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Study: Market Timing May Be On the Rise

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By Peter Ortiz

Market timing may be on the rise, putting long-term investors at risk, as funds continue to rely too heavily on intermediaries to thwart this activity, a new study by the Coalition of Mutual Fund Investors claims.

Federal regulators need to examine "hidden mutual fund accounts that have served as a haven for improper arbitrage activities and other abusive short-term trading," the study states.

"Who Is Watching Out For Mutual Fund Shareholders?" compares the years leading up to the market-timing scandal, 1999 to 2003, and activity that occurred from mid-2007 to February 2009. From 1999 to 2003 the rolling average of mutual fund redemptions and exchanges (when shares are exchanged, versus sold, from one fund to another within the same fund family) as a percentage of average net assets was between 34.8% and 45.6%, according to the study. That compares to a rolling average range of 23.2% to 28.8% from January 2004 to June 2007. And from mid-2007 until February 2009 that rolling average ranged between 24.9% to 35.96%.

The author, Niels Holch, executive director of the Coalition of Mutual Fund Investors, acknowledges that recent market volatility bears some responsibility, but says that an increase in redemptions from mid-2007 to February 2009 should prompt funds to seriously look into whether greater market-timing activity is taking place.

"We have to be concerned because it was at a level similar to the pre-scandal period," says Holch.

Market timing involves quick trades in and out of funds in order to take advantage of inefficiencies in the way funds set their net asset value. It can increase a fund's trading costs, which in turn can dilute returns for long-term shareholders. While market timing is not illegal, Eliot Spitzer led a crusade against funds over abusive market timing and late trading in 2003, and since then regulators and the industry have enacted measures designed to guard against these practices.

The study analyzes data from the Investment Company Institute, the fund industry trade group, and uses the same analysis that John Bogle, founder of **Vanguard**, used when he presented a report to Congress in 2003, Holch says. But critics charge there is no conclusive evidence that points to increased market timing and that there are strong incentives for funds to guard against market timing, including protecting their reputations.

The industry is doing a good job in monitoring for market timing, and there are many other reasons for an increase in redemptions, critics of the study say. The ICI and other critics also charge that the study does not factor in a crucial part of the market-timing equation — purchases — that are necessary for the round-trip transaction.

Holch admits that looking at redemptions alone is not a perfect measure. But because it is impossible to match purchases and redemptions from information on the ICI website, he contends that using purchasing data would not add much value in the analysis. He also contends that funds are not taking full advantage of the tools available to combat market timing.

"The problem with monitoring shareholder flows is the fact that hidden accounts from financial intermediaries are not disclosed to funds, leaving fund personnel only able to evaluate aggregated data that is of limited usefulness in uncovering abusive short-term trading activities," writes Holch, who has long sought greater monitoring of market-timing activity in omnibus accounts. (Omnibus accounts combine shareholders' or brokers' trades into one large order and obscure individual trades, thus making it more difficult to determine whether market timing is occurring within the account.)

Sean Collins, senior economist with ICI, counters that redemptions may be on the rise not because of market timing, but due to concerned investors, for example, moving money out of stock funds and into bond funds or money market funds.

"The bottom line here is there obviously is good reason redemption rates would have gone up, and they don't necessarily have anything to do with abusive market timing," Collins says.

Eric Zitzewitz, associate professor of economics at Dartmouth College, contends that the ICI has a valid point in that analyzing redemptions alone does not indicate that market timing is on the rise. But he says the study also should be of concern to funds and their boards and should prompt further review. Zitzewitz has previously published papers on the impact of market timers upon mutual fund investors.

"Fund boards should still be looking very hard at flow data to make sure none of this is an increase in arbitrage," Zitzewitz says.

Holch has argued that funds do have Rule 22c-2, or the redemption fee rule, put in place after the timing scandal, which allows them to demand that financial intermediaries turn over certain types of shareholder identity and transaction information. He reiterates his concern in this study, saying that funds are failing to take advantage of this tool to glean details of individual shareholder activity in omnibus accounts. Holch cites his own group's examination of prospectuses from 50 major fund shops that fail to require "regular disclosure of transaction and customer identity information from these hidden accounts."

"This is a significant lack of oversight by the funds, as more than 50% of all fund shares are transacted through intermediaries which control these hidden accounts," Holch writes. "This means that many funds are not able to apply prospectus policies and procedures to a majority of their individual shareholders."

Don Boteler, vice president of operations for ICI, says there is no evidence that funds are not actually making sufficient use of Rule 22c-2. In addition, there are several ways that funds have gained more transparency, including reviewing daily sales reporting feeds from broker-dealer firms where funds can see every transaction. The ICI also has worked with the industry in developing other tools that help funds better detect market timing, such as, the client data share service, which increases transparency of omnibus accounts. Another tool allows funds to request transactional data from counterparties and intermediaries in an automated fashion and for intermediaries to respond with requests for data in that fashion as well.

"Fund companies on their own are monitoring trading activity, and if they see anything unusual in trading patterns they will investigate," Boteler adds.

Jeff Keil, principal at **Keil Fiduciary Strategies**, says that while there could be an increase in market timing, the study overstates the unwillingness or inability of fund groups to identify timing. He also notes a much different environment in the post-Spitzer era, where funds have greater incentive and tools to address market timing.

While the ICI is correct in saying the industry has taken steps to reduce arbitrage opportunities, those efforts are "far from bulletproof," Zitzewitz says.

"I think he [Holch] is making a valid point in saying, 'Hey, these ratios are going up,'" he says.

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