ROOF ADVISORY GROUP, INC.™
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

February 2004

Advisory News Brief

Part of Roof Advisory Group's ongoing series of updates designed to keep investors informed about news & events impacting the financial marketplace.

The Mutual Fund Scandal

The widely publicized mutual fund scandal that started in September 2003, when the New York State Attorney General's office settled charges of wrongdoing with a large hedge-fund company, underscored yet another set of financial service industry abuses that were either illegal, immoral, or both.

In this instance, the transgressors were mutual fund companies; a part of the industry that had remained relatively unscathed during the past few years while several large accounting firms, brokerage companies, research analysts, investment bankers, and CEOs received their much-deserved public floggings. In general, the transgressions of these mutual fund companies involved permitting a small group of large investors to do things that either contradicted company policy and procedure or directly violated current securities regulations. A broadening array of mutual fund companies continue to find themselves in the unwanted glare of public scrutiny and the resulting shakeout will most likely continue well into 2004.

While the 'after hours trading' and 'market timing' (i.e. arbitrage of time zone pricing differences) that initially received attention in this investigation are indeed egregious violations of investor trust; the reality is that these abuses are much less damaging to the average investor than many of the ongoing industry practices that continue to be standard operating procedure in many firms today.

Hidden Costs & Conflicts of Interest

Most notable are hidden financial motivators, internal costs, and conflicts of interest associated with the sales, distribution, and operation of certain mutual funds. These impact investors in ways they may never realize.

As an example, many brokers and mutual fund salespeople have a significant incentive to market certain mutual fund groups that may not necessarily be based on the customer's best interest. Obviously, commissions or 'loads' play some role, and certainly impact fund performance, but these costs are readily identified and understandable by much of the investing public. Much less apparent to the average investor has been the mutual fund industry's evolution away from these very visible upfront sales charges to a much less visible form of sales compensation known as 12b-1 fees.

12b-1 fees are compensation for fund sales and marketing…period. These costs are embedded in a mutual fund's annual operating expense, essentially creating a sales charge that almost never goes away. Though part of a fund's expense ratio, these fees are *not* associated with internal fund management, research, trading, etc. In other words, the costs do not add any value to the ongoing performance of a mutual fund; in fact, just the opposite happens.

For instance, investors owning a mutual fund with actual internal operating expenses of 85 basis points (.85%) would see the amount their fund needs to earn to break even more than double with the addition of a 1.00% 12b-1 sales charge.

Impact on Return

Fund performance versus peer group can be dramatically impacted by these internal costs. For example, of the nearly 700 'large cap blend' equity funds tracked by Morningstar that have a ten year history; only 19 funds with 12b-1 fees of 1.00% or more have maintained a top quartile (25%) peer ranking for 3, 5, and 10 year periods. Only 2 of these funds managed to squeeze their way into the top 10% of this category's performers for the same periods.

This built-in performance drag is not lost on fund managers who are attempting to reach benchmark bogies. Don Phillips, managing director of Morningstar, Inc., recently observed in Barron's magazine that, "funds with higher expense ratios, particularly those fueled by 12b-1 fees, systematically take greater risks than those that don't have those fees." Taking greater risk to achieve mediocre returns is certainly not this firm's recommended recipe for investment success.

over…

Disclosure Concerns

While the internal fees and costs outlined above may not be readily communicated, they are disclosed in the mutual fund's prospectus. Even more detrimental to investors are compensation or incentive arrangements that create hidden biases and are rarely fully disclosed.

As an example, Morgan Stanley and several other brokerage firms received a lot of unwanted attention in 2003 from the Securities and Exchange Commission for a variety of sales practices that selectively sold investors internally-run (more profitable for the firm) mutual funds, along with those of fund companies that paid the brokerage firms a marketing fee for preferential treatment. As reported by the Wall Street Journal, the SEC's investigation specifically wanted to know "whether brokerage firms have pushed mutual fund products on customers because of the compensation they receive, rather than based on customer needs." This should hardly come as a surprise.

Unbiased Recommendations?

Securities regulations that supposedly guard the unaware investor against such overt 'pay to play' promotions are broad enough to allow a whole lot of dancing between the lines. Details of such practices were outlined by the Wall Street Journal throughout 2003 and it is quite apparent that investors typically get anything but objective mutual fund recommendations based solely on their investment needs. In November 2003, Morgan Stanley agreed to pay customers \$50 million to settle SEC allegations for, in part, allowing "a select group of mutual fund complexes (to pay) Morgan Stanley substantial fees for the preferred marketing of their funds."

While some 'revenue sharing' arrangements are legal if properly disclosed; what constitutes adequate 'disclosure' is currently unclear. Case in point. In January 2004, the Wall Street Journal reported that *90-95%* of all Edward D. Jones & Co. mutual fund sales come from just seven 'preferred' mutual fund companies despite having selling agreements with nearly one hundred (100) mutual fund firms. All of the mutual fund companies on the 'preferred' list have revenue sharing arrangements with Edward D. Jones & Co. Sources in the article estimate the revenue sharing payments received by the firm total somewhere between \$100 million to \$140 million annually.

Are investors fully aware of the promotional compensation arrangement? It's doubtful. Do the investment results of each of these 'preferred' fund companies rank in their categories the top tier? Absolutely not.

Poor Performers

This last issue is perhaps the most damaging result of mutual fund investment decisions based on factors other than objective assessment and investor need. Within the Morningstar universe, a total of 876 mutual funds have remained in the *bottom* quartile (25%) of their peer category or investment objective group for 3 year *&* 5 year *&* 10 year periods. In other words, the funds have never even been close to being 'average'.

Shockingly, 257 of these funds have always had performance that ranked in the *bottom* 10% of their peer category or investment objective group during the entire 10 year period. And this doesn't even include the multitude of poor performing funds that have been eliminated or conveniently morphed into new investments. Why do these funds still exist? Would an objective professional recommend or an informed investor buy these basement performers? Clearly not. (The accompanying 'Value of Selection' attachment illustrates the significant dollar impact of perennially poor peer performance on invested dollars.)

What's Next?

There is a long list of inadequately disclosed practices in the financial services industry that have the potential to negatively impact unsuspecting investors. These range from 'soft dollar' compensation arrangements to fund distributor reimbursements via 'administrative service fees'. Unlike the requirements for publicly traded companies, mutual fund board members and senior management *do not* have to disclose compensation, their ownership position, nor when they buy or sell shares in the funds they oversee.

Surprisingly, annuities and other insurance based products have thus far managed to avoid the current disclosure spotlight. We suspect this will change.

The Roof Advisory Group Advantage

Conversely, Roof Advisory Group clientele don't worry about conflicts of interest or hidden costs that compromise objectivity. We have always been an independent, fee-only investment management, advisory, and financial planning firm. We do not receive any commissions, loads, 12b-1 fees, or have any other revenue sharing arrangements whatsoever. Our full compensation is completely disclosed and comes from the service, not the products, we provide. This assures our clientele that their best interests are, and will always remain, our top priority.

Call us with any questions. The firm's expertise, experience and professional integrity continue to make Roof Advisory Group the place to go;

'When you're serious about managing your money.'

E. Jeffrey Roof