

DEPARTMENT OF ECONOMICS,
YALE UNIVERSITY,
New Haven, Conn., October 27, 1967.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate
and Foreign Commerce, 2125 Rayburn House Office Building, Washington,
D.C.

DEAR MR. CHAIRMAN: In response to the question stated in your letter of October 18th and in fulfillment of the commitment made to Mr. Watkins during the hearings, I am submitting the following comments and data.

Question 1. The disabilities under which mutual funds labor (pages 8 and 9 of the statement). The first disability cited in the statement is the tendency for cash inflow to be highest when the market is booming, causing funds to buy more securities when the market is high than when it is low. The data cited in the report of the SEC "Public Policy Implications of Investment Company Growth", and pages 287-289 lend support to this contention. The report cites the Wharton study to the effect that "net acquisitions by mutual funds were greatest in the first quarter of 1954 when the price rise was gathering momentum, in the fourth quarter when the price rise was at its sharpest, and in the first quarter of 1955 when stock prices were at their sixteen-month peak". Table VII-6, page 288, shows that in more recent years net acquisition by investment companies were highest in 1961, the year preceding the great break of 1962. The behavior of mutual funds during the third quarter of 1962 and the third quarter of 1966, cited on page 289, also suggests that the funds were heavy sellers following substantial breaks. According to the SEC report, this was due more to the discretionary investment decisions of fund managers than to the pressures of shareholders' redemptions. The concentration of sales following substantial breaks suggests that preceding these breaks, purchases were relatively heavy.

A second disability cited in the testimony is that the larger funds can obtain worthwhile positions only in the stocks of larger companies and tend to put prices up against themselves when they buy aggressively. Three variables are involved here: 1) the size of the fund and the resulting minimum position that it finds worthwhile, 2) the size of the company whose stock is bought, which limits broadly the amount of stock that could be available, and 3) the breadth of the market for the stock, which sometimes may be small even for a large company if the floating supply of stock is small. The net implication is that large funds cannot buy the stocks of very small companies or even of larger companies with a limited floating supply. Since many large companies have done extremely well, this does not necessarily preclude the large funds from making excellent investments. But the most spectacular investment results probably have been achieved by investors "getting in on the ground floor", i.e. buying stock in a small corporation that subsequently enjoyed great growth. This type of investment is difficult for large funds to make.

The third disability refers to the possibility of window dressing. Information to that effect must necessarily rely on hearsay from trade sources. I am prepared to assume that reputable funds seek to avoid operations that could be interpreted in this light. I hope that the testimony presented the "story", which personally I have no reason to question, in a sufficiently qualified form.

Question 2. The testimony qualifies the suggestion to terminate Section 22(d) by proposing the action only if it does not produce "excessively harmful repercussions." I regard retail price maintenance as undesirable in principle, whatever the industry so protected. In the case of mutual funds, I can see no obvious consequence flowing from the ending of 22(d) that could clearly be expected to produce "excessively harmful repercussions". The principal effect, in my view, would be to reduce the income of underwriters, retailers, and salesmen. The sales charge then would apply only to net sales of fund shares, not to gross sales, assuming that all redemptions would cease and be replaced by sales in a free market on the part of fund shareholders.