Funds' Risk Changes at Disclosure Times, Study Finds

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NEW YORK -- For investors in the $7.5 trillion mutual fund industry, is what you see really what you get?

For years, speculation has circulated in the industry that some fund managers "improve" their portfolios by dumping more speculative investments and loading up on more presentable ones right before they disclose their holdings to investors twice a year.

The industry's main interest group, the Investment Company Institute, has argued that rumors of "window dressing" are greatly exaggerated, and the Securities and Exchange Commission has never found enough evidence to bring a case asserting that kind of deception.

But a new study suggests that the practice may be quite common in bond funds, which account for $1.6 trillion of the industry's holdings.

Academics at Pace University and Wake Forest University found that bond funds load up on government holdings during disclosure periods but put more of their money into riskier, higher-yield corporate bonds in periods when they don't have to tell the public what is in their portfolios.

The study, which used data from a quarterly survey of funds conducted by the research firm Morningstar Inc., found the effect was particularly pronounced in corporate high-quality bond funds, which put 40.6 percent of their holdings into government bonds during disclosure periods, on average -- but only 35.6 percent during non-disclosure periods, said co-author Matthew R. Morey, a finance professor at Pace.

"They're buying government bonds right before disclosure periods," he said. "It makes them look safer than they are."

The portfolio manager benefits in two ways -- the fund gets a lower risk rating by holding government bonds during disclosure periods, yet it gets higher-than-expected returns because of its investments in riskier corporate bonds.

Investors are misled and may also receive lower returns than they would have without the last-minute churn because the fund has to spend extra money buying and selling its holdings, according to some academics.

"Investors are not getting a fair idea of what is happening," said Bentley College finance professor Leonard Rosenthal.

Sean Collins, an economist for Investment Company Institute, said there are legitimate reasons for bond funds to load up on government bonds at particular times of the year. Interest rates, which affect bond values, tend to fluctuate sharply both in late December, when the U.S. calendar year ends, and in late March, when the Japanese year ends, two times when many funds disclose their holdings. As a result, fund managers may increase government holdings to reduce their exposure to uncertainty, he said.

Collins said the institute believes that most portfolio managers quickly conclude that window dressing is not worth the trouble. "Is the average investor really going to notice this?" Collins asked.

SEC officials say revamping a portfolio just for public disclosure would constitute fraud, but they add that it is hard to prove that a fund manager was selling bad stocks or bonds or buying good stocks or bonds for improper reasons.

"We're on the lookout for window dressing . . . but you've got to get inside the portfolio manager's head and find a smoking gun, like an e-mail," said Paul F. Roye, director of the SEC's investment management division.

Wake Forest finance professor Edward S. O'Neal, the study's other author, said that SEC staff members who had seen a presentation of the study asked him to identify funds with the most striking trading patterns and that he identified about eight funds for them.

There haven't been any good studies recently on the subject of window dressing in stock funds, academics said, but a four-year-old study found evidence that stock fund managers used another technique to dress up their holdings at key times.

This end-of-quarter activity, generally called "portfolio pumping," involved managers who went into the market in the last minutes of a quarter or a year -- say five minutes before the markets close on Dec. 31 -- and bought shares in stocks they already owned to push up the closing prices of those shares.

The study, which looked at hot stock funds over a five-year period, found that they generally had their best days on the last day of a reporting period, such as a quarter, and their worst days on the first day of the following period. As a result, investors suffered because their funds were buying stocks at artificially high prices and potential investors were misled by slightly inflated reported prices, one of the authors, University of Pennsylvania finance professor David K. Musto, said in an interview.

"The whole idea is that investors would be focusing [on fund results] at the end of the quarter," Musto said. The effect is stronger in the funds that are fighting for a top ranking, and less pronounced in underperforming funds for which a short-term bump would have little impact on customer opinion, the study said.

This kind of last-minute buying binge is easier to prove because trading records can be used to show how the stock purchases drove up the price. The SEC has brought a couple of enforcement actions in recent years, Roye said. In 2001, Oechsle International Advisors and the brokerage firm ABN Amro and two key employees agreed to pay a total of $550,000 to settle allegations after the portfolio manager was caught on tape complaining, "It's hard to do, uh, this window dressing when markets suck."

Academics said they believe window dressing also occurs in money market funds, but so far there has been no clear harm to investors. Money funds tend to invest in short-term instruments and change their holdings frequently. Therefore, they simply buy more stable and higher-quality investments right before a reporting period, and don't incur unnecessary transaction costs.

Money funds also have a tradition of protecting investors from getting back less than they put in if a fund's higher-risk investments go bad. In 2001, five fund families bailed out their money market funds when they were caught holding worthless utility company debt during the California energy crisis, and Strong Capital Management did the same thing for three of its funds in 1991 when Mercury Finance defaulted.

It's virtually impossible for most investors to detect window dressing, but industry experts said high turnover in a fund's holdings -- more than 100 percent in a year -- is one clue that the fund might be making unnecessary purchases and sales.

SEC officials hope a rule adopted in February will cut down the incentive for window dressing and make it harder to do. Mutual funds will be required to disclose holdings quarterly rather than just twice a year, making it harder for managers to dress up portfolios for public consumption.

"If they have to do it four times a year, maybe that will discourage them from doing it at all," Roye said. All the last-minute buying and selling "is detrimental to performance. It can't be a winning strategy."