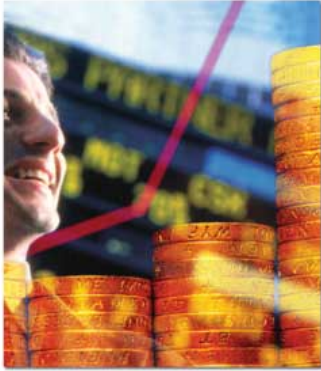


Econ 103 Money and Banking – Dr. Douglas Rice Week 8 Lecture – Mutual Funds



As we had a big week I will keep this short.

This week we are discussing mutual funds and security operations. Both topics interrelate with regard to the overriding concern of conflicts of interest. There is a conflict of interest when A isn't doing what they are supposed to be doing for B because they have been influenced by a third party C. The conflict is almost always centered on money, or should I say greed for money, as they have plenty of money yet still want more.

Anyway, this conflict is seen throughout the recent scandals. The accountants want your consulting business so the audit that is supposed to protect the public and investors is done with less care than it should be. The analysts that are supposed to put out unbiased recommendations to their customers and the public are biased toward companies that they have or want to have investment banking relationships with. The mutual fund industry is biased in how they vote proxies because they want the 401K business from the firms they own. The advisors are biased in recommending mutual funds to clients because some funds pay more in commissions to the advisors. The CEO's and other executives with large stock options undertake actions to get the stock up prior to option expiration knowing that those actions will not keep the stock up long term. They just increase the value until they can get out. Enron executives touted their own stock to employees while they themselves were selling it. And the list goes on and on and on.

The news was filled with scandals and troubles related to the stock market. We have CEO's indicted for everything from insider trading to tax evasion, accounting firms going bankrupt, company after company restating earnings and adjusting results that were thought to be audited and sound. Even Martha Stewart went to jail! The government responded with the Sarbanes Oxley act providing new laws regarding securities transactions. There were many elements to this act and here is a summary of the implications:

Implication and other notes from Sarbanes-Oxley

SEC

- Former SEC Chairman Harvey Pitt was ousted in an ethics scandal and was replaced by William Donaldson, founder of DLJ. Pitt is now back as a consultant in Washington, DC.
- Requires Companies to disclose if they have a code of ethics and what is in the code.
- Budget increase from \$650 in 2003 to \$835 in 2004 with 500 new employees.

Wall St.

- Can't delete emails or face 20 years in prison
- Mutual funds must disclose proxy votes.

Accounting

- Create a 5 member accounting oversight board
- Original Chair William Webster, former CIA head, resigned in scandal over his position on a board that was part of an accounting scandal. Replaced by William McDonough, President of the NY fed.
- Prohibits nine types of consulting services and mandates the lead partner on the account change hands every five years.
- Preservation of email and auditing docs for five years or jail time.

Companies

- Must state when their earnings announcements aren't using GAAP (vs. Proforma)
- Company executives can't sell if more than 1/2 of employees also are in black out period.
- Disclose all material off balance sheet transactions and relationships
- Lawyers must report suspected fraud to company executives or board.
- Must set up an independent audit committee and designate one person a "financial expert"
- Requires CEO's and CFO's to certify annual reports. They may opt to leave out information but that also opens them up to lawsuits from investors.

I would like you to consider a quote from Warren Buffett, considered the World's Greatest Investor and a man whose integrity is impeccable. He said, "If you want to make a lot of money, go to Wall St. and hold your nose." Wall St. doesn't make money by picking solid investments and holding them. They don't make money knowing the next hot investment trend. They make money off selling things. The sell us services like managing our money, stocks or bonds, etc. They make a fee for every transaction and it doesn't matter if the price goes up or down, they still get paid. In fact, its that pay that really is at the heart of the issue. The pay is so large that the line between ethical and unethical gets blurred for many people. These aren't bad people but for \$10 million a year, who could really say what their recommendation would be on Tyco stock? I bet it would be put in terms that allowed them to keep making \$10 million a year, don't you?



Also, I would like to take a moment to discuss is the global aspects of the equity markets. It is still rather difficult, without the use of ADR's and ETF's, to trade in other markets outside the US. But the good news is that there are ample ADR's, ETF's and mutual funds linked to foreign securities. So investing overseas is, for the most part, relatively easy. However, it is not without risk. There are all of the obvious risks in any equity but international equities add the risks of currency and country.

The old adage goes something like this, "add international stocks to your portfolio and reduce your risk while increasing your return." Your text will provide a correlation discussion and the need for foreign equities to be added to a portfolio to diversify risk. Well, I am not in a position to contradict that but I would like you to look at the major international markets over the last five years. They all pretty much move with a high correlation. Essentially, they are all in the tank. This doesn't dispel the theory totally but it does show that there is a good question about the need to diversify internationally. It may no longer be what it once was. That may not be easily seen by the average investor listening to an advisor that professes the theory based on market conditions long ago, especially if they don't look at the current situation.

