Analysis: It's embezzlement, stupid!

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WASHINGTON, Nov. 6 (UPI) -- In the early years of bank computer systems, about 1980, a Wells Fargo employee embezzled over $10 million by the simple expedient of rounding all the bank's customers bank balances down to the nearest dollar each day, and crediting the cents to his own account. The only difficulty with the scheme, as with many embezzlement schemes, was that he had to attend physically at the bank every business day -- in this instance I forget why -- and his fraud was discovered one week when he got sick.

Needless to say, he received a lengthy jail sentence.

So, just how does this differ from the "market timing" activities at many leading mutual funds? The hedge funds that were "market timing" the big mutual funds owed no fiduciary duty to the funds, but the funds' management certainly did, and in a number of cases, management itself appears to have been "market timing" against its own investors. The mutual fund industry states soothingly that the loss to investors was only around 1 percent per annum, but that loss is similar to the maximum management fees and expenses that I'm prepared to pay these bozos, so effectively as a mutual fund investor I'm being charged double.

There are varying degrees of iniquity involved in all this. At one extreme, a number of European and Asian funds were failing to adjust their prices immediately on close of the local market, thus allowing hedge funds to take advantage of a worldwide stocks rally that began during the U.S. trading day. This has probably always happened with the savvier private investors (I have to confess that when buying or selling Asian funds myself I try at least to avoid buying or selling on days on which the U.S. and European markets have moved sharply in the wrong direction after the Asian close.)

However, only with the increasing number of hedge funds, and the increasing orientation of the markets towards short term trading rather than medium or long term investment, did the volume of this kind of trading pick up enormously. There is a great difference, both in the ethics of the situation and the effect on the fund's other shareholders, between picking up a day's free gain at the beginning of a 3 year or even 3 month holding period, and constructing a hedge fund investment strategy that relies primarily on zipping in and out of mutual funds to capture illicit short term gains. It is the latter practice, so typical of the day-trading amoral 1990s, that has become a problem.

It is likely that this effect accounts for the majority of the 1 percent per annum loss to retail investors that is quoted. To counteract it, managers of a fund specializing in a non-U.S. market simply need to revalue the fund when the foreign market closes, and not at the U.S. close. To keep out day traders, impose a 1 or 2 percent fee for a holding period of less than 2 weeks; that, combined with the lesser degree of illicit bounce obtainable in a diversified fund, will prevent hedge funds from switching to "global" funds, for which part of the price is artificial whenever they revalue their books (unless they do it continuously.)

A second, and more serious degree of malfeasance occurred in those cases where a hedge fund was allowed to trade in a mutual fund after 4 p.m., when the price should in principle have been determined. By allowing trading post facto at a fixed

price, when the stock market was closed, mutual funds were giving hedge fund traders an unfair advantage over other investors. The motivation for allowing this trading appears to have been to increase the asset base of the fund, thus increasing the management fees received by the fund's sponsor; it seems to have been more prevalent in funds with a "rich" fee structure. Again, this practice became more prevalent in the late 1990s, with the increased focus on short term trading. Unlike the international example, however, it is clearly illegal, in that it allows a particular favored group of investors an unfair access that is denied to investors in general. This appears to have been the principal problem at Putnam Investments and at Alliance Capital, where the Securities and Exchange Commission announced Thursday that it planned to file civil charges.

The final degree of malpractice, exactly equivalent in my view to the Wells Fargo employee embezzling from the banks' customers, occurred when the fund's own management undertook short term "market timing" trades in the fund's shares (or knowingly accepted remuneration from a hedge fund for allowing the fund to do so.) In this case, unlike in the first case and arguably unlike in the second case, a clear fiduciary duty was being breached. There is no fiduciary relationship between a mutual fund and an independent hedge fund that undertakes short term trades in its shares. There is however a fiduciary relationship, of the strongest possible kind, between a fund and its management. "Market timing" trades by a management against the fund it manages is embezzlement, pure and simple, and should attract the steepest possible penalties.

In the end, it comes down yet again to integrity. Mutual fund groups that are properly run, such as (as far as I am currently aware) Vanguard, Fidelity and T. Rowe Price, may attract a certain amount of market timing against their funds by third parties, but they take steps to prevent it when it occurs, and their management has no involvement with its practitioners. Mutual fund groups like Strong, Janus, Putnam and Alliance, that allowed the lax ethical standards of the 1990s to infect their operations, do not deserve fiduciary responsibility over the public's money.

As I wrote in another column a year ago, that in this as in so many other areas "wing-collar and Packard" style of capitalism works infinitely better than "dot-com and day trader" capitalism ever could.

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