ES7 0494

S7-27-03

#67

Joseph A. Zelson
44 Morwood
Creve Coeur, MO 63141

December 5, 2003

-17j-1-
- considering
and b. dist
m. f. holdings

Mr. William Donaldson, Chairman
SEC Headquarters
450 Fifth Street, NW
Washington, D.C. 20549

Re: Mutual Funds

Dear Mr. Donaldson:

As a part of the financial industry, I feel very uncomfortable with the disclosures of greed and arrogance of some of the Mutual Fund Managements. Recently I was at the graduation ceremony of one of our grandchildren from high school, and I noticed that the school has a motto "Be nice; and do the right thing". I suspect that there is no way that we can make that a requirement for Mutual Fund Management organizations, but I believe we are faced with the problem of encouraging them to "do the right thing".

Along those lines, I am also sure that there is a limit to what the SEC can require without a certain amount of Congressional backup. In view of some of the news releases that the "spin doctors" have come up with and the Funds who have conducted themselves questionably (if not illegally), perhaps the SEC has the ability to establish some disclosure requirements which hopefully would have a favorable and meaningful effect.

Since the SEC has been criticized for apparently failing to be aggressive enough in their oversight of Mutual Funds, here are a couple of suggestions which, if implemented, would be consistent with the philosophy of regulation of the Securities business by requiring <u>disclosure</u>:

1. Require that the Prospectuses <u>disclose the compensation</u> of all Portfolio Managers and Officers of the Mutual Fund companies.
2. Require that all Portfolio Managers report to the Mutual Fund Management Companies' Compliance Officer at least quarterly on all Investment activity of theirs and members of their direct family including any Trusts. This requirement could even exempt Investments in Mutual Funds of the Management Company from this reporting requirement, except as to frequency.

Disclosure has magical effects!

It is my understanding that some Mutual Fund Management Companies prohibit their Portfolio Managers from maintaining outside Investment accounts. I don't know the compensation levels of Portfolio Managers, but assuming that their compensation is in the millions of dollars, the temptation for them to use their position of knowledge and special information to make significant profits in an outside personal investment account could be irresistible to some.

In addition, to the extent that these above-mentioned requirements would undoubtedly raise complaints fro Fund Managements that "they're not necessary", the Fund Managements have had the opportunity to police themselves and based on what's already been discovered, and what in my opinion, has not or even will not be discoverable, their protests should be ignored in view of their past opportunities.

It is also interesting to note that the disclaimers and reports issued by the Management Companies are very carefully worded. Example: Putnam's letter of November 2003, which you will notice, is silent on a number of points:

1.) They apparently do not prohibit their Portfolio Managers from maintaining outside personal investment accounts;
2.) Individuals known to be involved in the timing trading may still be employed by Putnam – they used the words "are no longer managing money at Putnam"

It would seem to me that Portfolio Managers who are compensated as handsomely as I expect that they are should be removed from temptation as much as is practical and possible.

And, it's my opinion that the SEC's failure to act promptly and decisively is likely to result in Congress stepping in; and we both know the results of Congressional solutions to problems (ala the recent Prescription Drug Plan).
Thank you for consideration.

Sincerely yours,

Joseph A. Zelson, ChFC

Enclosure: Putnam letter

One Post Office Square
Boston, Massachusetts 02109

PUTNAM INVESTMENTS

NOV 1 7 2003

November 6, 2003

Dear Putnam Investor:

You may have seen reports in the press about investigations involving Putnam. We are writing to provide you with an update on these events and the steps being taken to address them. Putnam Investments and the Trustees of the Putnam Funds take these issues with the utmost seriousness. Ethical conduct and investor trust are the foundation of our business.

The administrative actions that have been brought against Putnam by the Securities and Exchange Commission (SEC) and the Massachusetts Securities Division involve market timing in Putnam funds. Market timing refers to the frequent trading of fund shares, often in order to take advantage of pricing inefficiencies, and may affect the returns of investors who buy and hold shares for the long term. Putnam has had procedures in place to identify and control market timing. These systems were not perfect, but they did identify, and enable us to stop, the vast majority of market timers in Putnam funds.

Both the SEC and the Massachusetts actions include allegations regarding what appears to be [redacted]als. We want to state emphatically that such conduct has no place at Putnam, and that [redacted]ed in the SEC and state actions [redacted] at Putnam.

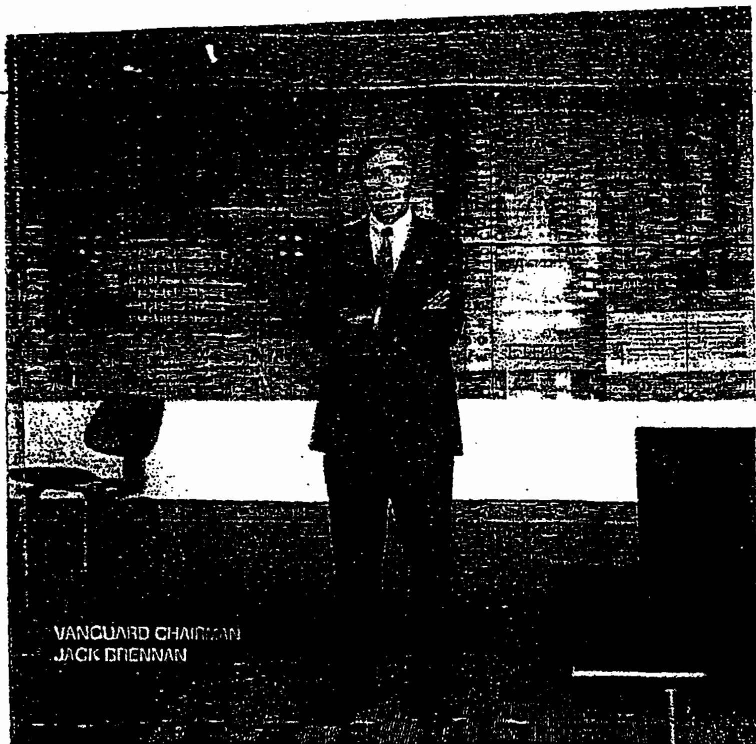
[redacted] NO prohibition AND ARE STILL EMPLOYE

In addition, the Massachusetts action includes allegations about market timing by plan participants in some Putnam-administered 401(k) plans. In one plan in particular, Putnam faced difficulty curbing the activity of a small group of individuals, and the trading persisted until recently, when Putnam closed the funds in question to all plan participants.

We want to communicate to you the steps Putnam and the Board of Trustees are taking to address these matters:

- **Reimburse the funds.** At this point, we have no reason to believe these activities resulted in significant financial harm to shareholders. Nevertheless, Putnam has pledged to make full restitution to the funds for losses resulting from improper market timing activity either by Putnam employees or within Putnam-administered 401(k) plans.
- **Independent review of all controls and procedures.** The Trustees of the Putnam Funds are conducting a comprehensive and independent review of all these matters and will determine the amounts necessary to reimburse the funds. In addition, Barry P. Barbash, a former director of the Securities and Exchange Commission's Division of Investment Management, has been hired by Marsh & McLennan Companies, Putnam's parent company, to conduct a review of Putnam's trading policies and controls. He will make recommendations to ensure that Putnam operates in accordance with the highest professional and ethical standards.

(over)



VANGUARD CHAIRMAN
JACK BRENNAN

Vanguard
"Do the right thing"

Like Fidelity, Vanguard is contacting all of its trading partners "to make sure they are enforcing our rules," says chairman **Jack Brennan**. "We don't expect to ever be able to let our guard down. You close a window on these people [rapid traders], they try to come in through the door." One of the steps Vanguard is exploring: preventing rapid or large traders from making exchanges between funds on the same day. In such a "split exchange," a speculator could sell one Vanguard fund today, but he could not buy another until tomorrow. ■ Brennan worries that rapid trading may be a bigger problem than the fund industry has publicly admitted. "I've heard [fund executives] try to rationalize why they tolerate market timing in their funds," he says. "I think it's more common than I thought." Vanguard, like Fidelity, has done an internal investigation to see if any rapid trading had been permitted. "I have great confidence" that Vanguard is clean, says Brennan. Although Vanguard has many mechanisms to prevent fast trades, including redemption fees and fair-value pricing, Brennan thinks that "the most important defense is cultural." He explains: "The day you start here as a new employee, you meet with one of the 10 most senior executives. We tell you, 'We have a simple code of ethics: Do the right thing, and you know what that is. The difference between right and wrong is black and white. If you think there's any gray area, you won't last long here.'" —J.Z.

charge less. But hundreds of actively run funds—including many from such leaders as **American Century**, **American Funds**, **Fidelity**, **T. Rowe Price** and **Vanguard**—also come in under those ceilings. (Is it ever worth paying a whisker more? Only if a fund observes the rest of the 10 Commandments religiously.)

Whenever you invest with a fund company that brags about beating the market, you are gambling that the manager can keep outperforming. It's one of the fund industry's best-kept secrets that the Securities and Exchange Commission allows a manager to raise fees when a fund beats a benchmark—but only if the manager cuts fees when it underperforms. That leads the manager, just like you, to risk real money on whether the fund can keep beating the market. And how many fund companies are willing to take that risk? According to data from Lipper, out of 15,836 stock and bond funds with a total of $4.3 trillion in assets, only 407 funds, with $435.8 billion, carry these "performance incentive fees." The vast majority of the fund industry refuses to bet alongside its own customers. Among the major fund companies that do charge incentive fees, and deserve a vote of confidence for it, are Fidelity, **USAA** and Vanguard; several smaller firms, including Bridgeway, **Numeric** and **Turner**, also use them.

2. THOU SHALT SUP AT THINE OWN TABLE In 1998 the managers of the Kaufmann fund told MONEY that they kept virtually none of their money in their own fund, preferring municipal bonds instead. Sadly, that attitude remains all too common. Instead of investing alongside you in the portfolios they run, many fund managers keep most of their cash elsewhere. (We can only wonder how many CEOs of rival companies might secretly be stashing their own money in Vanguard's lower-cost funds!)

Portfolio managers often invest the bulk of their net worth not in the funds themselves but in the management company that runs them. That gives them a greater stake in fattening the management fees *on* the funds than in maximizing the investment returns *of* the funds. [redacted]

But when the fund managers are themselves the biggest shareholders in their funds, they are highly likely to think like investors—because they are. As Robert Rodriguez of the **FPA** funds says, "When you own a lot of your own funds, you focus on growing your assets in a rational manner for the long term instead of getting greedy for the short term." Bridgeway, **Davis**, **FPA**, **Longleaf** and **Tweedy Browne** are among the smaller firms whose funds are owned largely by managers and directors. Unfortunately, the SEC has not yet required fund managers to disclose the amount of their individual holdings. But the "statement of additional information," a supplement to the prospectus, must list anyone who holds at least 5% of a fund's shares.

and may voluntarily disclose the extent of ownership by insiders. An emphatic statement by the manager in a press interview or on the fund's website — "I have all my money in this fund" — is another good sign. A few companies, including Bridgeway and Longleaf, have also stated officially that they do not permit personal stock trading by portfolio managers.

3. THOU SHALT NOT BE A GLUTTON It's like a broken record: Little fund gets hot, fund company promotes performance, fund goes cold. Small funds have the flexibility to buy a carefully selected group of small stocks, keep brokerage costs low and make sure the portfolio gets lots of attention. But when hundreds of millions of dollars pour in too fast, the manager often has to chase bigger stocks that are no longer cheap, hiking brokerage costs and saddling him with far more stocks than he can study thoroughly. That hits performance like a bucket of ice water, prompting many of the new investors to turn around and leave. As finance researchers Joel Dickson, John Shoven and Clemens Sialm have shown, this cycle of new money gushing into — and out of — a fund can trigger excess capital-gains taxes for the long-term investors.

While asset elephantiasis is bad news for outside investors, the fatter management fees on the swollen assets are great news for the manager. No wonder most fund companies can't bring themselves to close their funds to new investors before the returns for their existing investors are crippled.

If you're shopping for a fund that specializes in U.S. blue-chip stocks, asset elephantiasis is a minor concern, since size is no hindrance for such portfolios. But any fund that invests in smaller or foreign stocks can quickly get too big for your good. So it's important to buy such funds only from companies that have shown the courage to close them before it's too late. A few small firms, like **Bogle**, Bridgeway, Numeric and Longleaf, have had the guts to slam their funds shut. But even such major outfits as T. Rowe Price and Vanguard have closed funds well before they got too big. The prospectus, the fund company's website or its telephone representatives should tell you about past and present closings.

4. THOU SHALT NOT BOAST Just as Groucho Marx is said to have joked that he wouldn't want to belong to any club that would have him as a member, you should look for funds that are not desperate to have you. If the most important thing to a fund's managers is signing up new investors, that's a sign that they care more about increasing their own fee income than about improving your investment results.

Instead, you want a fund run by people who soft-pedal their past returns and keep future expectations realistic. An excellent way to see how the managers think about performance is to go back and read the fund's report from year-end 1999; it should sound notes of caution, not blasts of bravado.

Research by economists Michael Jones, Vance Lesseig and Thomas Smythe shows that funds whose advertisements promote hot returns tend to have higher risk and higher expenses, "which may produce a negative effect

The Scandal: Janus

Janus Capital is having one very long, very bad hair day. The Denver fund shop rocketed in the late '90s as its aggressive bets on tech and telecom produced staggering returns. But when tech stocks crashed in early 2000, Janus' fortunes followed. Losses mounted, investors fled and recently several talented fund managers departed.

The latest entry in Janus' catalogue of miseries, of course, is the allegation by New York State attorney general Eliot Spitzer that the company effectively sold to one hedge fund the right to make frequent jumps in and out of its mutual funds. (Janus prospectus materials explicitly prohibit this practice, known as timing.)

In fact, Janus has acknowledged that up until July of this year — when the subpoenas began arriving — it had "discretionary arrangements" that allowed at least 12 investors to use the funds for timing (although only four actually did so). And the company has said that at least seven funds (rather than just the two cited by Spitzer) were made available for timing, including Mercury, High-Yield Bond and Overseas. Janus says it has ended all such relationships, and promises both to pay out to shareholders all fees it earned from the timing activities and to make restitution to any shareholders found to have been harmed.

But these promises of payback — and the company's efforts to downplay the financial significance of the "discretionary arrangements" — fail to address the fact that by making special deals with market timers Janus betrayed its shareholders, putting its own financial interests ahead of theirs. Janus Capital CEO Mark Whiston has declined to talk to reporters about the deals, and the company's official statements appear to imply that its departed fund managers were responsible for the deals; at least one of them has sharply denied the suggestion.

An old journalists' maxim holds that "when they tell you it's not the money, it's the principle — it's the money." In fact, Janus' "discretionary arrangements" probably didn't cost any shareholder more than pocket change. This time, for once, it is the principle. — MAGGIE TOPKIS

JANUS CAPITAL CEO MARK WHISTON