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UNIVERSITY OF PENNSYLVANIA

Philadelphia 4

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Wharton School of Finance and Commerce

Securities and Exchange Commission
425 Second St., N. W.
Washington 25, D. C.

Gentlemen:

We are transmitting herewith a study of open-end investment companies, or mutual funds, made by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania at the request of the Securities and Exchange Commission.[1] The report, entitled "A Study of Mutual Funds," analyzes the growth, organization and control, investment policy, and performance of mutual funds; their impact on securities markets; the extent of their control of portfolio companies; and the financial and other relationships of mutual funds with investment advisers and principal underwriters. The report opens with a chapter entitled "Summary and Conclusions," which is followed by seven chapters containing detailed findings with respect to the foregoing matters.[2]

The study represents the first extensive description and analysis of the growth of the mutual fund industry to its present important position in the financial structure of the country since

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[1] The study was conducted by Dr. Irwin Friend, Professor of Economics and Finance, Dr. F. E. Brown, Assistant Professor of Statistics, Dr. Edward S. Herman, Associate Professor of Finance, and Dr. Douglas Vickers, Associate Professor of Finance.

[2] The most significant gap in this report is the omission of an analysis of selling practices and purchaser motivation. This will be filled by inquiries now under way.

the Commission's Report on Investment Trusts and Investment Companies (1939-1942).[3] The present study was undertaken pursuant to Section 14(b) of the Investment Company Act of 1940, which authorizes the Commission "to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress."

A preliminary draft of the Wharton School report was furnished to the Institutional Studies Committee of the Investment Company Institute. Thereafter, members of the committee submitted, both in writing and at a number of conferences, extensive comments and suggestions on the draft, some of which are reflected in the report.[4] Members of the Commission's staff also attended these conferences.

The report concludes that there is little evidence that size *per se* of individual funds or companies is a problem at the present time, and that the more important current problems in the mutual fund industry appear to be those which involve potential conflicts of interest between fund management and shareholders, the possible absence of arm's length bargaining between fund management and investment advisers, and the impact of fund growth and stock purchases on stock prices. These problems were found to be unrelated to company size, except to the extent that questions arise concerning the allocation between fund shareholders and investment advisers of the benefits resulting from large-scale operations. Many of these problems, particularly those relating to the divorcement of ownership from control and to the market significance of a relatively small number of large organizations, are not unique to mutual funds but characterize other financial and non-financial institutions as well.

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[3] That report, however, covered a period when mutual funds were of much smaller size. At June 30, 1941, there were registered with the Commission, under the Investment Company Act of 1940, some 141 open-end investment companies having net assets aggregating an estimated $448 million. By December 31, 1961, the number of open-end investment company registrants had increased to 344, and their aggregate net assets had grown to an estimated $24.4 billion.

[4] A preliminary draft of the report was also furnished to a committee of the National Association of Securities Dealers, Inc.

Frequently cited reasons for the purchase of mutual fund shares are the availability of expert investment advice, diversification of portfolio risks, convenience of security management, and economy of bookkeeping activities, with the first two of particular importance. Mutual funds, unlike most other financial institutions, tend to specialize in common stock investment, and, as compared with the alternative of direct purchases of stock by people with surplus funds, they provide a relatively easy means of diversifying risk which may be particularly useful to small investors. From the standpoint of the economy as a whole, this diversification of risk and widespread acceptance of the associated indirect investment in common stock tends to lower the cost of equity capital and stimulate more risky undertakings, with a higher average rate of return than would probably otherwise be realized for a given total investment.

From the viewpoint of a small investor who can ill afford large risks, it may be noted that the achievement of a comparable degree of diversification by direct purchase might involve acquisition costs in excess of the 8 percent sales charge typically imposed by the funds.[5] And this would undoubtedly be so if he turned over his portfolio fairly rapidly. In addition, further costs or at least inconvenience would be incurred as a result of such an investor's bookkeeping problems. On the other hand, if an individual investor were to hold portfolio securities for long-term investment, or if he bought securities in sizable lots, his costs would be lower. For purchasers of front-end load contractual plans, only limited returns can usually be realized unless such plans are held for substantial periods of time. When such plans are discontinued during the first two years of their life, the deductions for sales charges may exceed 30 percent of the total investment made (and may exceed 50 percent if discontinued during the first year). It may be noted that even if such plans are held to maturity the effective sales charge is greater than the nominal rate, since the sales charge is concentrated in the early years of the plan whereas the shareholder's equity builds up most rapidly in the later years.

With respect to the performance of mutual funds, it was found that on the average, it did not differ appreciably from what would have been achieved by an unmanaged portfolio consisting of the same proportions of common stocks, preferred stocks, corporate bonds, government securities, and other assets as the composite portfolios of the funds. About half of the funds performed better, and half

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[5] The 8 percent sales charge can, of course, be avoided by investment in a no-load fund.

worse, than such an unmanaged portfolio. While it might be expected that investors would be willing to pay higher prices in the form of management fees or sales charges for those funds with the better performance records, no relationship was found between performance and the amount of the management fee or the amount of the sales charge. It follows, on the basis of this evidence, that investors cannot assume that the existence of a higher management fee or a higher sales charge implies superior performance by the fund.

With respect to turnover of portfolio securities, turnover rates were found to be inversely related to size of fund, with the smallest funds generally having the highest turnover rates throughout the period and the largest funds the lowest turnover rates. The turnover rate for the stock holdings of all funds combined was higher than the comparable rate on the New York Stock Exchange for all stocks listed in that market. Substantially the same relationship was found to exist for all size groups of funds except the largest; in the latter category the equity turnover rates were found to be consistently lower than those of the stocks listed on the New York Stock Exchange.

In regard to the investment policies of mutual funds, some 93.5 percent of the assets owned by the funds on September 30, 1958, was held in corporate securities, with United States corporate issues accounting for 88 percent. At the same time, and at each of several earlier dates, approximately 75 percent of the total net assets of the funds was held in United States common stocks; the remaining assets were found to be spread fairly evenly among United States corporate bonds, United States corporate preferreds, foreign securities, and net liquid assets. The report also presents data concerning the relative proportions of investments in listed and unlisted stocks held by the funds, and the markets in which the funds' portfolio transactions have been effected, showing an increase in the importance of over-the-counter issues and transactions over the period covered. It was found that on September 30, 1958, the funds' holdings of United States common stocks were equal to approximately 3-1/2 percent of the value of all stocks listed on the New York Stock Exchange.

In an analysis of the impact of mutual funds on the stock market, it was concluded that the growth in the funds' net purchases of common stock, which accompanied the great expansion of the mutual fund industry, has probably contributed significantly to the increase in stock prices over the past decade. However, mutual funds are only one of a number of factors contributing to the rise in stock prices and price-earnings ratios--with corporate pension funds, other institutions, and individuals playing a major role, and a number of other post-World War II developments affecting the demand for and supply of stock issues, including the greater attention paid to inflationary tendencies, growth potentialities, capital gains, and the absence of major cyclical instability.

There is some but not strong evidence that net purchases by mutual funds significantly affect the month-to-month movements in the stock market as a whole; and there is stronger evidence that fund net purchases significantly affect the daily movements in the stock market. The statistical data suggest that this latter effect may be fairly substantial. In connection with the stabilizing or destabilizing effects of mutual funds on the stock market, the funds showed some tendency to trade with rather than against the trend in cyclical movements of stock prices; and this destabilizing tendency seemed to reflect discretionary action rather than the automatic channeling into the market of net inflow of money from shareholders. At turning points, the discretionary action of the funds--except perhaps for the largest funds--tended to stabilize at the lows and destabilize at the highs.

In connection with an analysis of fund activity in thirty individual securities which were mutual fund portfolio favorites, the funds showed a definite tendency to buy on balance in the two months prior to cyclical upswings in the prices of such stocks, and to sell on balance (or to have weaker purchase balances) in the two months prior to cyclical downswings. This lends some support to the hypothesis that fund activity may have been partially responsible for (and may have partially forecast) the major market movements in these issues. Mutual funds as a whole may to some extent have the ability to fulfill their own market predictions, and in particular, to validate their own appraisal of individual issues. There was more evidence of destabilizing behavior by mutual funds in individual issues than in the market as a whole, particularly within market declines.

With respect to portfolio company control, despite the growth of large holdings of mutual funds, outright control of portfolio companies by these organizations is a rarity and is confined mainly to small portfolio companies. Mutual funds with large holdings exercise varying degrees of influence over portfolio companies, but neither the extent nor character of their influence appears to be such as to warrant serious concern. These funds have generally evidenced approval or disapproval of portfolio company management and policies by buying or selling portfolio company securities, rather than by attempting to sponsor or participate in movements for management reorganization.

In an analysis of the relationships between investment advisers and mutual funds, it was found that the effective fee rates charged the funds tend to cluster heavily about the traditional rate of 1/2 of 1 percent per annum of average net assets, with approximately half of the investment advisers charging exactly this rate. This concentration around the 1/2 of 1 percent level occurs

more or less irrespective of the size of a fund's assets managed by an investment adviser, although operating expenses of the adviser were found to be generally lower per dollar of income received, and also lower per dollar of assets managed, as the size of a fund's assets increased. When the advisory fees were measured against the investment income of the mutual funds, the median percent of such income paid out in advisory fees in fiscal 1960-61 by a representative group of mutual funds was 16.3 percent.

For comparable asset levels, advisory fee rates charged mutual funds tend to be substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies. Nevertheless, it was found that the expenses involved in advising mutual funds were less than those incurred in advising other clients. Advisory fee rates of mutual funds also tend to exceed substantially the effective management costs of mutual funds which do not retain investment advisers. Advisory rates to mutual funds were found to be less flexible in relation to size of assets managed than rates charged other clients; they were also less flexible than the effective management costs of mutual funds without advisers.

These findings suggest that the special structural characteristics of the mutual fund industry, with an external adviser closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates. Other clients have effective alternatives, and the rates charged them are more clearly influenced by the force of competition. Individual mutual fund shareholders do not pay higher management fee rates than they would incur through other institutional investment channels (which, however, normally do not involve a substantial sales charge). Nevertheless, they do not generally benefit from the lower charges that the volume of their pooled resources might be expected to make possible. Mutual funds without advisers were found to have relatively lower and more flexible advisory costs--a situation which may be attributable, at least in part, to conventional limitations on salary incomes (as opposed to payments to external organizations).

The sale of mutual fund shares has been the principal means of expanding the volume of assets managed, and such increases automatically produce increases in the dollar amounts of management fees (with four out of five advisers charging flat management fee rates) and more brokerage business to distribute. The report raises the question whether there may be a conflict of interest between a mutual fund's shareholders and the fund's investment adviser as regards the effort that should be devoted to selling shares. While the benefits to the

adviser of more or less indefinite growth by intensive sales of mutual fund shares are fairly obvious, the benefits to a fund's shareholders from such indefinite growth are not equally apparent where the management fee rate is not scaled down with increases in the size of the fund. In this connection, it may be noted that there is a significant positive correlation between the size of the sales charge and the rate of inflow of new money into the individual funds.

The disposition of brokerage business by mutual funds is also a source of possible conflict of interest between controlling management groups and fund shareholders, particularly where the controlling management group is affiliated with a broker. Valuable services can be obtained in return for awarding brokerage, and when the brokerage is absorbed by the controlling management group, the fund's shareholders may receive no quid pro quo in return.

It was also found that the sale of mutual fund shares by broker-dealers is the most important factor influencing the brokerage allocations of the numerous mutual fund groups selling their shares in volume through independent dealers. These mutual fund groups frequently engage in so-called give-up transactions, in which executing brokers are instructed to pay to other brokers a portion of their brokerage commission. Give-ups are more extensively used by the larger funds which frequently have brokerage commissions available for their disposition after the acquisition of various services from brokers such as the receipt of investment advice, daily quotations, and other services. For these larger funds, 60 percent of the brokerage is commonly viewed as at the disposal of the fund's management. The extensive use of brokerage for rewarding dealers who sell the fund's shares raises the question, as in the case of the diversion of brokerage to affiliated brokers, whether there is a return of value to the shareholders in this type of arrangement. The widespread use of give-up transactions suggests that the structure of regulated commission rates on brokerage transactions may be significantly lacking in flexibility with respect to large transactions.

Data for the study were obtained initially by means of a comprehensive questionnaire which was mailed in December 1958 to all active registered management open-end companies with gross assets of over $1,000,000.[6] This questionnaire covered the 5-3/4

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6 See Investment Company Act Release No. 2729 (June 13, 1958).

year period from December 31, 1952, to September 30, 1958. In 1960, the study was enlarged to include various aspects of the organizational, operating, and financial relationships existing among the mutual funds and their investment advisers and principal underwriters. This additional area of study was surveyed by means of a second questionnaire, covering the year 1960, which was mailed in December 1960 to registered open-end companies and their investment advisers and principal underwriters.[7] Both questionnaires were prepared by the Wharton School in collaboration with the Commission and its staff, and reflected various technical comments and other suggestions made by the National Association of Investment Companies, predecessor of the present Investment Company Institute. Industry information from published sources has been used to update some of the questionnaire material.

Very truly yours,

/s/ Irwin Friend

IRWIN FRIEND
Securities Research Unit

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7 See Investment Company Act Release No. 3169 (December 29, 1960).