Webster’s defines a “steward” as a household manager, union representative, fiscal agent or one who attends passengers while traveling. Some of these concepts have become less relevant in today’s world.

- Before World War II, ocean voyage was the main mode of transportation abroad, and the steward was someone passengers depended on for their welfare.

- When plane travel took over from ships, it was the stewardess (and then in the 1980s, the steward again) who played the same essential role. Of course, in the 1990s, political correctness caused “stewardess” and “steward” to disappear in favor of “flight attendant.”

- The trade union movement has depended heavily on the work of the shop steward, the union representative closest to the men and women of the rank-and-file.

- And when I started in the investment management business in the 1960s, those who managed money for others thought of themselves – and were thought of – as stewards of their clients’ money. They aimed to protect their clients from loss and generate a reasonable – even an attractive – return as long as it could be done with risk in check.

With the passage of time, I find I hear the word “steward” less and less. But in talking about the mutual fund irregularities that have been exposed in the last few months, I cannot help but borrow a phrase from Jack Bogle that employs it. (I wish I could coin the phrases I use in these memos, but usually I find myself relying on the creativity of others. In this case, I absolutely can’t improve on Jack’s way of putting it.) On November 8, The Economist quoted him as saying, “Amassing assets under management became the [mutual fund] industry’s primary goal, and our focus shifted from stewardship to salesmanship.” (Emphasis added)

**That’s it. Right there. In a nutshell.** Of course some of the late-trading incidents involve individuals who simply took money out of their clients’ pockets and put it in their own (metaphorically). **But in case after case – involving late trading and other issues – mutual funds companies forgot their duty as stewards of other people’s assets, doing things that disadvantaged clients in order to build assets under management for their own benefit.**

Each of us faces the need to balance our own interests against those of others. The salesman stresses the positives and soft-pedals the negatives to increase his
commissions. The head of a charity draws a salary that reduces the amount left for the organization’s good work. The doctor collects for his services, and the more he charges, the fewer the people who can afford them. And we investment managers charge management fees, and sometimes a percentage of the profits, that cut into our clients’ net return. We all want to increase our incomes, but it should be possible to stick to the high road while doing so. The tradeoffs present challenges, but they can be overcome.

I do not argue that mutual fund executives – or investment managers in general – should be expected to serve in an eleemosynary capacity. Certainly Oaktree doesn’t run on pure altruism. Vanguard comes close to the ideal, as a non-profit organization owned by its fund owners, but Vanguard’s people take compensation, not vows of poverty. The critical question in my mind isn’t whether people make money, or even how much, but what methods they employ to do so, how candid they are about those methods, and how the inevitable conflicts of interest are resolved.

What’s Wrong With a Little Salesmanship?

My October memo “The Feeling’s Mutual” argued that late trading wasn’t the worst thing going on in the mutual fund industry. Rather, it pointed to questionable long-term practices relating to governance, marketing and compensation.

[Before I go further, I want to do something I failed to do in October: make clear that neither my earlier memo nor this one is intended as a universal indictment of the mutual fund industry. While there are questionable aspects to the industry’s general practices and some bad apples, there also are clean operators and even shining examples. I apologize to any of the latter that feel I’ve treated them like the former. The good news is that the money withdrawn from the bad apples is being reinvested in other mutual funds, meaning the good citizens are being rewarded, as they should be.]

Recent months have brought disclosure of a variety of questionable asset-building practices.

- Revenue sharing – According to the Wall Street Journal of January 9, this is an arrangement through which, in addition to any explicit sales compensation, “fund companies give brokers a cut of their management fees to induce them to sell their products.” Many brokerage firms have a list of preferred funds or fund companies, and often the funds pay to be on the list. The Journal reported, for example, that Edward D. Jones & Co. “has selling arrangements with about 100 mutual funds, but 90% to 95% of its fund sales come from the seven preferred companies who engage in revenue sharing.” Under revenue sharing, a brokerage firm can get a percentage of the assets invested in the relevant funds or of the management fees (and in some cases, of both).

- Brokerage-for-sales deals – These were described by the Journal (January 13) as
“arrangements under which fund firms direct trades to . . . brokerages in returns for its (sic) funds staying on their ‘preferred list.’” Sometimes funds allocate commissions to brokerage firms in order to pay off the revenue sharing obligations described above.

- Sales incentives – In its article on Jones, the Journal also reported “more than half of the firm’s brokers are invited on [Caribbean cruises and African-wildlife tours paid for by fund companies on the preferred list], based on meeting certain overall sales targets.” At some brokerage firms, brokers have received higher commission rates for selling funds that generate revenue sharing. Elsewhere, the commissions for selling funds managed by the brokerage’s in-house money management arm have been higher than those on third-party-managed funds.

On January 13 the Securities and Exchange Commission said that 14 out of 15 broker-dealers it examined had received cash payments from mutual fund companies. Is it wrong for brokerage firms and/or their brokers to receive compensation for emphasizing a company’s funds? After all, supermarkets accept compensation from food companies for giving them more desirable “shelf space.” Isn’t that a valid analogy?

The answer lies in the significant distinction between an ordinary businessman and a trusted adviser. Supermarkets have no fiduciary duty to their customers, and customers don’t expect supermarkets to provide objective, professional advice regarding which brands to buy. The opposite is true for stockbrokers.

Under securities laws, brokers are held to the high standard of trusted financial advisors – not just salespeople – and must either offer objective advice or properly disclose any serious conflicts. . . . “We recognize there is a conflict of interests between the broker and the mutual fund investor,” says Robert Plaze, associate director of the SEC’s Division of Investment Management. “That client needs to understand the recommendation of their broker is being affected by these payments.” (Wall Street Journal, January 9)

How would you like to learn that the heart surgeon to whom your general practitioner sent you had paid for the referral? That your banker recommended a trust-and-estate lawyer in exchange for a holiday cruise? Or that the broker who suggested you buy a certain fund was paid to do so?

“The deception is that the broker seems to give objective advice,” says Tamar Frankel, a law professor at Boston University who specializes in mutual-fund regulation. “In fact, he is paid more for pushing only certain funds.” (Ibid.)

The Los Angeles Times put it another way on January 18:

There are two ways to describe such payments, and both smell bad, said Don Phillips, a principal at fund research firm Morningstar, Inc. in Chicago: They’re either bribes by mutual fund companies to spur sales, or they’re blackmail by the
brokerages to do the same.

In the case of mutual funds that direct brokerage commissions to reward fund sales, there’s an additional alarming element: **Not only is the fund company paying for a recommendation, but it’s making these payments with its client’s money, not its own.** Commissions belong to the client. They should go to pay for things that benefit the client, such as superior research or best execution. When they are used to reward fund sales, their use benefits only the fund company.

**Sunlight as Disinfectant**

The solution is to inform clients of these practices. Where the interests of client and broker are in conflict, the broker should disclose the conflict. In this case, he should tell clients that he and his firm received special compensation for making the recommendation they’ve made, or for having sold large amounts of certain funds. Fund companies and brokers would respond that they’ve done just that.

The problem is that the SEC agreed that disclosure needn’t be made directly by each broker to each client. Instead, general disclosure in mutual fund prospectuses is enough. **Unfortunately, “legal disclosure” too often seems to be an oxymoron,** guided primarily by the question “how can we say something so as to minimize the likelihood that the reader will understand what we said?” For example, according to the Journal of January 9, “... Putnam typically discloses in its prospectuses that it may ‘pay concessions to dealers that satisfy certain criteria established from time to time by Putnam Retail Management relating to increasing net sales of shares of Putnam funds over prior periods, and certain other factors.’” Huh?

How many prospectus readers are capable of extracting the significance from that sentence? How many know the meaning of the word “concession” in this context? How many even read the last dozen “boilerplate” pages of a prospectus?

First, I think regulators should insist not on disclosure, but on **effective disclosure.** Things should be expressed in everyday English, such that laymen can grasp their significance. And the things that matter should be separated from the things that don’t.

Second, disclosure of the conflicts between fiduciary and client should be made directly by the fiduciary, and should be made clearly. How about, “The fund’s sponsor is paying me extra to recommend this fund to you”?

**The Average Common Denominator**

As I wrote in “The Feeling’s Mutual,” I think the most significant failing of the mutual fund industry – and the area where the most sweeping changes hopefully will be seen – relates to the governance responsibilities of fund directors. This can be looked at, for
example, in terms of the management fees paid by mutual funds.

I believe most of the mutual funds in a given market sector pay management fees (setting aside administrative expenses and marketing charges) significantly above those paid by institutional accounts of comparable size. While the cash inflows and outflows experienced by mutual funds may cause higher turnover – and thus more work for portfolio managers and back office personnel – the successful funds also see asset growth. So I see no justification for higher fee rates.

It’s the job of fund directors to police fees and ensure that they’re justified and fair. Do they do this? Do they actively resist requests for increases or pursue reductions? Who goes to the mat on behalf of the fund holders to keep down the management fees? With fund boards often headed by current or retired management company executives, how vigorous are the efforts to minimize fees?

Here’s what I think is a typical response, from John Hill, independent board chairman for the more than 100 mutual funds operated by Putnam: “We spend a lot of time looking . . . at costs. We’ve had a rule for years that fund expenses can’t be any higher than the median expenses of comparable funds across the industry.” (WSJ, January 13, emphasis added.)

In other words, the directors aren’t concerned about whether fees are fair or justified. Or whether they’re comparable to institutional account fees. They just look at how their funds’ fees stack up against those of other funds. So if the average mutual fund in a given sector pays its management companies a fee well above the institutional rate, they’re willing to do so also.

Suppose you wanted to invest $1 million of your own in high yield bonds. If you learned that a high yield mutual fund charges a .65% management fee while institutional managers charge .50%, you’d probably choose the latter. The knowledge that every high yield mutual fund charges .65% likely wouldn’t alter your decision. But mutual fund directors seem to derive great comfort from it.

Last week I conducted an empirical study by accessing the websites of the first nine high yield mutual funds that came to mind. The management fees on seven of these multi-billion dollar funds exceeded the institutional norm of .50%, ranging from .58% to .75% and averaging .65%. I wonder what those funds’ managers charge institutional accounts of similar size.

I’ve often heard the rejoinder that the “little guy” with $50,000 to invest can’t get into a top institutional manager. And even if he could, he couldn’t access the lowest fees. Thus it’s reasonable that he pays fees above institutional rates – he can’t do any better. But the fund could. Why shouldn’t the aggregation of 1,000 little guys, each with $50,000, pay the same fee as an institution investing $50 million?

In this year’s Berkshire Hathaway annual report, Warren Buffett shares his observations
regarding mutual funds. “Year after year, at literally thousands of funds, . . . the directors had mindlessly approved fees that in many cases far exceeded those that could have been negotiated.” In response, he proposes independent fund directors affirm each year that “we have negotiated a fee with our managers comparable to what other clients with equivalent funds would negotiate.” We’ll see if they do.

Are fund directors and executives putting their clients’ interests first? Are they acting as the stewards of their clients’ assets? Is there room for improvement? I feel there’ll be a lot of scrutiny on this subject in the months ahead. Hopefully all mutual funds and their directors will end up acting a lot more like stewards.

The New Math: 4 + (12b-1) = 3

Back in 1980, some genius figured out a way for the mutual fund companies to extract more from their funds: use investors’ assets to pay the costs of fund distribution. Rule 12b-1 was adopted, permitting charges against fund assets for this purpose. According to a Morningstar report of January 6, “The rule was introduced following a period of substantial outflows for the fund industry and was intended to help funds grow their assets.”

It was felt that asset growth would benefit funds and their investors, and thus it would be proper for investors to bear some of the cost. According to the rule:

A [mutual fund] company may implement or continue a [12b-1] plan . . . only if the directors who vote to approve such implementation or continuation conclude, in the exercise of reasonable business judgment and in light of their fiduciary duties . . . that there is a reasonable likelihood that the plan will benefit the company [i.e., the fund] and its shareholders.

As Morningstar puts it, “the latter phrase would seem to require that the fee will result in more assets, and ultimately lower costs – otherwise, there is no benefit to the fund” (or its investors). Of course, fund companies would have a clear conflict: more expense reimbursement for them would translate directly into lower asset values for their investors. The SEC recognized this conflict and stated in the release accompanying the rule that it remained “generally concerned about (1) the conflicts which may exist between the interests of a fund and those of its investment adviser in deciding whether a fund should pay its distribution costs, (2) the likelihood that the fund will benefit from paying such costs, and (3) fairness to existing shareholders.”

Thus the SEC required that 12b-1 fees be approved by majorities of the full board, the disinterested (i.e., independent) directors, and the fund’s shares. It went on to state that, “Since rule 12b-1 does not restrict the kinds or amounts of payments which could be made, the role of the disinterested directors in approving such expenditures is crucial.” (Emphasis added)
Based on data contained in Morningstar’s excellent report, the results in this regard are not encouraging:

- Of the 15,774 funds tracked by Morningstar, 9,981, or 63%, charge 12b-1 fees.
- Of 4,556 12b-1 funds for which there is at least five years of data on expense ratios, 66.2% showed an increase in the expense ratio over the last five years.
- The percentage of funds showing expense ratio increases was roughly the same in 12b-1 funds as in non-12b-1 funds, but the average increase for the 12b-1 funds was slightly greater than for the non-12b-1 funds.
- When looked at for nine years, the comparison is more negative. 12b-1 funds showed expense ratio increases more often than non-12b-1 funds, and the differential between the increases in the two groups was more unfavorable.

As Morningstar puts it, “The above data strongly suggest that 12b-1 fees do not help funds materially reduce their expense ratios over time any more than would otherwise be the case, and may, in fact, do the opposite.”

The fund companies have successfully transferred some of the costs of distribution to the funds’ investors, using 12b-1 fees primarily to pay brokers in order to increase assets and benefit the fund companies. But there is no evidence – certainly not in the form of decreasing expense ratios – that they benefit investors, as they’re supposed to. Despite this, Morningstar says, “Even as funds grow, their 12b-1 fees don’t usually decrease or go away.”

Why are 12b-1 fees so widespread and so persistent? And what’s the reasoning of the independent directors who approve them? How do the directors feel about the buy-and-hold investor who invests in fund shares and pays distribution fees for the next twenty years? At best, I’m afraid, the director’s answer regarding 12b-1 fees can only be the same as it is on management fees: “Our practices are no worse than those of our competitors.”

**One gem on which to close:** currently, 12b-1 fees are being collected by 227 mutual funds (or classes of multiple-share-class funds) that are closed. How can the directors of funds that aren’t trying to attract new investors justify the continuing imposition of fund distribution charges? How can they possibly interpret this as fulfilling their responsibilities to the funds’ investors? Who do these directors represent?

**What Else?**

I want to make it clear that just as I do not universally indict mutual fund executives and directors, I don’t think stewardship problems exist only in the mutual fund industry. Most of the shortcomings disclosed in the corporate scandals of 2001-02 – in Enron, WorldCom, Adelphia, HealthSouth and Tyco – stemmed from the failure of executives to act on behalf of the shareholders who own the companies, and from the
failure of directors to police the executives.

The examples are endless: excessive compensation, unwarranted expenditures, phony accounting, and transactions intended only to deceive or obfuscate. In general, executives forgot that they run companies for their owners and instead tried to turn them into personal piggybanks. Or they decided to eschew honest reporting in order to hype results and thus their own economics. Directors of these companies haven’t been accused of wrongdoing, just underachieving. They were too complacent and obliging, and thus asleep at the switch. As Warren Buffett says, “sadly ‘boardroom atmosphere’ almost invariably sedates their fiduciary genes.”

The fundamental questions regarding corporate directors and executives are the same as those I proposed earlier regarding mutual funds: How much ends up in the pockets of the company and its owners, and how much in the pockets of the stewards? What means are used to accomplish this “wealth transfer”? How much is disclosed, and how clearly?

A number of thought-provoking examples were discussed in the Wall Street Journal of December 29, under the headline “Many Companies Report Transactions With Top Officers; ‘Related Party’ Deals Disclosed By 300 Large Corporations; Potential for Conflict.” The article discussed not the headline-grabbing misdeeds of the scandal era, but matters that are routine at America’s largest corporations. Often called “related-party transactions,” they represent deals through which directors or executives receive benefits beyond their standard compensation. Of course, there’s only one possible source for this enrichment: the companies and their shareholders. The Journal and I draw no conclusion about whether these things are proper. But they certainly can serve as fodder for discussing the performance of stewards. Here are a few examples:

- A company employs or has business ties with 17 relatives of senior officials.
- An executive is reimbursed for making business trips on his airplane.
- A company buys “financial advisory services” from a director’s company.
- Directors receive hundreds of thousands of dollars in consulting fees, above and beyond their directors’ fees. The fees reward the director/consultants for supplying “general information” or “maintaining and enhancing the company’s strategic alignment.” In the latter case, the recipient happens to be the company’s second-biggest shareholder.
- A lawyer serves on a corporate board, and the company gives legal work to his firm.
- The son-in-law of a former board chairman runs a real estate joint venture involving the company, to which the company guarantees a minimum level of profitability.
- A company sells an amusement park to its controlling shareholder, with the buyer paying half the purchase price in the form of passes to the amusement park he just bought.

The Journal put it succinctly. “All these deals present the risk of conflicts between a company official’s two roles: representative of the shareholder and individual seeking to get the best deal for himself.” They raise significant questions:
• Are these deals negotiated at arm’s length? Are the terms the best the company can get?
• Who negotiates on behalf of the shareholders? How vehemently?
• Where a deal is proposed by a shareholder or shareholder/director with a dominant ownership position, who stands up for the minority shareholders?
• How can we be sure director A won’t simply vote for director B’s excessive deal in exchange for director B returning the favor?
• As I mentioned above, there has been no allegation – even in Enron, Tyco and Adelphia – of actual director impropriety. Rather, the questions surround the energy put into governance.
• After working together for many years, directors develop congenial relationships with each other and with the executives. How strongly will they then fight to resist questionable transactions between the company and their colleagues?
• Directors’ fees can run into the hundreds of thousands, perhaps with stock options and perks in addition. Will a director risk this package to fight for some faceless shareholders?
• In short, can a director who serves at the pleasure of the chairman police the chairman and his other handpicked directors and executives? How can directors be guaranteed the independence that shareholders need them to have?

The industrial economy achieved great strides because of a number of advances, one of which was the separation of management from ownership (and the accompanying development of a class of professional managers). The caveat, of course, is that managers and directors must serve diligently as stewards, protecting the interests of the firm’s absentee owners. The system only works if the stewards – entrusted with responsibility on behalf of others – are up to the task.

The Bottom Line

As you prepare your estate plan, you count on fiduciaries – lawyers, accountants, executors and trustees – to ensure that your assets will be disposed of as you intend. Would you want one of those fiduciaries to buy assets directly from your estate? Rent office space to your estate? Employ his relatives to serve your estate, for additional fees? Enter into a joint venture with the company you left behind? You’d expect the stewards of your estate to be “purer than Caesar’s wife.” Even with motivations that are entirely honorable, it would be impossible for your fiduciaries to simultaneously represent themselves and your heirs on opposite sides of a transaction and still maintain both the fact and the appearance of fairness. Thus they must content themselves with the compensation they’ve been assigned by you or by law. They must resist the temptation to do business with your estate in a way that could benefit them further . . . and to possibly move a little from your heirs’ pockets to their own. We must expect no less from the stewards that we and our companies do business with every day.

In my memos I try to resist citing Oaktree as the paragon of virtue. But when we founded our company, we established an acid test that we routinely rely on to keep us
on the right track. It was stated in our original brochure in 1995, and it has served us well ever since.

   It is our fundamental operating principle that if all of our practices were to become known, there must be no one with grounds for complaint.

To put it more simply, we assume everything we do will show up on “page one” some day – that nothing will remain a secret. Will there be a negative reaction? Will anyone object? It’s a simple test, but it seems every day that the newspapers describe someone whose actions could only have been premised on the assumption that no one – not media, shareholders, clients, auditors or regulators – would learn the truth.

Will directors approve of executives’ actions? Will shareholders feel that directors did their job correctly? Will clients conclude that fiduciaries have put responsibility to them ahead of their own interests? We think the standards for stewards’ behavior are pretty clear cut, which means making these assessments shouldn’t be that hard.

March 16, 2004
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