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Spitzer Be Damned

What's a better way of keeping fund costs down—lawsuits or plain old price competition? By Michael Maiello

NEW YORK'S POLITICALLY ASTUTE Attorney General Eliot Spitzer forced Putnam Investments and Alliance Capital Management to lower fund fees in the aftermath of the mutual fund market-timing scandals. And he rested his argument on a study by a couple of law professors who showed that fund companies charge retail investors twice as much in fees as they do big pension plans. Inspired by Spitzer, Guy M. Burns, a Tampa attorney, has launched a flotilla of lawsuits against huge fund operators to get them to do a Putnam.

Burns isn't doing as well as Spitzer. He recently bombed out in his suit against American Century mutual funds. (The other suits are pending.) The plaintiffs capitulated, withdrawing their action and issuing an abject statement that American Century is great at client services. The company's court victory seems to show that the fund industry can be pushed only so far when it comes to reducing fees. "The first legal test of Spitzer's theories has fallen flat on its face," crows James N. Benedict, the Milbank, Tweed, Hadley & McCloy attorney who represented American Century.

The lawsuit foundered after Judge Ortrie D. Smith of Kansas City, Mo. wouldn't allow any evidence of American Century's institutional pricing. Maybe part of lawyer Burns' problem also was that his big fat targets—which include Fidelity and Janus—aren't high-cost operations. American Century charges investors 1% a year to run their money. That's less than the average cost of an actively managed fund.

No question, it's cheaper to manage large pools of money than small ones. In their 2001 study, University of South Carolina's John Freeman and Florida State's Stewart Brown contended that, as assets grow at a mutual fund, managers should pass savings along to investors. The fund industry's trade group, the Investment Company Institute, responded that servicing a galaxy of individual fund holders—sending out prospectuses, manning 800-lines and mailing statements—was more costly than handling a few giant pension programs.

On occasion fund companies cut the portfolio-management fee (as a percent of assets) as the portfolio grows. But there is no federal law that compels them to do so.

Between 1993 and 2002 American Century Ultra's assets grew from $6 billion to $24.4 billion, and its fee income kept pace, growing from $60 million a year to $240 million. The expense ratio (portfolio management fee plus that servicing cost) stayed put at 1%. In 2000 American Century offered to shave five basis points off the portion of the fund exceeding $20 billion. Even a revised breakpoint is moot now, with assets down to $15 billion.

American Century contends that money management expenses account for only 15% of the total cost for managing a fund and that the remainder of the fees pay for the overhead. What it should say, a bit more forcefully, is that no investor is being kept in its fund at gunpoint. If you don't like paying 1%, just buy a cheaper fund. F

Milbank

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