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A STUDY OF MUTUAL FUNDS

Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce

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REPORT

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

Pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resolution 108, 87th Congress

SUBMITTED BY MR. HARRIS, CHAIRMAN

AUGUST —, 1962.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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87TH CONGRESS 2d Session } HOUSE OF REPRESENTATIVES { REPORT No. ——

WHARTON SCHOOL STUDY OF MUTUAL FUNDS

AUGUST —, 1962.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HARRIS, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

The Committee on Interstate and Foreign Commerce, by House Resolution 108, acting as a whole or by subcommittee, was authorized to investigate and study the adequacy of the protection to investors afforded by the disclosure and regulatory provisions of the various securities acts. Such authorization continues that made to the committee for many years.

Your committee and its Subcommittee on Commerce and Finance, under the chairmanship of Mr. Mack, again have been active in the consideration of the current situation in the securities markets and of the adequacy of the protection afforded to investors and to the public by the various securities acts which now are on the books. Last year, for reasons set forth in the committee report (No. 882, 87th Cong.), it seemed to the subcommittee that it was highly appropriate again to review the rules governing the activities of the various securities markets to see whether they are adequate to protect investors, to determine just how they are being administered by the exchanges and the over-the-counter associations, and what changes, modifications, or expansions of the rules or statutes might be desirable in the public interest.

Accordingly, the subcommittee sponsored, the committee approved, and the Congress enacted legislation directing the Securities and Exchange Commission to make such review and to report to the Congress by January 3, 1963 (extended to April 3, 1963), the results of its study and investigation together with its recommendations, including such recommendations for legislation as it deems advisable (H.J. Res. 438, Public Law 196, 87th Cong.).

The Commission already had initiated, through the Wharton School of Finance and Commerce, a study of the mutual fund industry. This study now has been transmitted to the Commission, and covers a description of the structure of the industry, the growth of investment companies, the performance and market impact of the funds, and the relationship between the funds and their investment advisers. It does not cover certain aspects of the industry which are under further study. It perforce does not purport to reflect the views or recommendations either of the Commission or of the committee.

Obviously a study of the growth of the mutual fund industry during the past 25 years and its impact upon the securities markets, both in the substantial share it represents of securities distributed over the counter and in the tremendous portfolio it possesses of both listed and unlisted securities, is of great significance to an understanding of today's securities markets.

In view of the timeliness of this study, therefore, it is being submitted herewith as a report for the information of the Members of the House and of the general public.

LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 27, 1962.

Hon. OREN HARRIS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

SIR: In accordance with your request, I am transmitting a report prepared for the Commission and entitled "A Study of Mutual Funds" by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania.

The study was undertaken pursuant to section 14(b) of the Investment Company Act of 1940 which authorizes the Commission from time to time "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 * * *." Pursuant to such authority, the Commission engaged the Wharton School to make a fact-finding survey of certain aspects and practices of open-end investment companies or mutual funds. The report transmitted herewith is the result of the Wharton School's undertaking.

The publication of the study should not be construed in any way as a reflection upon or criticism by the Commission of the investment merits of mutual fund shares, of the investment company as an important vehicle for investment, or of any particular company. Neither should it be assumed that certain critical comments in the study with respect to particular practices or conditions in the industry necessarily imply that they are contrary to the requirements of the Investment Company Act of 1940 or that they are within the regulatory scope of that Act.

The Wharton School study is the most comprehensive analysis of the mutual fund industry since the Commission's study made prior to the adoption of the Investment Company Act of 1940 more than 20 years ago. As such, it deserves careful consideration and analysis by all who are interested in that industry. This is the more true because the tremendous growth in number and size of the mutual funds during that period has resulted in an expanded and significant role for the mutual fund industry in the securities markets, as a competitor for the public's savings, and in the economy as a whole. It is obvious both from the study and from our own experience that the mutual fund industry is important and is becoming more so. Mutual funds as a medium of investment have enjoyed widespread acceptance, particularly among smaller investors. The offering of mutual fund shares for some years has been a major factor in the new issue market. The Wharton study for the first time expresses in a comprehensive manner the growing potential of the funds in relation to market activity and to the affairs of portfolio companies.

The mere statement of the volume of capital, most of it from smaller investors, being managed by the funds and their advisers emphasizes the importance of a careful scrutiny of all aspects of the industry from the point of view of investor protection. It seems appropriate therefore to refer to certain matters both within and without the context of the study which are pertinent to its consideration and evaluation by the Commission, by members of the industry and indeed by all persons having an interest in the industry.

Many of the practices of which the Wharton School appears critical may be attributable to an industry structure which is clearly contemplated by the Investment Company Act of 1940. Implicitly, however, many of the comments in the study, particularly as reflected in chapters I and VIII, raise questions of broad policy whether some of the practices and patterns which originated in an earlier time and under different conditions and which have become conventional within the broad tolerances of the Act should be reconsidered.

For example, the study in commenting upon the typical management structure of the industry under which a significant part of the funds' activities are performed by affiliated organizations such as advisers, underwriters, and brokers, who control or are represented on the boards of directors of the funds, draws attention to the potential for divided loyalties arising from these arrangements.

Questions are raised by the study as to the relationship or lack of relationship between the growth, size, and performance of funds, and sales commissions and other sales incentives. Attention is also directed to the relationship or lack of it between growth, size, and performance of funds, on the one hand, and, on the other hand, advisory fees and costs of operation of the funds and of the advisers, including fees charged by advisers to other clients. The study questions whether the apparent historical emphasis upon constantly increasing fund assets by intensive sales efforts has always been in the interest of fund investors. The employment of special inducements to sales efforts, particularly in the case of the so-called penalty-type contractual plans, reflects an emphasis on sales not necessarily consistent with the best interests of the investor. The study comments upon the role of and in general questions the effectiveness of the "unaffiliated" directors of the typical fund.

The Wharton School has explained that there are many investment company matters which it has not studied and which it was not intended to study. Some of these, such as sales techniques, the adequacy of training and supervision of salesmen, and the possible use of inside information by those closely affiliated with investment companies, are already the subject of inquiry.

The Wharton School study is a report to the Commission and not by the Commission. It reflects the compilation by the Wharton School of economic data supplied by members of the industry at the Commission's request. Although it would be premature at this time for the Commission to attempt an evaluation of the conclusions and comments in the study, it is apparent that the Commission's rules under the 1940 Act and indeed some of the provisions of the statute itself may require reassessment. The Commission accordingly has directed its staff to undertake a detailed analysis of the study with the view to making such recommendations as may seem appropriate.

This will of necessity require consideration in some respects of material being developed in related Commission studies now in progress. The Commission hopes that members of the industry will engage, as its staff is doing, in a careful evaluation of the study to the end of attaining the highest possible standards and promoting continued public confidence in the industry.

To the extent that the data compiled by the Wharton School may not be entirely adequate for a proper exploration of some of the questions raised by the study, it is anticipated that further inquiry, including possible hearings on particular issues and consideration of the policy questions mentioned above, will be conducted as part of a comprehensive program of study by the Commission with a view to determining and formulating such legislative, rule, and enforcement proposals, if any, as may be desirable and thereafter reporting to the Congress.

The Commission currently is engaged, pursuant to the direction contained in the Mack resolution (H.J. Res. 438, Public Law 196, 87th Cong.), in a study of the rules governing the activities of the various securities markets to see whether they are adequate to protect investors, to determine just how they are being administered by the exchanges and the over-the-counter associations, and what changes, modifications, or expansions of the rules or statutes might be desirable in the public interest. The Commission is to make such study and report to the Congress from time to time, with a final report by April 3, 1963 (H.R. 11670, Public Law 561, 87th Cong.).

Obviously a study of the striking growth of the mutual fund industry during the past few decades, and of its impact upon the securities markets, both in the substantial share it represents of securities distributed over-the-counter and in the tremendous portfolio it possesses of both listed and unlisted securities, is of great significance in an understanding of today's markets.

In view of the timeliness of the Wharton School study, it seems appropriate that it be available for the information of the Members of the Congress and of the general public.

By direction of the Commission:

Respectfully,

WILLIAM L. CARY, *Chairman.*

LETTER OF TRANSMITTAL

UNIVERSITY OF PENNSYLVANIA,
WHARTON SCHOOL OF FINANCE AND COMMERCE,
Philadelphia, August 9, 1962.

SECURITIES AND EXCHANGE COMMISSION,
Washington, 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 the Commission's "Report on Investment Trusts and Investment Companies" (1939–42).[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.

[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.

[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.

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 nonfinancial institutions as well.

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 2 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

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

of the funds. About half of the funds performed better, and half worse, than such as 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 stockholdings 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 U.S. 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 U.S. common stocks; the remaining assets were found to be spread fairly evenly among U.S. corporate bonds, U.S. 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 U.S. common stocks were equal to approximately 3½ percent of the value of all stocks listed on the New York Stock Exchange.[6]

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

[6] The corresponding figure was over 4½ percent as of December 31, 1961.

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 30 individual securities which were mutual fund portfolio favorites, the funds showed a definite tendency to buy on balance in the 2 months prior to cyclical upswings in the prices of such stocks, and to sell on balance (or to have weaker purchase balances) in the 2 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 one-half of 1 percent per annum of average net assets, with approximately half of the investment advisers charging exactly this rate. This concentration around the one-half 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 million. This questionnaire covered the 5¾-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. 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.

The study was initiated under the joint direction of Dr. Irwin Friend, professor of economics and finance, and Dr. Willis J. Winn, professor of finance. Shortly thereafter, Dr. Winn was appointed dean of the Wharton School and was able to continue only in an advisory capacity.

Although the responsibility for the contents of this report rests solely with the Securities Research Unit, many valuable suggestions were made by members of the staff of the Securities and Exchange Commission. The Unit is particularly indebted to Allan F. Conwill, Director, and J. Arnold Pines, Chief Financial Analyst, of the Commission's Division of Corporate Regulation. The Unit also wishes to express its appreciation for the many helpful comments and other assistance provided by members of the mutual fund industry.

Very truly yours,

IRWIN FRIEND,
Securities Research Unit.