expense ratios in 1998 that were lower than the 0.60 percent weighted average ratio for all 30 funds. As shown in table 1, the 16 low-fee funds experienced overall asset growth of about 32 percent, whereas the assets of the 14 high-fee funds declined 16 percent from 1998 to 2001. In addition, the low-fee funds' average expense ratio declined by 7 percent whereas the high-fee funds' ratio decreased only 2 percent.

Table 1: Change in Assets and Expense Ratios for 30 Bond Funds, by High- and Low-Fee Funds, 1998—2001

	Total assets (in millions)		Percentage change	Expense ratios (in percent)		Percentage change
	1998	2001		1998	2001	
14 high-fee funds	$74,295	$62,045	-16 percent	0.84	0.82	-2 percent
16 low-fee funds	87,571	115,380	32 percent	0.41	0.38	-7 percent

Source: GAO analysis of data from Lipper.

Looking specifically at the extent to which individual funds expense ratios changed, we found that the expense ratios for the majority of the large stock and bond funds we analyzed had also increased since 1998. As shown in table 2, the expense ratios for 28 or 61 percent of the 46 large stock funds we analyzed increased from 1998 to 2001. The table also shows that half of these 28 funds had increased their total assets but their expense ratios continued to increase. However the majority of these expense ratios increases were less than 10 percent. Table 2 shows four funds whose assets increased by more than 30 percent and whose expense ratios increased by more than 10 percent. However, these four funds management fees included provisions that would allow the fund adviser to

charge a higher rate if the fund's performance exceeded certain benchmarks. For example, the expense ratio of one of these funds increased from under 0.60 percent in 1998 to 0.88 percent in 2001. This increase is due in large part to the fund's fee schedule, which calls for part of the fund's management fee to go up or down between 0.02 percent and 0.20 percent of assets annually, depending on whether the fund's 3-year performance was better or worse than the return of the S&P 500 index, which this fund's performance did exceed. Of the remaining 18 funds we analyzed, most of whose assets increased, their expense ratios either did not change or decreased between 1998 and 2001.

Table 2: Changes in Assets and Expense Ratios in 46 Large Stock Funds, 1998–2001

	Percentage change in assets					
Change in expense ratios	**+100 or more**	**+100 to +30**	**+30 to 0**	**0 to –30**	**-30 or more**	**Total**
Increase over 30 percent	1	1	1	1	-	4
Increase between 10 percent and 30 percent	-	2	1	2	-	5
Increase under 10 percent	-	3	5	9	2	19
Subtotal	**1**	**6**	**7**	**12**	**2**	**28**
No change	-	-	1	-	-	1
Decrease under 10 percent	5	4	2	3	-	14
Decrease between 10 percent and 30 percent	1	1	-	-	1	3
Decrease over 30 percent	-	-	-	-	-	-
Subtotal	**6**	**5**	**3**	**3**	**1**	**18**
Total	**7**	**11**	**10**	**15**	**3**	**46**

Source: GAO analysis of data from Lipper.

The expense ratios for the majority of bond funds that we analyzed also increased. As shown in table 3, the expense ratios for 18, or 60 percent, of the 30 large bond funds we analyzed also increased from 1998 to 2001. Over this period, 14 of the funds' assets decreased—which could increase their expense ratios because less of their assets would be subject to lower fee rates under a declining rate fee schedule. Four funds assets and expense ratios increased between 1998 and 2001. However, of the 18 funds with increased expense ratios, the majority of the increases were less than 10 percent.

Table 3: Changes in Assets and Expense Ratios in 30 Large Bond Funds, 1998–2001

	Percentage change in assets					
Change in expense ratios	+100 or more	+100 to +30	+30 to 0	0 to –30	-30 or more	Total
Increase over 30 percent	-	-	-	-	-	-
Increase between 10 percent and 30 percent	-	-	-	2	1	3
Increase under 10 percent	1	2	1	9	2	15
Subtotal	**1**	**2**	**1**	**11**	**3**	**18**
No change	-	-	-	-	-	-
Decrease under 10 percent	-	1	5	2	-	8
Decrease between 10 percent and 30 percent	-	3	-	1	-	4
Decrease over 30 percent	-	-	-	-	-	-
Subtotal	**-**	**4**	**5**	**3**	**-**	**12**
Total	**1**	**6**	**6**	**14**	**3**	**30**

Source: GAO analysis of data from Lipper.

SEC Is Proposing Additional Fee Disclosures, but Other Alternatives Could Provide More Specific Information

SEC is proposing that investors receive additional information about mutual fund fees, but other alternatives for disclosing fees exist that could better inform investors of the actual fees they are charged. The SEC proposal would allow fees to be compared across funds, but would present information to investors in dollar amounts using only illustrative investment amounts. In contrast, various alternative means of providing additional fee disclosures would provide dollar amounts calculated using each investors' own account balances or number of shares owned and present this information in the quarterly statements they receive that show the value of their mutual fund holdings. Although mutual funds generally do not emphasize the level of their fees in their advertisements, SEC is also proposing that additional disclosures be made in such materials.

SEC Proposal Provides Additional Information on Fees

Since 1988, SEC has required that mutual fund prospectuses include a table that shows all fees and charges associated with a mutual fund investment as a percentage of net assets. The fee table reflects (1) charges paid directly by shareholders out of their investment such as front- and

back-end sales loads and (2) recurring charges deducted from fund assets such as management and 12b-1 fees. The fee table is accompanied by a numerical example that illustrates the aggregate expenses that investors could expect to pay over time on a $10,000 investment if they received a 5-percent annual return and remained in the fund for 1, 3, 5, or 10 years.[10] In addition, SEC adopted requirements in January 2001 that require mutual funds to disclose their after-tax returns. SEC staff told us that taxes can have an even more significant impact on investors' returns than fund expenses.

In response to the recommendation in our 2000 report that SEC consider additional disclosures regarding fees, SEC released proposed rule amendments in December 2002 whose primary purpose is to require mutual funds to disclose additional information about their portfolio holdings, but also proposes that they make additional disclosures about their expenses.[11] Under this proposal, SEC would require that mutual fund investors be provided with information on the dollar amount of fees paid using preset investment amounts. This information would be presented to investors in the annual and semiannual reports prepared by mutual funds. Specifically, mutual funds would be required to present a table showing the cost in dollars associated with an investment of $10,000 that earned the fund's actual return and incurred the fund's actual expenses paid during the period. This disclosure is intended to permit investors to estimate the actual costs in dollars that they bore over the reporting period using the actual return for the period. In addition, SEC is also proposing that mutual funds present in the table the cost in dollars, based on the fund's actual expenses, of a $10,000 investment that earned a standardized return of 5 percent. This second disclosure, would allow investors to more easily compare the differences in the actual expenses of two funds irrespective of any performance differences between the two.

SEC is also proposing that a narrative accompany these two new expense disclosures. The narrative would explain that mutual funds have transaction-based charges, such as loads or fees for exchanging shares of

[10] In 1998, SEC increased the hypothetical investment amount illustrated in the fee table example from $1,000 to $10,000 to reflect the size of the more typical fund investment.

[11] Securities and Exchange Commission, *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, 68 Fed. Reg. 160-01 (Washington, D.C.: Dec. 18, 2002).

one fund for another, and ongoing costs, as represented by the expense ratio, and that the numerical examples are intended to help shareholders understand these ongoing costs and to compare these costs with the ongoing costs of investing in other mutual funds. The narrative would also explain the assumptions used in the examples, note that the examples do not reflect any of the transaction-based costs, and advise investors that examples are useful in comparing ongoing but not total costs of investing in different funds.

The method of disclosure that SEC is proposing is consistent with one of the alternatives discussed in our June 2000 report. As SEC's rule proposal states, the two new expense figures being proposed are designed to increase investor understanding of the fees that they pay on an ongoing basis for investing in a fund. The proposed disclosure in shareholder reports would supplement the fee disclosure required in the mutual fund prospectus. According to SEC staff, the new disclosures they are recommending would be placed in the annual and semiannual reports because these documents contain more information than quarterly statements and thus would allow investors to better understand fee information in an appropriate context. SEC staff also believe that providing this information in these reports will allow investors to compare the fees of one fund to another. If adopted, we agree that the proposed disclosures would provide investors with additional useful information.

SEC has received a wide range of comments on their proposal specific to disclosure of fund expenses. Most comments were in support of SEC's requirement to include the dollar cost associated with a $10,000 investment. For example, one investment advisory firm commented in its letter that the new disclosures SEC is proposing would benefit investors by allowing them to estimate actual expenses and compare costs between different funds in a meaningful way. Some commenters also noted that requiring specific dollar disclosures was not necessary, given the potential costs and burdens to mutual fund companies. One large labor union supported SEC's proposal, but encouraged SEC to explore cost-effective methodologies to provide investors with their actual share of fees. An industry association representing attorneys stated in its letter that it generally supported the additional disclosures SEC was proposing, but given existing disclosures requirements, the benefits of these additional disclosures appeared marginal at best.

Alternative Disclosures Could Provide Investors More Specific Information

Alternatives to the SEC proposal could offer more investor-specific information. While SEC's proposed disclosures would provide additional information that investors could use to compare fees across funds, the disclosures in SEC's 2002 proposed rule amendments would not be investor specific because they would not use an investor's individual account balances or number of shares owned. In addition, SEC's proposed placement of these new disclosures in the semiannual shareholder reports, instead of in quarterly statements, may be less likely to increase investor awareness and improve price competition among mutual funds. Quarterly statements, which show investors the number of shares owned and value of their fund holdings, are generally considered to be of most interest to investors.

In our June 2000 report, we offered another alternative for disclosing fee information that would provide shareholders with the specific-dollar amounts of fees paid on their shares in their quarterly account statements. We noted that such disclosure would make mutual funds comparable to other financial products and services such as bank checking accounts or stock or bond transactions through broker-dealers. As our report noted, such services actively compete on the basis of price. If mutual funds made similar specific-dollar disclosures, we stated that additional competition on the basis of price would likely result among funds.

SEC and industry officials raised concerns about requiring specific-dollar disclosures in quarterly statements. They believed that the potential costs associated with accounting for, and reporting, costs on an individual basis could be significant. After our June 2000 report was issued, ICI commissioned a study by a large accounting firm to survey mutual fund companies about the costs of producing such disclosures.[12] This study obtained information from 39 mutual fund companies and entities that provide services to mutual funds.[13] To produce specific-dollar disclosures, the respondents indicated the most costly activities that would be necessary to produce this information included

[12] PriceWaterhouseCoopers, *ICI Survey on GAO Report on Mutual Fund Fees*, (Jan. 31, 2001).

[13] The survey obtained information from 39 mutual fund companies and their designated affiliates, as well as from independent transfer agents and shareholder servicing agents, national and regional broker-dealers, securities clearing firms, and financial planning firms. The assets of 39 mutual fund companies that provided data represent approximately 77 percent of total industry net assets as of June 30, 2000.

- enhancing current data processing systems
- modifying investor communication systems and media
- developing new policies and procedures and
- implementing employee training and customer support programs.

Officials highlighted, in many cases, that mutual fund companies do not have access to the name and account information for individual shareholders to whom the fee disclosures would be made. Instead, broker-dealers or financial planners maintain account information on the many shareholders who purchase their mutual fund shares through these third parties. The third parties in turn maintain what are called omnibus accounts at the mutual fund. As a result, the mutual fund will know only the total number of shares owned by clients of a particular party, but not know how many actual shareholders there are and how many shares each shareholder owns. To disclose the specific-dollar amount of fees for each of these shareholders would require funds and third parties to communicate daily to receive the specific cost information that would then have to be attributed to each shareholder's individual account.

The ICI study concluded that the aggregated estimated costs of the survey respondents to implement specific-dollar disclosures in shareholder account statements would exceed $200 million, and the annual costs of compliance would be about $66 million. However, this estimate did not include the reportedly significant costs that would be borne by third-party financial institutions, which maintain accounts on behalf of individual mutual fund shareholders.

Although ICI's estimates are significant in the aggregate, when spread over the accounts of many investors, the amounts are less sizeable. For example, ICI reported that at the end of 2001, a total of about 248 million shareholder accounts existed. If the 39 fund companies, which represent 77 percent of industry assets, also maintain about the same percentage of customer accounts, then the 39 companies would hold about 191 million accounts. As a result, apportioning the estimated $200 million in initial costs to these accounts would amount to about $1 per account. Apportioning the estimated $66 million in costs to these accounts would amount to $0.35 per account.

Another option to improve mutual fund fee disclosures would involve calculating estimates of fund expenses attributable to individual investors. One former fund adviser suggested that mutual funds could provide investors with fairly precise estimates of what they are paying in fees in their quarterly account statement by multiplying the funds' expense ratio

for the prior year by the assets that the shareholder held as of the last day of the year or period. According to the former fund adviser, this calculation, which would help investors better understand the fees their investments are incurring, could be made at minimum cost to mutual funds.

According to some mutual fund officials, the expense calculation disclosure presents similar cost concerns and raises other issues. According to ICI staff, mutual funds and third-party financial institutions may have to develop improved communication links to pass the information needed to make this calculation, and thus would incur some of the same costs as specific-dollar disclosures would entail. In addition, mutual fund officials expressed concerns that providing investors estimates could also create problems. For example, an estimate calculated on the basis of the investor's holding on the closing day of the statement could be highly inaccurate if the number of shares owned by the investor has changed dramatically during the period. ICI staff also noted that fund complexes would likely want to include considerable explanatory material or disclaimers about the nature of the estimated information that this type of disclosure would provide. Before requiring mutual fund companies and others to incur such costs to produce these additional disclosures, ICI officials said that the benefits to investors would have to be better quantified.

As a result, although additional disclosures could provide investor-specific information and in documents that investors receive more frequently, fund companies and other financial institutions would incur costs to produce such additions to the existing reporting made to fund shareholders. The benefit to investors from receiving this additional information has not been quantified.

Mutual Fund Advertisements Usually Do Not Focus on Fees, but SEC Is Proposing Additional Disclosures

Although mutual fund officials say that funds compete vigorously against each other, they generally do not emphasize fees in their advertisements and SEC is proposing additional disclosures be made. In our 2000 report, we reported that fund advisers generally do not emphasize the level of their fees when attempting to differentiate their funds from those of their competitors. We recently analyzed 29 different mutual fund advertisements that ran in the 2002 and 2003 mutual fund editions of three major business magazines. Of these, only three advertisements emphasized low management fees, 12b-1 fees, or expense ratios. In addition, while one mutual fund family, which accounted for 9 of the 29 advertisements, frequently advertised that its funds had no loads, the

primary emphasis in the majority of advertisements was on other themes such as, in order of their frequency, the importance of long-term investments, risk management, good performance as evidenced by high rating by mutual fund advisory services, and tax savings.

In 2002, SEC proposed amendments to investment company advertising rules.[14] These changes would allow mutual funds to advertise more timely information than that appearing in fund prospectuses and would require more balanced disclosure of information, particularly in the area of past performance. The proposal also includes a provision that would require funds to indicate that information about charges and fees can be found in a fund's prospectus. Under current requirements, mutual funds are not required to discuss fees in advertisements. Nevertheless, in practice, most of the mutual fund advertisements that we analyzed already included language that referred investors to the fund prospectus for information on fees and charges.

Mutual Fund Trading Costs Are Additional Expense to Investors but Are Not Prominently Disclosed

In addition to the expenses reflected in the expense ratio, mutual funds also incur trading costs that also affect investors' returns. Among these costs are brokerage commissions that funds pay to broker-dealers when they trade securities on a fund's behalf. Currently brokerage commissions are not routinely or explicitly disclosed to investors and there have been increasing calls for disclosure as well as debate on the benefits and costs of added transparency.

Brokerage Commissions Add to Investor Costs

When mutual funds buy or sell securities for the fund, they may have to pay the broker-dealers that execute these trades a commission. In other cases, trades are not subject to explicit brokerage commissions but rather to markups or spreads. For example, the broker-dealers offering the stocks traded on NASDAQ are often compensated by the spread between the buying and selling prices of the securities they offer.[15] Other trading-related costs that mutual funds can incur include potential market impact or other costs that can arise when funds seek to trade large amounts of

[14] U.S. Securities and Exchange Commission, *Proposed Amendments to Investment Company Advertising Rules*, 67 Fed. Reg. 36712-01 (May 24, 2002).

[15] These different prices are called the (1) bid, the price at which the broker-dealer is willing to pay and (2) ask, the price at which the broker-dealer is willing to sell.

particular securities. For example, a fund seeking to buy a large block of a particular company's stock may end up paying higher prices to acquire all the shares it seeks because its transaction volume causes the stock price to rise while its trades are being executed.

Data from mutual funds indicates that brokerage commissions and other trading costs can be significant. Estimates of the size of brokerage commissions mutual funds pay ranged from 0.15 percent of funds' assets to as much as 0.50 percent. Various academic studies conducted in the mid-1990s found that brokerage commissions were around 0.30 percent of a mutual fund's total assets.[16] For example, a study that looked at more than 1,100 stock and bond funds found that brokerage commissions for these funds averaged 0.31 percent of fund assets.[17] These studies also found that brokerage commissions increase as turnover—the extent to which the fund buys and sells securities—increases.

In some cases, a portion of the brokerage commissions that funds pay may represent payment for research services from the executing broker-dealer. When a portion of the commission entitles the fund to such research, this amount is called "soft dollars." One academic study estimated that mutual funds pay brokerage commissions of about $0.06 per share traded.[18] Because individual investors trading through discount broker-dealers can trade for as little as $0.02 per share, the study's author attributes the higher amount of commissions—about 66 percent of the total amount per share—paid by mutual funds to charges for soft dollar research. Fund managers are allowed to engage in this practice under a provision created by the Congress in Section 28 (e) of the Securities Exchange Act of 1934. In adopting this section, the Congress acknowledged the important service broker-dealers provide by producing and distributing investment research to fund managers and permitted fund managers to use commission dollars paid by managed accounts to acquire research. SEC staff told the authors of this study that funds that obtain research using soft dollars would have the opportunity to reduce their expense ratios because the fund's manager

[16] These studies include: R. Fortin and S. Michelson, "Mutual Fund Trading Costs," *Journal of Investing*, (Spring 1998); J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec, "Mutual Fund Trading Costs," Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania, (Nov. 2, 1999); and M. Livingston and E.S. O'Neal, "Mutual Fund Brokerage Commissions," *Journal of Financial Research*, (Summer 1996).

[17] R. Fortin and S. Michelson.

[18] M. Livingston and E.S. O'Neal.

is not incurring as many direct costs for research activities. However, this study, which looked at 240 stock funds, also found that the funds with higher expense ratios also had higher brokerage commission costs. The authors said that this could either mean that these funds are investing in stocks that are more costly to research and to trade or that the managers of these funds were less resolute about reducing their expense ratios even though they did not have to pay directly for some of the research services obtained for their funds.

Calls Made for Increased Disclosure of Brokerage Commissions

Brokerage commissions are not disclosed in documents routinely sent to investors, and some parties have called for additional disclosures.[19] Currently, SEC requires mutual funds to disclose the amount of brokerage commissions paid in the statement of additional information (SAI), which also includes disclosures relating to fund policies, officers and directors, and tax matters. Specifically, SEC requires funds to disclose in their SAI how transactions in portfolio securities are conducted; how brokers are selected; and how they determine the overall reasonableness of brokerage commissions. Unlike fund prospectuses or annual reports, SAIs do not have to be sent periodically to a fund's shareholders, but instead are filed with SEC annually and are sent to investors upon request. The amount disclosed in the SAI does not include other trading costs borne by mutual funds such as spreads or the market impact cost of the fund's trading. SEC staff told us that, although investors are not sent the disclosures on brokerage commissions unless they request it, funds are required to disclose their portfolio turnover in their prospectuses, which new and existing investors are routinely sent.

Academics and other officials have called for increased disclosures relating to mutual fund brokerage commissions and other trading costs. In the academic studies we reviewed that looked at brokerage commission costs, the authors often urged that investors pay increased attention to such costs. For example, one study noted that investors seeking to choose their funds on the basis of expenses should also consider reviewing

[19] The cost of brokerage commissions to a fund is reflected in the fund's daily net asset value. Nevertheless, SEC requires a fund to disclose the aggregate amount of brokerage commissions paid during its 3 most recent fiscal years in the statement of additional information. If there is any material difference from the most recent fiscal year's brokerage commissions paid as compared with the prior 2 fiscal years, the material difference must also be explained.

trading costs as relevant information.[20] The authors of another study note that research shows that all expenses can reduce returns so attention should be paid to fund trading costs, including brokerage commissions, and that these costs should not be relegated to being disclosed only in mutual funds' SAIs.[21]

Others who advocated additional disclosure of brokerage commissions cited other benefits. Some officials have called for mutual funds to be required to include their trading costs, including brokerage commissions, in their expense ratios or as separate disclosures in the same documents in which they disclose their expense ratios. For example, one investor advocate noted that if funds were required to disclose brokerage commissions in these ways, funds would likely seek to reduce such expenses and investors would be better off because the costs of such funds would be similarly reduced. He also indicated that when funds are required to disclose information, competition among funds usually results in them attempting to improve their performance in the area subject to the disclosures. He explained that this could result in funds experiencing less turnover, which could also benefit investors as some studies have found that high-turnover funds tend to have lower returns than lower-turnover funds.

However, mutual fund officials raised various concerns about expanding the disclosure of brokerage commissions. For example, some officials said that requiring funds to include brokerage commissions in their expense ratios would not present comparable information to investors because of the differences between funds that invest in securities upon which commissions are usually paid, such as shares listed on the New York Stock Exchange and funds that invest more in securities listed on the NASDAQ, for which usually the broker-dealers offering such securities are compensated by spreads rather than explicit commissions. Similarly, most bond fund transactions are subject to markups rather than explicit commissions. If funds were required to disclose the costs of trades that involve spreads, officials noted that such amounts would be subject to estimation errors. ICI staff and others also told us that the costs of trading, including brokerage commissions, are required under current accounting practices and tax regulations to be included as part of the initial value (or basis) of the security purchased. As a result, this amount is used to

[20] J.M.R. Chalmers, R.M. Edelen, and G.B. Kadlec.

[21] M. Livingston and E.S. O'Neal.

compute the gain or loss when the security is eventually sold and thus the amount of any commissions or other trading costs are already explicitly included in funds' performance returns. If these costs were to be included in the expense ratio, then funds could seek to be allowed to present their returns without such costs included so that the additional disclosure would not appear to be a new expense amount.

In addition, SEC staff told us that fund directors are expected to oversee their fund's brokerage arrangements and review the fund's transactions to ensure that they are getting good trade executions. As a result, these directors have a fiduciary obligation to ensure that the level of brokerage commissions and other trading costs are being managed in the fund investors' best interests.

O