

Who's Harry

Meet the most important person in the mutual-fund universe

BY SUZANNE MCGEE • The hottest new presentation in mutual-fund boardrooms is formally titled *Hear My Voice: What a Fund Customer Wants From a Fund Director*. But it might just as well be called *All About Harry*. "Please, don't let some dog manage my money," pleads 'Harry' in the skit, scripted by mutual-fund board consultant Meyrick Payne, a senior

partner at Management Practice Inc. "We don't want to be abused by the [fund managers] spending our money unnecessarily. Sometimes, I worry that the richest people in our community carry a business card which says portfolio manager."

Harry, a fictional blue-collar worker from Ohio with a large part of his family's savings invested in the equally fictional Seminar funds, may be a product of Payne's imagination. But his creator—who actually acts out the skit for clients—argues that Harry's concerns are real, and all-too-easily overlooked.

That state of affairs is unsustainable in the wake of the trading scandals and other misdeeds that have rocked the \$8.1 trillion industry in recent years. Any responsible fund board member, Payne argues, must be able to identify those interests—solid performance, reasonable fees, low costs, strong back-office systems and good governance—protect them and maintain investors' confidence that the system isn't rigged. "The job of a fund director is to make sure that investors like Harry get a fair shake," says Payne. "It means making sure they get the best funds at the best possible price."

So far, much of the push to make boards more effective has focused on ensuring that they are independent. Under a Securities and Exchange Commission rule that was passed last June, 75% of a fund's directors, plus its chairman, must be independent of the management company by the end of this year.

Keeping Harry Happy

What boards should do for fund shareholders:

- Keep an eye out for inflated expenses.
- Monitor conflicts of interest.
- Provide decent service.
- Ensure that there's a fair chance at getting reasonable returns.
- Negotiate fair fees.
- Make sure fund managers don't benefit at shareholders' expense.
- Be certain that everyone is complying with the rules.

The X Factors

But just being independent isn't enough, concludes Sterling Yan, assistant professor of finance in the Department of Finance at the University of Missouri in Columbia.

In a recent study, Yan found that board size and compensation had more to do with how effective a fund board was at keeping fees low and scandals at bay in 2002 than how many board members were independent. Sometimes, too few directors oversee too many funds. And better pay doesn't always result in directors willing to support things investors want. "It wasn't the result we expected," Yan confesses.

In the wake of the scandals, board members will need to find tangible ways of representing the interests of "Harry"

and millions of other investors like him. That may mean investing a significant portion of their own assets alongside those of Harry and his friends. It almost certainly means they will need to monitor carefully the complex issues—such as those linked to trading costs—that can eat into Harry's investment returns. They also must make themselves more accessible and their role more understandable to Harry.

"Everyone understands what a money manager does," says Michael Scofield, a lawyer and independent chairman of the Evergreen Funds, who last fall sent a letter to shareholders spelling out, in detail, how the Evergreen board undertook its responsibilities. "We need to be equally clear—publicly and among ourselves—about what the role of a fund director is. We look out for the customers—the investors—and not for the interests of the fund managers and the shareholders in that management company."

That distinction became blurred in the last decade or so, critics say. "You would talk to a director, and they'd use the word "consumer" instead of "investor" when they described their funds," says Don Phillips, managing director of Morningstar, the Chicago-based fund research company. "They spent so much time with the fund managers in very cozy relationships that they forgot that they are there to represent invisible shareholders."

It's easy to see how that could happen. In the corporate world, the ties that bind managers, directors and shareholders are relatively straightforward. At a company

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like General Motors, for instance, directors are responsible for overseeing the performance of management, but both groups ultimately are accountable to GM shareholders. But each publicly traded mutual-fund complex consists of two sets of shareholders, each with its own distinct interests. One group owns stock in the fund-management company and has an interest in seeing that it generates the highest returns possible. The second invests in the mutual funds and wants them to generate the best possible return. When those interests clash, it's up to the board to represent investors. It's almost as if General Motors had a second board, one charged with representing GM car buyers.

To be sure, there are places where those interests coincide. For instance, both want their funds to generate consistent top-tier performance, albeit for different reasons: investors want solid returns, while fund companies hope to use those returns to attract new assets and boost fees, revenues and profits for their own shareholders. But there are also potential conflicts. Investors don't care whether their management company is able to launch a new fund or attract new assets. Instead, reasonable fees and a keen eye for keeping expenses under control top their agenda. That conflict of interest ended up in the spotlight during the market-timing and late-trading scandals. Embittered retail investors realized how easy it was for their interests to come a distant second to fund companies intent on boosting profits by giving big clients, such as hedge funds, preferential treatment.

"During the boom years, too many fund directors confused the management company's agenda with the interest of shareholders," says Morningstar's Phillips. "As a director, it's not your job to expand the asset base."

What's Needed

But just having independent directors isn't enough. Putnam Investments, one of the fund groups caught up in the scandals, boasted one of the industry's most independent boards.

In the wake of the events of the past few years, a sadder and wiser John Hill, longtime independent chairman of the Putnam board, says directors also must be independent-minded—able to ask questions and demand satisfactory an-

swers, even in the face of recalcitrant or sometimes hostile managers like former Putnam chief executive Lawrence Lasser. (Hill praises Putnam's new management as being "far more open and receptive.") "It's up to directors to prove that they are more effective than the perception of management companies, which may often be that they are a pain...but not a threat," he says.

For Mercer Bullard, assistant professor at the University of Mississippi School of Law and founder of Fund Democracy, an advocacy group, "ornery" is a good character trait for a mutual-fund director these days. "You want to be relentless and somewhat unpredictable," he says. That's just how Arne Carlson, independent chairman of the American Express Funds, describes his fellow board members. That stubborn approach helped Carlson and his colleagues win a battle with fund managers over disclosure.

"The language in our contract used to say we had to ask specifically for information about the funds, but now the obligation is reversed: they have to give us anything that might be relevant and now we are the ones who get to decide what's important and what isn't," Carlson says. "It keeps people on their toes on both sides."

A good fund board is more than a collection of gadflies, or course. Its members must be familiar enough with the ins and outs of money-management, compliance rules and back-office procedures, to raise the right issues for discussion. Many directors, for instance, are starting to scrutinize the way mutual-fund trading desks function, noting that as stock market returns remain lackluster, transaction costs can spell the difference between a fund that is an outperformer and one that is a laggard.

Next month, Evergreen board members will devote an entire day to learning more about ways to ensure that trading desks are functioning as efficiently as possible. "These costs affect returns, and we need to be able to communicate to shareholders that we are protecting their interests on this front," Scofield says.

A number of boards are quietly beefing up their ranks, adding directors able to tackle these complex issues.

The most prized recruits are institutional pension-fund managers or trustees. They have financial expertise and, with their background selecting money man-

agers to run pension money, are the closest a fund board can come to reflecting "Harry's" interests. Putnam lured industry heavyweight Myra Drucker, former director of the General Motors pension fund, onto its fund board last summer, along with Richard Worley, managing partner of Permit Capital. "We wanted to add people who could combine objectivity with a knowledge of how the business works," Hill observes.

An Ideal Candidate

Michael LeRoy, who spent years auditing and evaluating mutual funds as a PriceWaterhouseCoopers partner, is an ideal candidate for a position on fund boards. Now a financial consultant and investment banker with his own Sherman Oaks, Calif.-based firm, LeRoy last fall joined the board of Bjurman Barry funds, a small Los Angeles-based group and is considering taking on other board assignments.

"There aren't many directors out there who understand how the back office of a fund works, how to know if the fund has negotiated a good relationship with its transfer agency, whether its computer systems are secure and whether the internal controls are adequate to prevent fraudulent transactions," he says. "That's what I am trained to do. I can ask the accountants the right questions and spot red flags faster than any commercial banker sitting on that board."

Among their many tasks, fund boards must communicate regularly and directly with investors on issues such as management expenses, fees, returns, or even, as Evergreen's Scofield did, simply spelling out how the board tries to protect shareholder/investor interests.

"We have moved into an era where it's no longer enough to just abide by the letter of the law, and where directors have to be more than anonymous people listed in an addendum to a prospectus," argues Payne, the creator of Harry.

"Harry has to know you're in his corner; you have to convince him this is the right place to have his assets, perhaps by investing a substantial part of your own assets alongside him in the fund."

Only then, Payne maintains, will still-skittish retail investors feel confident that mutual-fund governance has improved enough that it's safe to take their money out from underneath their mattresses. ■