THE WALL STREET JOURNAL.

http://www.wsj.com/articles/SB105207969873142900

MUTUAL FUNDS MONTHLY

Can You Answer This Question: Who Owns Your Mutual Fund?

Key Players Are Directors and Adviser, But Investors Are the Ultimate Owners

By **JOHN SHIPMAN** Dow Jones Newswires
Updated May 5, 2003 12:07 a.m. ET

To a great many investors, a mutual fund may as well be a black box.

Most know that mutual funds hold stocks, bonds or money-market securities. People put money into the box with the expectation that their outlay will increase in value, though for the past three years, stock-fund investors have learned that isn't necessarily the case.

But beyond that, many investors would probably be hard-pressed when asked to describe the structure of the investment vehicle that about 93 million fund shareholders have entrusted with more than $6 trillion of their savings.

What most may not know is that each mutual fund is actually a separate company whose key components consist of its board of directors, an investment adviser and a group of shareholders, who are the company's owners.

Under the Investment Company Act of 1940, funds are organized and regulated as investment companies. Similar to other operating companies, funds have directors elected by shareholders. But unlike most companies, they have nearly no employees.

Instead, the board is responsible for contracting with various third-party providers to obtain the myriad services that make up the operation of a fund -- from maintaining records on how many shares each holder owns, to the professionals who select the securities for the fund's portfolio.

According to the Investment Company Institute, the industry's largest trade group,

MORE 'FUND'AMENTALS

- Pick Your Fund: Hedge or Mutual (/articles/SB104646888939113600) (03/02/03)
- Getting the Most From Fund Costs (/articles/SB103975414255974433) (12/2/02)
- Adding Up the Cost of Your Fund (/articles/SB103705645927042454) (11/4/02)
- ETF Spells Indexing to Many (/articles/SB103100172624824035) (9/3/02)

directors are responsible for five main areas: performance evaluation, contract approval, fee approval, pricing of fund shares and oversight of portfolio management and compliance issues.

In each of those functions, the board's ultimate focus is that of a watchdog protecting the interests of the shareholders. The shareholders are in a unique position because in addition to being the fund's owners, they are also its only customers.

That is significantly different from other companies where the board is focused on the company's profitability and providing a return on investment for shareholders.

Fund boards have also been required to include a majority of independent, or noninterested, directors, and under changes adopted by the Securities and Exchange Commission in recent years, independent directors are required to be nominated for their board seats by other independent directors. The definition of "independent" is fairly loose when it comes to fund board members, however.

An independent director can't be an employee of the fund investment adviser or a member of the immediate family of an employee. Other restrictions also apply. But former employees of the fund's investment adviser or the adviser's affiliates are considered to be independent when it comes to serving on a fund board. So, for example, Joseph S. DiMartino, who was president of Dreyfus Corp. for a dozen years before becoming chairman of the fund boards for the Dreyfus fund group, is considered an independent director.

The independence of directors is seen as key to deciding issues in which the interests of the shareholders differ from those of the investment adviser. A case in point is that fund directors are required to negotiate a management fee with a fund's investment adviser. Obviously, a high fee benefits the adviser, but paying higher-than-necessary fees eats into shareholders' returns.

In theory, the board is able to choose any adviser it deems appropriate to invest the fund's portfolio, based on the adviser's investing style, track record and fees. However, in practice the investment adviser picked to manage the portfolio is most often an affiliate of the investment-management company that sponsors the fund.

For example, Boston's Fidelity Investments, the nation's largest fund firm, has a unit called Fidelity Management & Research Co., which manages most of its portfolios, even though Fidelity's fund board, which oversees all of its funds, has the authority to go anywhere to find an investment manager. Most large fund companies follow similar models, and they also have other affiliates that handle the marketing and distribution of their funds.

Investor Warren Buffett generated attention earlier this year for critical comments on the independence of fund directors included in the annual report issued by his holding company, Berkshire Hathaway Inc. "A monkey will type out a Shakespeare play before an 'independent' mutual-fund director will suggest his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance," Mr. Buffett declared in the 2002 report.

Others think Mr. Buffett is off base. If directors began dumping investment advisers more frequently in favor of those with better performance, there would be a revolt on the part of investors, argues Mercer Bullard, a former SEC attorney and founder of the shareholder advocacy group, Fund Democracy. "Investors choose a fund precisely because they want a specific adviser," Mr. Bullard explained. An increase in management turnover would run counter to the wishes of the shareholders, he believes.

Mr. Bullard agreed that directors should be negotiating harder on fees charged to shareholders; however, the law sets a low standard, he said, in that it states fees only need to be considered "reasonable" by directors.

Directors have also been catching some flak over their compensation, which some consider excessive for what is technically considered part-time employment.

According to the consulting firm Management Practice Inc., of Stamford, Conn., directors' pay at the 50 largest fund companies increased by 8% in 2002, to a median of $113,000, which some find objectionable given the losses suffered by investors in recent years. Mr. DiMartino of Dreyfus Funds received $815,938 last year for chairing the boards of 191 funds, according to SEC filings.

Selecting who will actually manage a fund's portfolio is the most important task of a fund's board. The managers are required to see that the portfolio assets are invested described in the investment objectives contained in the fund's prospectus. The board and adviser sign a contract with the board spelling out those investment duties and setting compensation.

In most cases, management fees are based on a percentage of the fund's average net assets during certain periods, such as annually or each quarter. Incentives also can be added for achieving certain performance goals.

While the managers selected to run portfolios are often affiliated with the company sponsoring the fund, that's not always the case as firms can farm out the investing chores to other firms, called "subadvisers." One firm that makes a regular practice of picking investment managers outside its own shop is Vanguard Group of Malvern, Pa. In addition to its internally managed index fund portfolios, Vanguard, the nation's No. 2 fund company as measured by total fund assets, has a number of actively managed portfolios run by outside managers.

Jeff Molitor, director of portfolio review at Vanguard, said that hiring outside managers is "a distinct cost advantage," and also provides "true diversity of thought" in terms of employing a variety of portfolio managers with different styles and investment processes.

The final component of the mutual fund is, of course, the shareholders who ultimately own the portfolio's holdings. It's their need for a professionally managed investment vehicle that provides a market for these products, and the board and investment adviser are, at least in theory, accountable to the shareholders.

However, fund shareholders rarely exercise their rights as owners, and therefore by default they must rely on the independence of their fund boards to protect their interests.

Initially the sponsors or those who incorporate the mutual fund as an investment company choose members of the board, who serve for terms of indefinite length. Director vacancies may be filled by a board vote and without a shareholder vote until the ratio of directors elected by shareholders falls below two-thirds. At that point, seats can remain vacant or shareholders can be asked to fill vacancies. But if the number of directors elected by shareholders falls below half the board, shareholders must be asked to vote on the entire board.

Typically fund boards don't wait for that to happen, according to Tom Lemke, an attorney with Morgan Lewis in Washington, D.C., who specializes in investment companies. For example, when funds ask shareholders to vote on policy or other changes, such as an elimination of an investment restriction, it's standard to also include a vote for board members, resulting in shareholders often being asked to vote for directors more frequently than required by law, Mr. Lemke said.

MUTUAL FUNDS MONTHLY

Why did I ever buy that stock in the first place? It is a question that plenty of investors have asked themselves. A Mosaic portfolio manager never has to scramble to remember his original rationale.

See mutual-funds data for April

Leaders and Laggards
How Largest Funds Fared
Performance Yardsticks

Write to John Shipman at john.shipman@dowjones.com