



U. S. Securities and Exchange Commission
Washington, D. C. 20549 (202) 272-2650

**News
Release**

**FADS IN ADS:
RECENT DEVELOPMENTS IN
MUTUAL FUND ADVERTISING**

Address to

**The Investment Company Institute
Mutual Fund Training Conference--1987**

**Hyatt Regency Hotel
Washington, D. C.**

June 15, 1987

**Joseph A. Grundfest
Commissioner**

The views expressed herein are those of Commissioner Grundfest and do not necessarily represent those of the Commission, other Commissioners or the staff.

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The mutual fund industry has grown dramatically during the past ten years. In 1980 there were 564 mutual funds with \$135 billion in assets.¹ By the end of last year, the number of mutual funds exceeded 1,840, and mutual fund assets were in excess of \$716 billion.² Mutual funds and their assets, which have grown more than five-fold in six years, are thus among the few segments of the economy growing at a rate that can keep pace with the national debt.

As funds proliferate, so do the marketing strategies for selling them. In fact, some believe that fund marketing strategies have out performed the funds themselves. This new emphasis on marketing underscores the old saying, by now almost an article of faith in the investment company industry, that "funds are sold, not bought." Two marketing strategies used with increasing frequency that give new meaning to the saying that "funds are sold, not bought," are performance advertising and novel 12b-1 fee structures. In my address

*I would like to thank my legal counsel, Nancy Morris, for her substantial assistance in the preparation of this address.

¹Investment Company Institute, 1987 Mutual Fund Fact Book 60, 62.

²Id.

today, I would like to share some observations about both of these marketing techniques and some of the regulatory and policy issues they raise.

Advertising, particularly performance advertising, plays a significant role in promoting mutual fund investments. In a performance ad, a fund proclaims its market prowess with eye-catching claims like: "+872% In 12 Years," "an impressive 300% [growth] in less than 3 years," or "575.8% in 10 years."³ Funds have dramatically increased their spending to get this sort of message across to the public. For example, the print advertising budgets of thirteen major fund groups tracked by Advertising Information Services, Inc. increased by 130% last year to \$68.3 million.⁴ Television advertising budgets are also climbing at a significant rate. In 1986, some funds entered the TV market with multi-million dollar campaigns whereas in 1985 they did no television advertising at all.⁵

Funds are also using novel sales load plans as marketing tools. Some broker-sold funds are lowering sales loads while many direct market no-load funds are increasing fees. Moreover, both load and no-load funds are subtracting 12b-1

³All these claims appeared in the June 14, 1987, N.Y. Times, Business Section.

⁴Henderson, Mutual Funds Scramble for Your Money, U.S.A. Today, May 28, 1987, at 1B.

⁵Last year Kemper Financial Services spent \$2.5 million for commercials while in 1985 it spent nothing. Fidelity spent \$2.2 million for commercials last year, up from \$64,800 in 1985. Bennett, A Frenzy to Market Mutual Funds, N.Y. Times, Apr. 26, 1987, at F1.

fees from fund assets to pay for advertising and marketing costs. The practical distinction between "load" and "no load" funds is thus becoming even more fuzzy. This trend raises a question as to whether the strict, binary distinction between load and no-load remains viable in today's marketplace, or whether we need to recognize that load is more a question of degree than of kind, i.e., every fund is "loaded" to some degree at some point in time.

In this kind of an environment no wonder investors are confused. Heck, sometimes I'm confused. Who can compare the performance figures touted in ads? How can you be sure a "no-load" fund really is no-load? And how can you tell if a load fund is fully loaded, partially loaded, or only slightly loaded?

To remedy certain perceived problems in mutual fund advertising practices, including the difficulties posed by problems of comparability, the Commission recently proposed new rules that would, under certain circumstances, standardize the computation of mutual fund performance data, and require certain additional disclosures. The Commission's staff is also reviewing many issues raised by the proliferation of 12b-1 plans. This afternoon, I would like to describe some aspects of the Commission's proposed rulemaking, ask some questions about the substance of those proposed rules, explore some questions raised by the spread of 12b-1 plans, and provide some insight into the subtleties that can arise when the

Commission considers rules designed to control the flow of information in a complex marketplace.

Advertising

Investment company advertising, like other securities advertising, is subject to the Securities Act of 1933. Prior to 1970, mutual funds advertised their products only in "tombstone" ads. These announcements are limited to identification of the existence of a public offering and the availability of a prospectus. Tombstones may also include a general description of the investment company and an attention getting headline, but may not include any performance figures.

In 1979 the Commission adopted two rules to permit funds greater freedom in advertising.⁶ As a result of the 1979 rulemaking initiatives, no limits are placed on the contents of ads provided that: (1) the substance of any information in the ad is contained in the statutory prospectus; (2) the ad states from whom a prospectus can be obtained and advises the investor to read it before investing; and (3) the ad is not misleading.

Although the regulatory framework for investment company advertising established in 1979 has remained largely in place, the Commission made some modifications in 1980, a time at which money market funds were experiencing tremendous growth as a result of high prevailing interest rates. Because of the

⁶Investment Company Act Rel. No. 10852 (Aug. 31, 1979); Investment Company Act Rel. No. 10915 (Oct. 26, 1979).

significant role that yield quotations play in promoting money market funds, concern over a lack of comparability among money market fund yield quotes, and concern over the potential for confusion and misperception, the Commission, with industry support and approval, prescribed a standard yield formula for money market funds.⁷

In the past five years, the dramatic growth in mutual fund sales during a prolonged bull market has been accompanied by an increase in fund advertisements quoting performance figures. In particular, many income funds are promoting the sale of their shares by prominently displaying annualized, compound yield figures based on recent short or long period results.

In March 1986, the Investment Company Institute submitted a proposal to the Commission staff to standardize yield and distribution calculations of income funds. After reviewing the ICI proposal, the Commission proposed new rules and revisions to address these and other concerns.⁸ As characterized in the ICI comment letter, "[u]nder the SEC proposal, an income fund would only be permitted to include in an advertisement its current yield and its total returns for each of the most recent five calendar years and a stub period. Yield could not be advertised unless accompanied by all six total return figures. Funds other than income funds would be

⁷Investment Company Act Rel. No. 11379 (Sept. 30, 1980).

⁸Securities Act Rel. No. 33-6660 (Sept. 17, 1986).

limited to performance advertisements setting forth their total returns for all six periods. All other performance advertising would be prohibited."⁹ Advertisements containing performance data also would be required to include an explanation of the historical nature of the data and emphasize the risks of principal and income fluctuations.

This proposal has been greeted with the equivalent of a Bronx cheer from the mutual fund industry.¹⁰ The industry opposes the provisions that would standardize the computation of performance advertised by equity funds and require total return figures when an income fund advertises its yield. Industry commentators have also argued that a rigid format for calculating performance could itself mislead investors, and that the proposals can actually restrict consumer information. In addition, the industry argues that the Commission's proposal would competitively disadvantage it as against institutions offering financial products that are not required to make similar disclosures, and complains that the Commission's proposal would infringe upon the industry's First Amendment freedoms.¹¹

⁹Investment Company Institute, Comment Letter Re: Advertising by Investment Companies (File No. S7-27-86) (Dec. 22, 1986) at 1-2.

¹⁰See id.

¹¹Id.

The industry is not alone in its questioning approach to various aspects of the proposed advertising rules, and it would be disingenuous to claim that all Commissioners embrace all aspects of the proposed regulations. I myself have some substantial questions, and would like to focus on some of them in this address.

The proposal that may most need careful examination is the suggestion that funds be required to provide five years worth of historical data if they provide any performance data at all. Commission staff recommended this proposal for comment on grounds that it would provide comparable data about the performance of mutual funds "in a manner which reflects the nature of a mutual fund investment."¹² It is not clear to me, however, that this argument holds water because there are at least three points at which the argument may spring a large leak.

First, there is no evidence of statistically significant serial correlation in risk adjusted fund performance figures.¹³ In other words, on average and over time, a fund that performs well or poorly in one year, or in one quarter, is not particularly likely to perform well or poorly in the following year or quarter. Of course, given the very large number of mutual funds in the marketplace there will be

¹²Securities Act Rel. No. 33-6660.

¹³R. Hagin, Modern Portfolio Theory 112 (1979), quoting I. Friend, M. Blume, J. Crockett, Mutual Funds and Other Institutional Investors: A New Perspective (1970).

examples of "runs" in the data--situations in which a particular firm appears to perform uncharacteristically well or poorly over a longer period of time. However, the proportionate incidence of these runs is so small that they are consistent with statistical models that predict no serial correlation in fund performance figures.

In other words, the past is unlikely to be prologue in mutual fund performance. Therefore, boilerplate caveats found in mutual fund ads warning that "past performance is no guarantee of future results" may have more truth in them than many fund advisers would like to admit.

Interestingly, managers of funds that have had uncharacteristically successful performance records readily concede that the past may not be prologue. For example, Peter Lynch, head of Magellan Fund, a fund operation with one of the more successful track records over the past decade, has said that it would be unreasonable for investors to assume that Magellan could continue to grow at the same pace it has experienced in the past.¹⁴

Now, if Mr. Lynch is correct that his past performance may not be an accurate barometer of future results, why should the Commission encourage, require, or even permit the publication of Magellan's past results when Mr. Lynch himself

¹⁴Vartan, Market Place, Behind the Fall at Magellan, N.Y. Times, May 21, 1987, at D10. See also Vanguard's Bogle: A Square-Rigger in the Diesel Age, Barron's, May 18, 1987, 64, 67.

believes that they are unlikely to have predictive value? I ask this question with tongue firmly planted in cheek, because it nicely illustrates just one of the paradoxes that can arise when: (1) funds seek to promote themselves on the basis of past performance; (2) regulations seek to control those promotional efforts; and (3) there is scant evidence that past performance is correlated with future performance.

Second, to the extent that a goal of the Commission's rulemaking proposal is to promote greater comparability across fund advertisements, it is not at all clear that historical performance data, unadjusted for risk levels and other criteria, provide a reasonable starting point for purposes of comparison. Performance across funds can differ for a wide variety of reasons, including systematic and stable differences in the riskiness of fund portfolios, as well as structural changes in portfolio composition that result from changes in portfolio managers, or fund objectives, to name just two possible causes of inter-fund noncomparability over time. Thus, to the extent that past may not be prologue even within the same fund, past performance may be even less likely to have predictive value across funds.

This is not to suggest that there are no meaningful disclosures that can be made for the purpose of promoting comparability. For example, public disclosures of the fund's most recent beta, the covariance of the fund's portfolio with the rest of the stock market, could provide a benchmark by

which investors could compare the riskiness of competing funds apart from historical performance data that are unadjusted for underlying risk.

In fact, a good argument can be made that disclosure of a fund's beta is among the more relevant performance statistic available. I recognize, however, that some people don't believe in betas, or complain that they are too complicated for most retail investors to understand. I disagree. I think beta can be explained quite simply as a description of a fund's volatility compared to the volatility of the market as a whole. For example, if beta is expressed in percentage point terms, then a fund that has a beta of 200 will rise twice as fast as the market as a whole in a bull market, and fall twice as fast in a bear market. A fund's beta can certainly change over time, and some managers may claim they have an ability to time the market and thereby adjust betas to avoid bear markets while riding bull markets. But even if such claims are true--and the evidence of fund timing ability is not very good¹⁵--one would think that disclosure of a sufficiently recent beta would be a valuable summary statistic of the exposure an investor is accepting when he or she invests in a fund today. Moreover, beta is not only a reasonable description of a fund's current risk, it is also useful for inter-fund comparisons: when comparing a fund with

¹⁵See, e.g., Henriksson, Market Timing and Mutual Fund Performance: An Empirical Investigation, 57 J. Bus. 73 (1984).

a portfolio beta of 200 as against one with a beta of 50, you know full well which fund is likely to be more volatile, and the degree of difference in that volatility.

Similarly, disclosure of aggregate price earnings ratios and other current, descriptive data would at least give investors meaningful summary statistics that characterize the attributes of the fund's current portfolio--not the portfolio it had years ago. Thus, even if one wants to mandate disclosure in a form that promotes comparability, five years worth of historical data may not be a particularly meaningful way of promoting comparability.

Third, and perhaps most important, even if there are meaningful bases for comparability of historic unadjusted fund performance across funds, or even for predictability of future fund performance from past track records, it is a totally separate question whether the use of such statistics should be mandated by federal regulation. Any fund purchaser interested in comparing the attributes of different funds already has available to him a veritable cornucopia of information sources describing hundreds of funds. These data sources, which are cheap and readily available, compare performance records and other relevant characteristics using a wide variety of measures.¹⁶ There are also newsletters that recommend

¹⁶See, e.g., A Guide to Mutual Funds, Consumer Rep., June 1987, 352-64; A Quarterly Survey of Mutual Fund Performance, Barron's, May 18, 1987, 46-93; The World of Funds: How to Find Your Way, Bus. Wk., Feb. 24, 1986, 58-85; The Money Guide to Mutual Funds, Money, May 1986, 202-34; Find a Fund to Match

specific funds and suggest switching strategies among funds, as well as newsletters that rate other newsletters.

Thus, the unregulated marketplace has already generated far more detailed information than would be required by the proposed regulations. This information is also often available at modest cost, or even for free. Why, in this environment, the federal government should, in some circumstances, mandate specific disclosure requirements that may be demonstrably inferior to disclosures already available in thousands of news racks and libraries across the country, and that may have little if anything to do with the effective measurement of fund performance, is a question that deserves carefully to be considered.

But before this audience celebrates what it may perceive as the implications of my last remark, I want to point to one aspect of mutual fund performance advertising that I personally find troubling--although it may not serve as a basis for federal intervention. The evidence is overwhelming that, on average and over time, mutual funds underperform the market.¹⁷ In many situations, but perhaps not all, investors

Your Goals, Changing Times, Sept. 1986, 63-67. See also Mutual Fund Sourcebook, Winter 1986 (measures fund risk by degree of variance from U.S. Treasury bill rate); CDA Investment Technologies, Inc., CDA Mutual Fund Report and Cadence Universe Performance Report.

¹⁷See, e.g., When Keeping Up With the Averages is Better than Average, Bus. Wk., June 8, 1987, 114-15; Wall Street's Laggards: Why Mutual Funds Badly Trail the Market, Bus. Wk., Jan. 26, 1987, 34-35; Sharpe, Risk Aversion in the Stock Market: Some Empirical Evidence, J. Fin. 416 (May 1975);

could do substantially better for themselves if they invested in an indexed no-load fund, with low management fees, that simply tried to track the market averages. Large institutional investors are slowly but surely learning this lesson, and the size of indexed portfolios has grown to at least \$150 billion, with much of that growth in the most recent two years.¹⁸ Small investors should, perhaps, take this lesson to heart. Instead of letting themselves be "sold" whatever product appears to be hot on the particular day they call their broker, small investors might be better served if they took some time to learn about the fund market and shopped for a fund with a modest fee structure that adequately serves their needs.

Therefore, the real revolution in fund advertising will not, I suspect, come from any government regulation. It will come if, and when, investors learn on their own to shop more

Sharpe, Mutual Fund Performance, 39 J. Bus. 119 (Jan. 1986); Jagannathan and Korajczyk, Assessing the Marketing Timing of Managed Portfolios, 59 J. Bus. 217 (April 1986); Chang and Lewellen, Market Timing and Mutual Fund Investment Performance, 57 J. Bus. 57 (Jan. 1984); Henriksson, Marketing Timing and Mutual Fund Performance: An Empirical Investigation, 57 J. Bus. 73 (Jan. 1984); Henriksson and Merton, On Market Timing and Investment Performance. II. Statistical Procedures for Evaluating Forecasting Skills, 54 J. Bus. 513 (Oct. 1981); McDonald, Objectives and Performance of Mutual Funds, 1900-1969, J. Fin. Quantitative Analysis 311 (June 1974); Modigliani and Pogue, An Introduction to Risk and Return, Fin. Analysts J. (March/April, May/June 1974); R. Brealey, An Introduction to Risk and Return from Common Stocks, Chapt. 4 (1969).

¹⁸Anders, Using Rote and Math, Wells Fargo Succeeds as a Money Manager, Wall St. J., Mar. 23, 1987, at 1, 15, col. 1.

intelligently for fund products, so that funds will be bought, not sold.

Living with 12b-1 Plans

Recent evidence suggests, however, that many new mutual fund investors are becoming more reliant on brokers for advice, and are doing proportionately less smart shopping on their own. Five years ago, no-load funds accounted for about 45% of market share. Today they account for only about 25%.¹⁹ Evidently, a large number of investors are willing to pay a premium to brokers for assistance in selecting a mutual fund suitable for their investment needs, and the trend is away from small investors who "buy funds" and who are "not sold."

Part of this trend can, I believe, be explained by the recent, prolonged bull market which has attracted many new investors with little background in the securities markets. These investors are eager for substantial advice and assistance in order to find a suitable investment. They are therefore particularly subject to being "sold" a fund even though an equivalently performing fund could perhaps be bought at lower cost, if the investor just knew how to find it.

Some investors, even relatively savvy ones, are surprised to find out that their fund, whether load or no-load, levies a recurring charge--a 12b-1 fee--against fund assets to cover certain marketing expenses. Adopted in 1980, Rule 12b-1

¹⁹Bennett, supra note 5.

permits mutual funds to use fund assets to finance the distribution of their shares, provided certain conditions are satisfied.²⁰ Since the rule was adopted, more than 925 mutual funds have adopted 12b-1 plans and have used those plans to finance a variety of distribution activities.²¹

As these plans proliferate, it is becoming increasingly difficult for investors to evaluate and compare various fees and charges over a period of time. Last year, the Investment Company Institute withdrew its opposition to a 1984 Commission proposal that would have required a fee table up front in the prospectus. The ICI, seeing the Commission's light, submitted a proposal that would require mutual funds to include in their prospectuses a table showing nonrecurring expenses, such as sales loads and withdrawal fees, and a table showing recurring expenses, such as 12b-1 fees and management fees.²² According to the Investment Company Institute, the proposal is designed to facilitate informed evaluation of expenses and charges, and to enhance an investor's ability to compare costs of investing

²⁰The investment company must prepare a written distribution financing plan which must be approved by a majority of the company's shareholders, a majority of its board of directors, and a majority of its disinterested directors. Investment Company Act Rel. No. 11414 (Oct. 28, 1980).

²¹Lipper Analytical Services (Dec. 1986) (unpublished).

²²Investment Company Institute, Statement of the Investment Company Institute Regarding the Operation of Rule 12b-1 Plans (Aug. 8, 1986).

in different funds with differing price structures and distribution systems.

There might, however, be merit in taking the SEC-ICI proposal one step further. It seems to me that mutual fund investors might find it useful to have fund-specific illustrations that describe various charges investors incur over an extended period of time, assuming hypothetical constant gross rates of return. For example, suppose we assume a portfolio that maintains a constant value of \$10 per share, and a constant portfolio size of \$500 million. Thus, if this fund has no sales load, and charged no other fees or expenses, \$10 invested today would yield \$10 in one year, five years, ten years, or twenty years.

However, just as there is no free lunch, there are no free funds. A simple table could describe to the investor how fees would eat into the initial \$10 investment over the course of time, and would also be able to illustrate the effect of any back-end redemption fees or recurring management or marketing fees. The table could work by illustrating how much an investor would be able to withdraw from the fund at the end of one year, five years, ten years, or twenty years, assuming constant fund size and portfolio value. This simple format would aggregate fees and loads of all types, and provide for easy comparability across funds with very different fee and load structures. I understand that many fund professionals might like to insert assumptions about future growth rates in

share value or portfolio size, but such assumptions would distract readers from the essential goal of such a table, which is to answer the question, "how much does a fund have to grow over a particular interval so that I could at least recover all the sales and management fees I will have to pay over those years?"

The same simple format would allow an investor to compare the aggregate fees he would pay in funds with varying front-end loads, back-end loads, and recurring fees depending on the amount of time the investor expects to stay with the fund. Thus, investors who want to maintain greater liquidity because they might withdraw funds in a year might select funds with low front-end fees, while investors who expect to stay for the long haul might select funds that reward longer term investors with fees that are relatively low if amortized over a span of years.

As many of you know, prospectuses for variable life insurance policies contain standard tables that illustrate how the policy operates. The tables show how the death benefit and net cash value of a variable life insurance policy could vary over time, assuming standard hypothetical gross rates of return. The death benefits and net cash values depicted in the tables reflect deductions that have been made from the premiums paid as well as various charges assessed against the insurance company separate account and, where applicable, the

underlying mutual fund in which it invests. The table I suggest is much less complicated.

Now, I want to make it perfectly clear, that although I think such disclosure could be very helpful, I do not necessarily support such an approach as a mandatory disclosure requirement. I am suggesting, however, that there may be an unfilled demand in the marketplace for this kind of information. The financial press--newsletters, general financial newspapers, and the like--could, I think, improve their fund comparison services by providing tabular descriptions of the "life cycle" effect that different fee structures and loads have on small investors. In other words, not every disclosure idea deserves a regulation mandating that disclosure. We have a vigorous information market out there, and if there is a demand for tabular representation of fee structures in a form that provides for ready comparisons, I suspect someone will be ready, willing, and able to supply those data.

Conclusion

In conclusion, if one wants to find problems with the mutual fund industry and the way it peddles its services, there is no shortage of easy targets. However, it is far from clear that further governmental regulation is necessary, or that it can adequately address many of these problems--if that's what they are. The most effective solution to many of the shortcomings that critics find in the industry may well be

a smarter investor population that sees through industry claims, understands how and why funds underperform market averages, and protects itself by buying smart and not letting itself be sold foolish.

Unfortunately, federal regulation will never be able to mandate investor intelligence. Indeed, it is a potentially dangerous and self-defeating delusion for federal regulators to think that the market can be materially improved by mandatory disclosure requirements that would convey little useful information--not that industry advertising disclosure right now is particularly informative or useful.