

Statement of Don Phillips
Managing Director, Morningstar, Inc.
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Government Sponsored Enterprises of the
Committee on Financial Services
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Thank you for the opportunity to appear before this distinguished Committee. My name is Don Phillips and I am a Managing Director of Morningstar, Inc., an independent investment research firm that provides data and analysis on a variety of investment vehicles, including mutual funds. Morningstar was founded in 1984 and today employs over 800 people covering more than 100,000 investments worldwide. In excess of 150,000 individual investors and 50,000 financial planners subscribe to our services in the U.S. alone. In addition, there are over two million registered users of our investment web site, Morningstar.com.

We currently cover mutual funds in 17 different countries. As such, we've seen how the fund industry has evolved in different settings with various structural and regulatory approaches. As a general rule, funds are structured in one of two ways, contractually or as corporations. When the contractual approach is deployed, the party writing the contract (the fund management company) predictably skews the contract in favor of its interests rather than of those of the investor who signs the contract. Not surprisingly, mutual funds have struggled to earn the public's trust in markets where the contractual format has been used.

The United States has long embraced the corporate structure of funds management, which is why the industry is governed by the Investment Company Act of 1940 (1940 Act), not by an Investment Product or Investment Services Act. In the U.S. and other countries where the corporate structure has been embraced, funds have enjoyed great success. The reason is clear: The corporate structure places investors' interests first. This spirit is captured in the preamble of the 1940 Act, which states that funds are to be "organized, operated (and) managed" in the interests of shareholders rather than in the interests of "directors, officers, investment advisors, ...underwriters, or brokers."

The beauty of the corporate structure is that it places the investor at the top of the pyramid. An independent board of directors is created to uphold shareholder interests and to negotiate an annual contract with the money manager to provide services to the fund and its shareholders. As defined by the 1940 Act, the fund management company is not the owner of the fund, but rather the hired hand brought in to manage the assets in the interests of the its shareholders. Clearly, this is a structure that goes out of its way to prioritize and protect the interests of fund investors.

While today's fund executives live by the letter of the 1940 Act, they don't always embrace its spirit. Go to any industry gathering and you will rarely hear investors referred to as "shareholders," and even less frequently as "owners." Instead, they are "customers." In the vernacular of today's industry leaders, fund management companies are "manufacturers" of "products" that are sold through "distribution channels," such as "mutual fund supermarkets," to "customers" who operate, presumably, on the premise of buyer beware. In effect, today's fund leaders have inverted the relationship envisioned by the framers of the 1940 Act. Rather than being at the top of the pyramid, fund investors today find themselves at the bottom of the food chain. Tellingly, one of the fund industry's major debates in recent years has not been how to serve shareholders better, but "Who owns the customer, the manufacturer or the distributor?" In an era where the hierarchy of the investor has been so altered, it is perhaps not surprising that investor protection has lapsed.

Despite these issues, it is our opinion that the mutual-fund industry is neither inherently corrupt nor in need of a major structural overhaul. While the boundaries may need to be clarified, it is not necessary to organize a whole new playing field. The vast majority of people in the fund-management industry, as in any line of work, are honest and hard working. Collectively, they provide a valuable service to the American public. Moreover, the U.S. fund industry does have a good long-term record of serving investors. This record owes not to the superior moral nature of fund executives, but rather to the industry's high level of transparency that has been brought about by the corporate structure of funds. To the extent that the industry has lost its way in recent years, we believe that it is a function of its leaders losing sight of the spirit of the 1940 Act. The profitability of the fund management company or its employees must never take precedence over the interests of fund shareholders.

In Morningstar's opinion, H.R. 2420, also known as the Baker Bill, aptly sought to bolster the 1940 Act. Its adoption, especially in a strengthened version, would go a long way toward better protecting the 95 million shareholders who put their faith in mutual funds. As for other issues this committee might consider in its efforts to protect investor interests, Morningstar would like to submit the following four principles as a possible path toward restoring the public confidence in mutual funds—a confidence that has been badly battered in recent months.

1. Apply the Same Disclosure Standards to Investment Companies as to Publicly Traded Operating Companies

If mutual funds are indeed corporations, let's treat them as such. Unless there's a compelling reason to draw the lines differently, there's no good reason to treat publicly traded investment companies (mutual funds) any differently than publicly traded operating companies (stocks). However, because equity shareholders have historically had a louder voice than have fund shareholders, it's not surprising that disclosure standards for stocks remain far higher than those for funds in many areas. It's time for someone to speak up for fund shareholders and level the playing field. This Committee has an opportunity to do just that.

For fund investors to know if their interests are aligned with management's, it's imperative for them to know what their manager's incentives are. Every week, we speak with mutual fund portfolio managers who tell us that before they buy stock in a company, they look to see how management is compensated. They want managers who "eat their own cooking" and who's interests are aligned with theirs. That's why institutional equity managers have long demanded and received detailed information on the compensation and holdings of company stock of senior corporate executives. Indeed, equity investors would protest loudly if this information were denied to them. Why then are fund shareholders not given the same insights into their funds?

Consider the case of a manager's holdings or trades in his or her fund. An equity investor has access to detailed information on the purchases, sales, and aggregate holdings of senior executives and other insiders at an operating company. Stunningly, fund investors are denied access to the very same data about the managers of their funds. While it's easy to appreciate why management might not wish to provide such data, it's hard to argue why an investor shouldn't have the right to see it. Indeed, such sunlight might well have been beneficial in the recent cases of four Putnam portfolio managers or Strong Fund's chairman Richard Strong, who have been accused of market timing their own funds. Can you imagine these executives engaging in such actions if they knew that it would become public information that they were trading so rapidly? Sunlight, indeed, is the best disinfectant.

Not only is there no trading record for managers in their own funds, but even the aggregate investment a manager has in his or her own fund is shielded from the fund shareholders' view. While any equity investor can see how many shares Bill Gates owns in Microsoft, there's no way for a fund investor to see if his or her manager has any "skin in the game." In the wake of the recent fund scandals, several mutual fund portfolio managers have stated publicly that because they invest heavily in their own funds, the kinds of trading abuses seen in other shops would not happen at theirs. This statement is a virtue that any fund manager can claim, but none has to prove. Why would such information that has long been disclosed on corporate insiders, not be available on fund insiders? It's time to level the playing field.

The same principle applies to management compensation and the incentives it creates. Disney shareholders know to the penny what Michael Eisner is paid to run their

company. Like all holders of publicly traded stocks, they receive a statement from the compensation committee with their annual proxy materials outlining how the committee has structured the CEO's pay and on which metrics his or her bonus is based. Indeed, it is not uncommon for these materials to include a CEO's entire employment agreement. Given the high level of disclosure on operating companies, it is hard to reconcile why no disclosure whatsoever is provided on fund executive compensation.

Fund investors do not know if their manager's bonus is tied to short-term, quarterly returns or to rolling five-year returns, to pre-tax or post-tax returns. If the manager's pay is linked to pre-tax returns, surely a manager will be less likely to be concerned about the tax consequences of his or her decisions. How can this not be material information to an investor considering placing a fund in either a taxable account or an IRA? In addition, one would hope that a fund manager's compensation is tied to fund performance rather than a fund's asset growth. A manager's incentive should be to manage, not to sell. But, with no compensation disclosure, how can a fund investor be sure?

2. Bring More Visibility to the Corporate Structure of Funds and the Safeguards it Provides

The typical fund investor is largely unaware of the corporate structure of funds. Few investors in, say, Fidelity Magellan think of themselves as the owners (alongside their fellow shareholders) of the fund. Instead, they think that Fidelity owns Magellan and they merely purchase its services. It's a notion that the fund industry doesn't discourage. Indeed, funds do little to draw attention to their corporate structure or to the role of the board of directors. In fact, the names and biographical data of fund directors are not even included in many fund prospectuses, but instead are relegated to the seldom-read statement of additional information.

To remedy this situation, Morningstar suggests that each fund prospectus begin with an explanation of the fund's corporate structure, such as the following:

When you buy shares in a mutual fund, you become a shareholder in an investment company. As an owner, you have certain rights and protections, chief among them an independent board of directors, whose main role is to safeguard your interests. If you have comments or concerns about your investment you may direct them to the board in the following ways...

By bringing more visibility to the fund's directors and by alerting shareholders to their role in negotiating an annual contract with the fund management company, the balance of power may begin to shift from the fund management company executives where it now resides to the shareholders and directors where it belongs.

It's not surprising that independent directors have been subservient to the needs of the fund management companies, rather than to shareholders. Directors have far more contact with management than they do with fund shareholders. Indeed, several years ago I met a director who served on the board of many funds at a large fund complex. He also

served on the board of a Fortune 500 company. He told me that while he received a dozen or so letters a month from shareholders concerning the public company, he had never in more than 10 years received a letter from a fund shareholder. How can fund directors represent shareholder interests if there is no communication between the two groups?

We'd suggest three more things regarding fund directors. First, we believe it is highly beneficial, if not essential, that the chairperson of the fund board be an independent director. While in U. S. operating companies the chairperson and the CEO are often the same, there exists a conflict of interest in funds that does not exist in operating companies. In an operating company there is only one party to which directors, be they independent or not, owe their loyalty—the stockholders. In a mutual fund there are two parties to which the non-independent directors owe their allegiance, one is the fund shareholders, the other is the stakeholders in the fund management company. Only the independent fund directors have a singular fiduciary responsibility to fund shareholders. Accordingly, it stands to reason that fund shareholders are best served when an independent chairperson oversees their fund.

Our second suggestion would be that this independent chairperson be responsible for writing to fund shareholders in the fund's annual report to address the steps the board takes each year in reviewing the manager's performance and the contract that the fund has with the fund management firm. By bringing to light these important review functions, one assures that the structural safeguards of the investment company will work in practice as well as in theory.

Third, we'd advocate a stronger role for fund directors in reviewing all communication between the fund management firm and fund shareholders, including marketing materials designed to attract new investors. The fund's communications and marketing message should effectively communicate the fund's investment strategy and the potential risks it may incur. The better an investor understands a fund, the more likely he or she will use it effectively.

3. Insist that Fund Management Companies Report to Fund Shareholders as They Would Owners of the Business

While the above steps begin to address shareholder reporting, there is particular room for improvement in the way that costs are communicated to investors. If one were reporting to an employer on how much of the boss's money had been spent and what it had been spent on, the expectation would be for a full and candid disclosure that quickly conveyed the actual cost to the owner. If there were multiple owners, the costs would be divided so that each owner could quickly see the dollar cost he was incurring. That's not the case with mutual funds. Funds state their costs in percentage terms, not dollars, and they state them as a percentage of assets entrusted to the manager, not in terms of the percentage of the investor's potential gain that has gone to management fees—potentially a far more relevant number.

For example, an investor with \$300,000 in a bond fund is currently told that his fund has an expense ratio of 1.5%. However, if an investor expects bonds to return 5% per year over the course of his investment horizon, that 1.5% expense ratio in reality reflects a 30% annual toll on the likely returns he will receive from their investment. While establishing expected returns for asset classes is problematic, it's clear that the real toll of fund fees is dramatically understated (1.5% versus 30%) in the way funds currently report them to shareholders. One solution, as contemplated in the discussions surrounding the Baker Bill this past summer, is to simply state that a \$300,000 investor in a fund with an expense ratio of 1.5% will face a bill for asset management services of approximately \$4,500 per year. As Vanguard founder John C. Bogle has already told this committee, this calculation could be easily estimated by multiplying a shareholder's end-of-period account balance by the fund's expense ratio and printing this figure on the investor's annual account statement.

For many middle-class Americans, mutual-fund management fees are now one of their 10 biggest household costs, yet the same individual who routinely shuts off every light in their house to shave a few pennies from their electric bill is apt to let these far greater fund costs go completely unexamined. Getting these fees stated in a dollar level that corresponds with an investor's account size is an important first step. We have truth-in-lending laws that detail to the penny the dollar amount a homeowner will pay in interest on his mortgage, isn't it time for a truth-in-investing law that would bring the same commonsense solution to mutual funds, the retirement vehicle of choice for a whole generation of Americans?

Of course, as this committee has previously heard from Mr. Bogle, stated fund expenses are only part of the bite investors face when they buy funds. There are also transaction costs and hidden soft-dollar charges that are hard for even the most astute investor to get her arms around. The Baker Bill took the appropriate steps in seeking to address these issues. Fund investors deserve to see how their money is being spent. Costs should be broken down into investment management costs, operational costs, and distribution costs, including "pay-to-play" arrangements with distributors. We'd like to see the expense ratio broken down into the preceding three parts and see a new transaction cost ratio that combines brokerage costs and the frictional costs of trading added to fund statements. While there are aspects of such a ratio that would require industry discussion, any attempt to give investors a truer sense of the full costs they pay would be a step closer to reporting to owners in a manner consistent with their position as owners.

4. Ensure That All Shareholders Are Treated Fairly

Our final point is one that we wouldn't have thought needed to be raised six months ago, but in the wake of the recent fund trading scandals, it has become a significant issue. Funds face a challenge in trying to serve concurrently the interests of traders and long-term investors. While most funds promote themselves as vehicles for long-term investing, their daily valuation and liquidity options make them targets for active traders, such as market timers. There's nothing wrong with funds serving either audience, but as recent events make clear there are times when it is difficult to serve both together.

The most basic answer to the trading challenges is to remove the potential for arbitrage in mutual funds. Traditionally, funds invested primarily in domestic blue-chip stocks and investment-grade bonds—highly liquid securities that started and stopped trading at essentially the same time. Today’s funds, however, trade in everything from U.S. micro-cap stocks to Asian private placements—securities that often do not lend themselves to ready pricing at 4 p.m. Eastern time. Clearly, the SEC and the industry need to adopt fair policies to ensure long-term investors that their interests can’t be undermined by traders who exploit these opportunities for arbitrage. The desires of a few must not undermine the rights of the many.

In addition to fair-value pricing policies, it is worth considering the implementation of higher redemption fees for short-term trades. From our conversations with fund managers, it is clear that they believe that redemption fees are the best deterrent to market timers. Of course, a fee is only effective if it is enforced. We think funds must be much less lax in waiving fees for bigger accounts or for 401(k) plans, and that directors should be informed when and under which conditions these fees may be waived. In addition, we support a hard close for mutual fund pricing. If a trade order is not in the fund’s possession by 4 p.m. Eastern time, it should be transacted at the next day’s price. This may mean some funds will become less attractive to some investors, but over time both parties—traders and long-term investors—may be better off by parting ways. In either case, funds need to be clear which audience they serve. If a fund pledges to act in the best interests of long-term investors, it must find a way to eliminate the potential damage that can be done to them by short-term traders.

Collectively, legislators, regulators, and the industry can rebuild and preserve the public’s trust in mutual funds by putting stronger structural elements in place that better align fund management company interests with those of fund shareholders. By bringing more visibility to the corporate structure of funds and by leveling the playing field between publicly traded operating companies and investment companies, this Committee can demonstrate to American investors that mutual funds will continue to operate on one of the cleanest, best-lit playing fields in all of finance. The industry doesn’t need a wholly new set of operational rules or new oversight groups, it simply needs to be held accountable to both the letter and the spirit of the rules that have guided it well for decades. We believe the simple improvements suggested here can help keep the industry focused on its ultimate mission—helping investors meet their goals and secure a safer future for their families.