Fund of information: Let the masses in; That the SEC's view after a year-long probe of the hedge-fund business


Abstract (Summary)
Last week's buzz that US securities regulators would regulate hedge funds has died, as the SEC will probably do little more than make hedge funds register as investment advisers, which many are already required to do as they pursue retirement funds and other mainstream institutional investors. Instead of slapping more rules on hedge funds and making them available to the public, regulators likely will free up mutual funds to offer a special class of riskier, hedge-fund-esque vehicles. Currently there are long-short mutual funds, sometimes known as "specialty diversified funds," as well as funds-of-hedge-funds with comparatively modest minimum investments. In other news, SEC chairman William H. Donaldson revealed that he wants to revisit decimalization in a broad inquiry including self-regulatory organizations, or SROs, such as the NYSE, and electronic communication networks, or ECNs, networks for buying and selling stock. Elsewhere, Schwab Chief Executive David Pottruck was on the media circuit last week as Schwab released results of its independent, anti-Wall Street stock ratings system. The independent ratings have produced a mixed bag as of so far.

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[Headnote]
News and analysis of people and portfolios in the industry

FORGIVE US FOR WRITING ABOUT hedge funds in a mutual-funds column, but the line between them is increasingly blurring.

Last week the buzz was that U.S. securities regulators would try to keep a wave on the sand and regulate hedge funds.

That buzz quickly died. The Securities and Exchange Commission will probably do little more than make hedge funds register as investment advisers, which many are already required to do as they pursue retirement funds and other mainstream institutional investors. As registered advisers, hedge funds would be subject to SEC audit and examination.

And for the rest of us, the commission seems to want to make hedge funds available to the masses—but in mutual-fund wrapping paper. "If hedge funds are so great, than why shouldn't they be available to everyone?" asked Commissioner Roel Campos at last week's two-day SEC roundtable on hedge funds.

Precisely. But instead of slapping more rules on hedge funds, regulators likely will free up mutual funds to offer a special class of riskier, hedge-fund-esque vehicles. Currently there are long-short mutual funds, sometimes known as "specialty diversified funds," as well as funds-of-hedge-funds with comparatively modest minimum investments.

But the SEC may go further and scrap leverage restrictions and other trading limits constraining mutual-fund managers, encourage performance-linked fees on traditional mutual funds and then hope and pray that "hedge funds" in mutual-fund drag begin to flourish.

Why so little hedge-fund regulation? There's little pressure for it. Wall Street executives don't want more scrutiny of a vehicle...
in which they all invest. Moreover, unlike the bulk of mutual funds, most hedge funds have made money in the three-year bear market.

As the Standard & Poor's 500 Index fell at an annual rate of 16% a year in the three-year period ended March 31, the CSFB/Tremont index of hedge funds rose 3.46%.

SEC Chairman William H. Donaldson has invested in hedge funds, although he declined to say in which ones. "It's a very legitimate vehicle," he told Barron's on the sidelines of last week's conference. He founded Donaldson Lufkin & Jenrette, a brokerage firm that was subsequently bought by Credit Suisse First Boston. Like Donaldson's old firm, CSFB is now also a prime broker to hedge funds.

But even rich folk don't always win in hedge funds. Unhappy investors may recall DLJ raised about $1 billion in 1998 for a hedge fund called Ocelot. It was run by Julian Robertson, already the manager of giant Tiger Fund. Ocelot suffered disastrous losses in 1998 and 1999, but investors were locked into the fund for five years. Tiger finally liquidated Ocelot in 2001.

Only one person at the roundtable was willing to say it outright: "Hedge funds are unsuitable investments for unsophisticated investors," declared David Swenson, chief investment officer of Yale University. He added that "it would be best for the investment world to have high hurdles in place" to keep small investors out of hedge funds.

Expect trade-offs between the SEC and the hedge-fund community. Douglas Scheidt, associate director for the SEC's division of investment management, said he favors doubling the minimum requirement for hedge-fund investors to more than $2 million in net worth. Scheidt said hedge funds also should be allowed to publicly discuss their performance, which is banned under current regulations as a form of advertising. "The current system decreases the amount of information out there," Scheidt argued.

Some hedge-fund executives said last week they supported raising minimum wealth requirements for their investors as the industry seeks to stave off other new SEC regulations. Mutual-fund companies now offer products called funds of funds that allow investors to put money into several hedge funds. The minimum investment level for these funds can be as low as $25,000.

Who would be the mutual-fund industry's main beneficiaries if leverage limits and other rules were scrapped? Fidelity, no doubt, the Boston-based fund firm that casts a long shadow all the way to Washington.

Fidelity mutual funds already use performance-linked fees in their funds. Performance-based pay is otherwise rare in the mutual-fund industry, and mutual-fund portfolio managers usually don't beat the market, observed George Hall, president of the Clinton Group, a $9.6 billion hedge fund.

The SEC began investigating the $600 billion hedge-fund industry last year, spurred by concerns that investment pools once limited to wealthy investors were opening to ordinary, retail investors.

But at the conclusion of the roundtable, commissioners said the concerns were unwarranted. "Retailization' really hasn't happened," said Commissioner Cynthia Glassman. "That's not a problem that we have to fix." Rather than cracking down on hedge funds, Glassman confirmed the SEC may need to consider loosening rules that govern mutual funds, allowing them more freedom in trading strategies.
Many hedge funds are outperforming stocks and stock mutual funds, putting retail investors at a disadvantage. "We started out worrying about whether the investor was being protected from hedge funds," said Campos. "Now, we're talking about whether the investor needs to get into hedge funds, or hedging."

"As of today, retailization doesn't exist," said John Gaine, president of the Managed Funds Association. But he called that a sign of "class warfare" on Wall Street, where wealthy investors have access to hedge funds while "the little guys cannot."

Chairman Donaldson said the SEC's probe is moving into its "most critical phase yet," as the agency reviews data and comments from industry experts. Recommendations by the commission staff are expected this summer. "We're going to try and do it as soon as possible," said Paul Roye, director of the SEC investment management division.

Revisiting Decimals

Seemingly out of nowhere, Chairman Donaldson is calling for a review of pricing of stocks in decimals. He never supported the switch decimals from fractions, and once compared the idea to switching Americans to the metric measurement system. That was back in 1991, when he was head of the New York Stock Exchange.

Last week Donaldson revealed that he wants to revisit decimalization in a broad inquiry including self-regulatory organizations, or SROs, such as the NYSE, and electronic communication networks, or ECNs, networks for buying and selling stock. "The organization of the central marketplace, the organization of the SROs, the impact of the ECNs, globalization...all of this is a fast-moving picture that we need to step up our efforts to understand," Donaldson said.

Decimalization has clearly cut into Wall Street profits and traders are howling, especially in the markets with subpenny pricing-reporting a bid at, for example, of $7.3125. Sub-penny pricing has led to razor-thin bid-and-ask spreads and made limit orders harder to fill, critics of decimals argue.

The Security Traders Association issued a statement last Thursday saying it would welcome "a complete reexamination of the impact of trading in decimals." Former SEC Chairman Arthur Levitt, whose commission enacted decimals, agreed. "We have to carefully consider the impacts of decimalization," he said. "It is clearly something that has helped investors...and has lowered costs. But what impact it has had upon trading, impact on liquidity, is something that should be closely examined."

What has been the effect on mutual funds? Pardon us while we repeat ourselves, but the cost has been significant. (We reported this in a March 3 column, "Wall Street Meets K Street.")

"Common Cents? Tick Size, Trading Costs, and Mutual Fund Performance," a study by a Vanderbilt University assistant professor of finance, Nicolas Bollen, and co-author Jeffrey Busse, estimated that following decimalization, trading costs rose by as much as 1%-2% of assets annually for active managers (costs didn't rise at index funds).

Rather than help the small individual investor, as decimalization's proponents envisioned, decimalization appears to have levied an indirect but important cost in the form of lower mutual-fund returns," their paper revealed. Lower, that is, by a few percentage points-and every bit hurts in a down market. A copy can be found at Vanderbilt's Website (http://mba.vanderbilt.edu/faculty/nbollen.cfm).

Schwab Speaks

If Donaldson succeeds in dumping decimals, what does the largest American discount broker, Charles Schwab, think would be a possible alternative? In an interview, Schwab Chief Executive David Pottruck told Barron's one solution might be to leave the top 100 most liquid stocks trading in decimals, but bring back "nickels," or five-cent increments, for less liquid stocks.

He pointed out that with the "spread," or profit margin on a typical stock trade, at around two-tenths of a penny, versus 2.5 cents several years ago, "nobody wants to be in the middle of that trade." As a result, stocks gap down dramatically.

Pottruck was on the media circuit last week as Schwab released results of its independent, anti-Wall Street stock ratings system.
The independent ratings have produced a mixed bag. Schwab's equity ratings outperformed the Wilshire 5000 index over the past 12 months when using the average A-rated stocks.

However, Schwab's own Schwab Core Equity Fund, managed using the firm's equity rating system, has performed in line with the S&P 500 (the fund prospectus says this is the relevant benchmark).

In the most recent six months, Schwab Core Equity underperformed the S&P 500 by 3.5%, but outperformed in the one-year period by 1.5%.

Schwab expects no more across-the-board, corporate-wide layoffs. "We'll continue to fine-tune," said Pottruck. April trading volume fell 10% from a year ago, but activity in May has picked up — which the firm attributes to the easing of geopolitical uncertainty. Schwab added $1 billion to its net assets in April.

As for market chatter that Schwab would like to acquire Toronto-Dominion Bank's discount brokerage arm, TD Waterhouse, Pottruck had "no specific comment."

But he conceded it's no secret that Schwab is interested in acquisitions, whether in brokerage, the 401(k) business, or to add onto their U.S. Trust unit.

Last week Charles Schwab, founder of the firm, told an investment conference that Toronto-Dominion Bank's best strategy would be to sell its TD Waterhouse U.S. operation. If TD Bank does put Waterhouse on the auction block, Schwab said: "We would love to buy it."

Schwab told the conference that the San Francisco-based company wants to build "an open architecture" that allows investors with growing portfolios an opportunity to have any number of different advisers, with each handling a portion of a Schwab account.

"TD is looking at whether it wants to devote the resources necessary to build Waterhouse, which is the fourth or fifth horse in a five-horse race," Schwab stated. "The issue for them is whether they'd be better off devoting those resources to shoring up their position in their home market."

Some Rosier Returns
[black right triangle] Domestic diversified stock funds rose 2.96% in the week ended Thursday, outperforming the broad market's 2.87% rise. Among major styles, small-cap growth funds delivered the top performance, gaining 3.25%. Among sector funds, science and technology gained 5.22% and health and biotech gained 4.84%. Of large funds, Vanguard Windsor II was up 3.19% and Dodge & Cox was up 3.13%.

-Jack Willoughby

"I think they'd be better off selling the U.S. business to someone like us," he said. "However, they may feel they're in a box when it comes to opportunities in Canada."

Although margin lending has improved, Schwab stock barely budged on Friday, closing at 9.60, and analysts were cautiously upbeat on the discount broker's prospects. In a research note titled "Slight Signs of Life," Rich Repetto of Putnam Lovell NBF Securities in New York, whose firm does no investment banking business with the company, said he was raising his
second-quarter earnings estimate for Schwab by a penny, to eight cents per share.

Still, he said, an uptick in daily average trades at Schwab in April and May was less than expected and trailed the results of major competitors, including Ameritrade and TD Waterhouse.

"While this may be the start of an upward climb in trading activity, we've had several head fakes over the past 12-to-18 months," Repetto wrote, referring to recent volatility on Wall Street.

[Sidebar]
The SEC chairman himself has invested in hedge funds. "It's a very legitimate vehicle," says Donaldson.

[Sidebar]
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