

without having to accept a higher risk. The technique consists in isolating securities that move independently of, or even counter to, the market. It rests on the fact that a portfolio in which all stocks move in the same way is no better diversified than any single one of these stocks. If this seemingly simple principle were widely practiced, its usefulness, like that of all other stock market techniques, would of course disappear. Independently moving stocks would be pushed to high prices at which they could cease to have special attraction. But Douglas was able to show that the market does not avail itself of this technique, although some superior investors may do so. This finding, aside from its technical interest, further helps to dispel belief in the superiority of most professional management.

[Those who find it difficult to believe that there should be no pay-off to the vast mass of research that Wall Street pours into the securities market may want to consider also some specific disabilities under which the mutual funds labor. One of them is that their big cash inflow comes when the market is booming. They therefore tend to buy more securities when the market is high than when it is low. This is inverse dollar averaging. It leads to paying a higher than average price in the course of a market fluctuation. (One of the few good techniques that are open to an investor with a stable cash flow is real dollar averaging—investing the same amount periodically and thus buying more shares when they are cheap than when they are dear. This technique, too, would of course be neutralized if enough investors had the means to follow it.)

A second disability of the larger funds is that they can obtain worthwhile positions only in the stocks of larger companies, and tend to put prices up against themselves when they buy aggressively. Another side of this is the apparently deliberate use, in some cases, of such buying power to run up prices.

A third is the desirability, for purposes of salesmanship, to show a good position in the most lately popular stocks. One must hope that there is no truth to the story of the salesman who complains to his manager that prospects won't buy the fund because it has no XYZ stock, whereupon the manager a few days before statement day buys himself a position in XYZ at top prices. But one cannot be sure.

If evidence is desired of what some market professionals think of the value of some professional management, there are the closed end investment funds. Their shares are selling in the market like any other stock at a freely fluctuating price. They provide the same kind of management—sometimes by the same individuals—as mutual funds. With few exceptions the closed end funds sell at substantial discounts from the market value of their portfolio, of the order often of 20-30 percent and even more.

This cannot be explained on the grounds that their purchaser buys some unrealized appreciation in which he has not participated but on which he must pay the tax when the gains are realized. The asset value of these funds would have to consist entirely of unrealized appreciation to justify a discount of at most 25 percent at present tax rates. Moreover, there is the prospective reduction in capital gains tax liability that results from the lower price of the stock when it goes ex its capital gains dividend. The fact is that, where there is no sales pressure, the market puts a negative valuation upon investment management. The unexploited availability of investment management at a discount naturally raises a question regarding the justification of a substantial advisory fee for mutual funds.

Needless to say, a fund will always have expenses connected with its operations. For these it must charge. The SEC data show that the nonadvisory expenses have varied widely, with a median of .09 percent. In some cases operating expenses appear to be covered out of advisory fees.

What has been said so far applies logically to all investment advice, not just that paid for by mutual funds. On average its result are unlikely to be better than random choice, its value therefore very low or zero. This does not mean that the individuals engaged in investment analysis are not in general very able people, doing a competent job. But by the nature of their work they all—excepting possibly a very few superior people—tend to neutralize each other. It is much less meaningful, therefore, to compare the level of mutual fund advisory fees with other fees, than to raise the question how far any of these fees are economically justified. In any event it seems clear that whatever can be done without undue interference with the market to bring down mutual fund advisory fees, as the Commission proposes, will be a step in the right direction.