

## Safe as mutual funds

**The simplicity and the steadiness of American investments – in happier days**

**Duncan Campbell-Smith**

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Any book on American finance whose title has a Rise but no Fall looks insouciant this month, to say the least. Let us hope that Matthew P. Fink is right to sound an optimistic note. His history of mutual funds in the United States ends before the current crisis in the markets, which last month saw the mutual funds industry teeter alarmingly before being shored up by unprecedented support from the US Treasury. Any alternative was simply deemed in Washington to be unthinkable – which accords nicely with the author's view in *The Rise of Mutual Funds* that they have grown over several decades into an indispensable mainstay of household savings in America. Nowhere does Fink draw an explicit contrast between the (so far) successfully regulated history of US mutual funds and the whizz-bang trajectory of US residential mortgage financing. But none of his readers will need to have this pointed out. Events have made Fink's book, if not its title, very timely indeed.

Mutual funds are vehicles for pooling the money of individual savers into sizeable amounts that can be invested under the guidance of third-party managers. In the United Kingdom, unit trusts are more or less their counterparts. Their critical characteristic is that they allow investors to sell back their shares in the pool at any time, in exchange for a pro-rata fraction of its current net asset value. With this "NAV" advertised in the press daily, mutual funds are permanently exposed to the possibility of heavy redemptions. Their balance sheets have therefore always been kept simple. Unlike hedge funds, they never borrow money in order to invest more of it than their shareholders hand over.

How far any individual fund can reward its shareholders will depend on the markets and the skill of its contracted investment managers. Fink joined the industry's Washington-based trade association, the Investment Company Institute, in 1971 and headed it from 1991 until 2004. His

analysis is less concerned with performances achieved by the several thousand funds (this sustains a small publishing sector in itself) than with the development of mutual funds as fiduciary businesses, judging them by the efficiency and integrity with which they have helped individuals to channel their cash into the markets of their choice. At this, they have been spectacularly successful.

The first mutual funds were set up in the 1920s in Boston, still the true home of the industry. They were deliberately fashioned from the start as a more conservative version of "closed-end funds" which were increasingly popular on Wall Street at the time. These borrowed heavily to ramp up their returns, and their shares were traded on the stock market rather than being directly redeemable with the issuer. All this jarred with the worthies of Boston. One of the early mutual fund pioneers in that city, Paul C. Cabot of State Street Investment Corporation, contrasted the reputation of a typical fund's Boston-based trustee with "the reputation of the slick Wall Street fellows who take the shirt off your back".

The slickers dominated the marketplace for a while longer, with funds that traded at ever higher premiums to their net asset value. But they got their comeuppance in the Great Crash (the one of 1929, that is). Mutual funds fared far less badly, and steadily gained ground on their New York rivals through the 1930s. By 1940, when legislation put the whole investment industry on a modern footing, the mutuals were setting the pace. Their expansion ever since has been an integral part of the growth in US retail investment. The post-war bull market in equities helped the mutual fund industry to amass 10 million individual accounts by 1970.

The massive switch from defined-benefit pensions to defined-contribution pensions based on private plans, fully launched by 1974, helped turn mutuals into a household word: they accounted by 2006 for

about half of all assets in individual retirement accounts. Even when equities suffered bear markets, mutual funds continued growing by offering alternative investments in the US money markets – where any single dollar invested could always be redeemed for at least a dollar, plus any gain. Dedicated money market funds were first launched in 1972, led by the Reserve Primary Fund. By the autumn of this year they controlled assets worth \$3.4 trillion. Not surprisingly, the Bush administration rushed to underwrite their holdings when the Reserve Primary fund “broke the buck” last month, and offered investors just 97 cents on each dollar invested.

Fink recounts his pre-rescue history in elegant prose that is impressively free of jargon. He takes an evident but very gentlemanly satisfaction from the way in which so many of the longest-established players – such as State Street, Putnam, Fidelity and Wellington – have managed to retain their leadership, despite incursions into the sector by insurance groups, big banks and broker-dealers. Above all, he provides an excellent account of the way that mutual funds have been regulated since the 1930s. The record, notwithstanding some trading scandals in 2003–04 which Fink describes perhaps a little too luridly, is a good one. Compared with the excesses of the US savings and loans industry of the 1980s, the exuberant dot.com broking departments of the 1990s and the hyperactivity of the late-departed investment banking houses, the mutual funds industry has been almost squeaky clean.

One reason for this must be the relatively straightforward nature of mutual funds themselves. They have never been products incomprehensible to the layman and requiring contracts a hundred pages long. A second factor, which Fink is too modest to point out, has been the experience and continuity at the head of the industry: he himself is only the second of two presidents at the Investment Company Institute since 1971. But the biggest single explanation for the regulatory success has been the close rapport since 1934 between the trade association and the industry’s statutory watchdog, the Securities and Exchange Commission (SEC). Fink explores this in some detail. He used to think of it, he writes, as the “only ape in captivity” phenomenon: because the zookeeper, the SEC, had pervasive jurisdiction only over mutual funds, it kept trying out the latest regulatory remedies on mutual

funds, while the other great apes, such as bank funds, hedge funds, and so on, roamed free in the wild.

While the vigilance of the SEC and the industry itself has kept abuses of the mutual fund model to a minimum, there remains one potentially alarming aspect of the industry’s growth. Wall Street’s “Dr Doom” economist, Henry Kaufman, pointed out in 1994 that the sheer size of modern mutual funds had given retail investors a new power over the markets, as yet untested by a really prolonged bear market. “The technology is in place”, warned Kaufman, “for a cascade of selling by investors in mutual funds.” Fink quotes the speech in which Kaufman suggested a need for withdrawals from mutual funds to be subject to a two-month or three-month notice period. But he does not refer to it again, beyond noting that Kaufman’s proposal “sits in [the] policy makers’ medicine cabinet and is likely to be brought out in the case of a new financial panic”. As of this week, it remains on the shelf. Optimists will join Fink in expecting the mutuals back soon with another big idea.

Matthew P. Fink  
THE RISE OF MUTUAL FUNDS  
An insider’s view  
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**Duncan Campbell-Smith’s** book *Follow the Money*: The audit commission, public money and the management of public services 1983–2008 was published earlier this year.