

# **Emerging from a Crisis:**

**The mutual fund industry and the stock market**

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# Canary in a Coal Mine

- ❖ Canaries were used to test the air in coal mines
- ❖ Canaries were sent into the mine, if they emerged, then it was safe to enter
- ❖ What do we learn from the Canary today?
- ❖ How will the mutual fund industry emerge from the darkness of the current scandal?



# A Market in Crisis

- ❖ Bull Market in Wall Street Scandal

  - ❖ Enron, Tyco, Investment Banks, Martha, NYSE, ...

- ❖ September 3, 2003

  - ❖ New York Attorney General Eliot Spitzer files a complaint alleging mutual fund trading improprieties by Canary Capital Management LLP

    - ❖ Market Timing

    - ❖ Time Zone Arbitrage

    - ❖ Late Trading



# The Dilution Impact of Daily Fund Flows on Open-end Mutual Funds

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*Journal of Financial Economics*

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# Example: No market timer

## Day 0

Risky assets            \$100

Cash                            \$0

Net assets                 \$100

Shares                            10

**NAV                            \$10.00**

## Day 1

Risky assets            \$110

Cash                            \$0

Net assets                 \$110

Shares                            10

**NAV                            \$11.00**



# Example: With a market timer

## Day 0

Risky assets            \$100

Cash                            \$10

Net assets                    \$110

Shares                            11

**NAV**                            **\$10.00**

## Day 1

Risky assets            \$110

Cash                            \$10

Net assets                    \$120

Shares                            11

**NAV**                            **\$10.91**



# Mutual Fund Dilution

- ❖ Fund traders contribute cash
  - ❖ Cash can be invested in risky assets after a lag
- ❖ If fund traders are skilled
  - ❖ Cash dilutes positive risky asset returns
- ❖ Skill can be expected in international funds, but domestic funds are generally a “fair game”
  - ❖ Stale prices
  - ❖ International funds typically set their end-of-day prices (NAVs) using closing prices from the home exchange, which are usually hours *stale*



# Industry in Crisis

- ❖ In the weeks after the initial complaint, numerous fund families were named
  - ❖ Many funds had “arrangements” with timers
  - ❖ More far-reaching than the initial complaint
- ❖ Reports of investors fleeing named funds
- ❖ A vast majority of the allegations have been directed at domestic funds
  - ❖ Why?
  - ❖ Are there stale prices in domestic funds?



# Late Trading

- ❖ Prices are “stale” to a late trader
  - ❖ “Yesterday’s horse race”
- ❖ Allegedly, intermediaries provided late-trading facilities to some traders
  - ❖ Retirement plans and other order processors normally submit good orders at night
    - ❖ Traders apparently gained illicit access to the system
  - ❖ Security Trust Corporation ordered to shut down

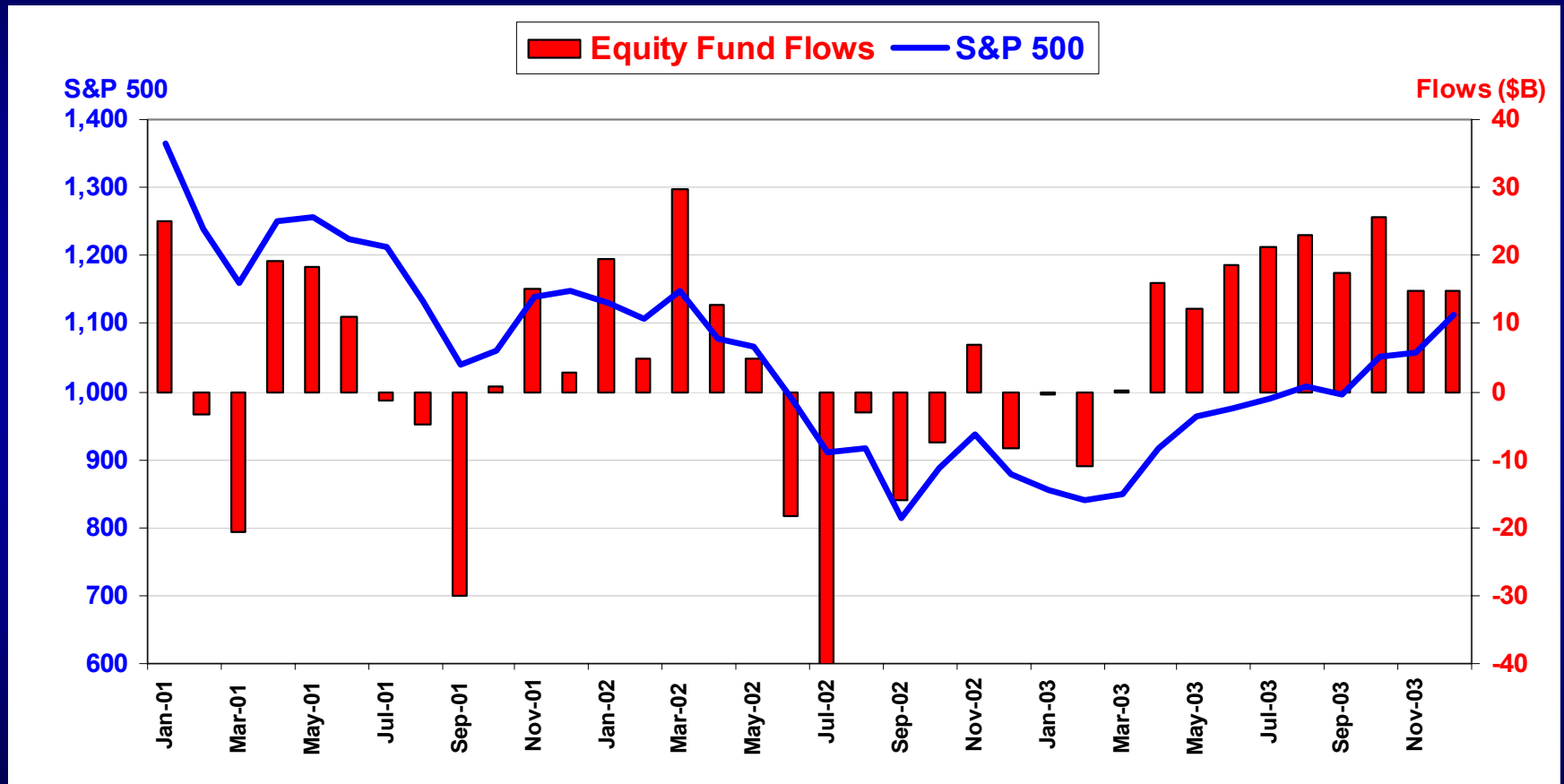


# Emerging from the Crisis

- ❖ How far-reaching is this scandal?
  - ❖ Watch for the Canary to emerge
    - ❖ Alliance Funds settlement
    - ❖ MFS Funds settlement
    - ❖ Federated Funds
  - ❖ Instances other than Canary are isolated?
- ❖ Solutions
  - ❖ SEC Proposal: All orders must be received by the mutual fund by 4:00 PM
- ❖ How will the industry weather this storm?



# Fund Flows and the Market



# Outlook

- ❖ The mutual fund industry will emerge from the crisis with stronger regulation and scrutiny
- ❖ The industry will remain the primary access point to the markets for many households
- ❖ Flows into stock funds will continue reflect investors' confidence in the market

