Dual Fund Management Can Pose Conflict: John F. Wasik (Correct)

Commentary by John F. Wasik - Nov 27, 2006

(Corrects 19th paragraph to indicate that Vanguard doesn't bar mutual-fund managers from running hedge funds.)

Nov. 27 (Bloomberg) -- There are more than 100 mutual-fund managers who are also overseeing hedge funds. Can they fairly and effectively serve two masters?

While recent academic research provides two different views, there's little question that the dual-management role is rife with conflicts.

Mutual-fund investors have the right to feel slighted. After all, hedge-fund managers are likely to pay more attention to portfolios that are free of stringent regulation when the rewards are sometimes four times greater.

``It's a tough mix, and only managers with high character and integrity can do both," said John C. Bogle Sr., founder of Vanguard Group, the second-largest mutual-fund company, based in Valley Forge, Pennsylvania. Although no longer an executive with the company, which contracts with external dual-fund managers, Bogle sees some glaring deficiencies that haven't been addressed.

Bogle is concerned that the dual managers have conflicts of interest. The main issues? ``Spending more time and effort where the fees and incentives are the largest; deciding how to prorate transactions in the same stocks; and being more conscious of oversight by often face-to-face large investors than usually faceless small mutual-fund investors," he said in an e-mail. ``Those, at least, begin the list."

Greater Hedge Rewards

The pay envelopes in the unregulated hedge-fund world can be lucrative. The average asset-weighted expense ratio of a U.S. actively managed stock mutual fund is 0.89 percent annually, according to Morningstar Inc., the Chicago-based financial-information firm. These fees are what managers are deducting from investors' fund assets every year for their services.

Hedge funds, in contrast, charge an average of 3 percent. Add another percentage point to that bounty

for managers of funds of funds, which group together several portfolios.

Without the legal obligation to disclose what they own on a timely basis, closely hewing to stated objectives or worrying about direct oversight from the U.S. Securities and Exchange Commission, the $1.3 trillion-plus hedge-fund industry knows that it's not subject to the agency's close scrutiny. In addition to the meager regulation, hedge funds can reap 20 percent of fund profits.

Concerned about trading abuses, the SEC said this month it would step up probes into insider trading by hedge funds. Linda Thomsen, the agency's director of enforcement, told Bloomberg News: ``These days, the money is in hedge funds, so the potential for abuse, the potential for securities-law violations is there because there is so much money there."

Mutual Investors Lose

One view is that mutual-fund investors come out as losers when their money manager is also running a hedge fund.

In a study published earlier this year, an examination of dual or ``side-by-side" managers found that the mutual funds underperformed. The research was conducted by Gjergji Cici and Scott Gibson of the College of William & Mary Mason Business School and Rabih Moussawi of the University of Pennsylvania.

``Based on return gaps, which measure the impact of unobservable managerial actions," the study concluded, ``side-by-side mutual funds significantly underperformed matched mutual funds that were not in such relationships."

Measures of returns beating a certain benchmark, called ``alpha," found side-by-side mutual funds were worse off. ``Moreover, consistent with favoritism, side-by-side mutual funds were allocated significantly fewer underpriced IPO shares."

In other words, not only did the mutual funds do worse in a dual situation, they didn't receive as many bargain-priced initial public offerings of new stock to buy.

Mutual Funds Win

The pro-dual-manager school of thought suggests that hedge-fund advisers are motivated by having more freedom trading in a less-regulated environment and that improves their decision-making on the mutual side.

A study published last month found that ``side-by-side mutual-fund managers significantly outperform peer funds, consistent with the privilege being granted primarily to star performers."

That research was conducted by Tom Nohel of Loyola University-Chicago, Zhi Wang of the University of Illinois at Urbana-Champaign and Lu Zheng of the University of California-Irvine.

``Despite the potential for conflict of interest," Nohel says, ``there's no evidence to suggest a loss of investor welfare" for mutual-fund shareholders. The study also showed a slight underperformance of dual hedge managers when compared with a peer group.

Neither study discusses in detail best practices or institutional safeguards employed by money managers. Vanguard, for example, says its advisers are subject to close supervision by the company, internal governing policies, fiduciary obligations under the Investment Advisers Act of 1940 and a code of ethics.

Questions to Ask

``All of Vanguard's external investment advisers are subject to several levels of controls and regulation to ensure that the interests of Vanguard fund shareholders are protected," Amy Chain, a company spokeswoman, said in an e-mail. While Vanguard allows internal managers to run hedge funds, none do so at the present.

Which study should you believe? In either case, keep in mind that returns were examined, and not actual trading.

Since disclosure of portfolio positions is lacking on the hedge-fund side, you should ask the following questions:

-- Do the hedge funds share similar holdings in the mutual funds they manage? If so, which securities?

-- If any ``dual" holdings are noted, do the hedge-fund managers hold derivative positions -- and trade in them -- based on the underlying securities of the mutual portfolios?

-- Are there any trades in the hedge-fund portfolios that would affect the net asset value of the jointly managed mutual funds?

There is no evidence to suggest that any one of the above is taking place, yet the questions need to be asked.

Then there's the even thornier human-nature question of whether managers are focusing their trading skills on hedge funds in hopes of reaping the higher paycheck.

Is it possible that the dual managers would naturally gravitate toward the lesser potential rewards of

the mutual-fund side? Paging Dr. Pangloss.

(John F. Wasik, author of ``The Merchant of Power,'' is a Bloomberg News columnist. The opinions expressed are his own.)

To contact the writer of this column: John F. Wasik in Chicago at jwasik@bloomberg.net.

To contact the editor responsible for this column: James Greiff at jgreiff@bloomberg.net.