ResearchCommentary

Reports of "Portfolio Pumping" by Mutual Funds: A Closer Look

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A July 2, 2004 article by Mark Hulbert of CBS MarketWatch suggests that mutual funds may have engaged in "marking the close" on June 30, 2004. As described by the SEC, marking the close, also called "portfolio pumping," is the practice of increasing a fund's stake in portfolio securities at the end of a financial period solely for the purpose of fraudulently driving up the value of the fund.[1]

Hulbert bases his story on the observation that mutual funds outperformed the returns of the S&P 500 index on June 30 (Figure 1). He points to this outperformance as evidence that equity fund portfolio managers place purchase orders shortly before the stock market closes on the last day of the quarter to artificially boost fund returns. In theory, this activity boosts the price of the equities that funds are holding, giving a one-day upward spike in performance that is reversed the following day as the portfolio manager unwinds the previous day's purchases.

Portfolio managers purportedly do this to boost fund performance rankings in an effort to gather additional assets and management fees or possibly to raise their own compensation.

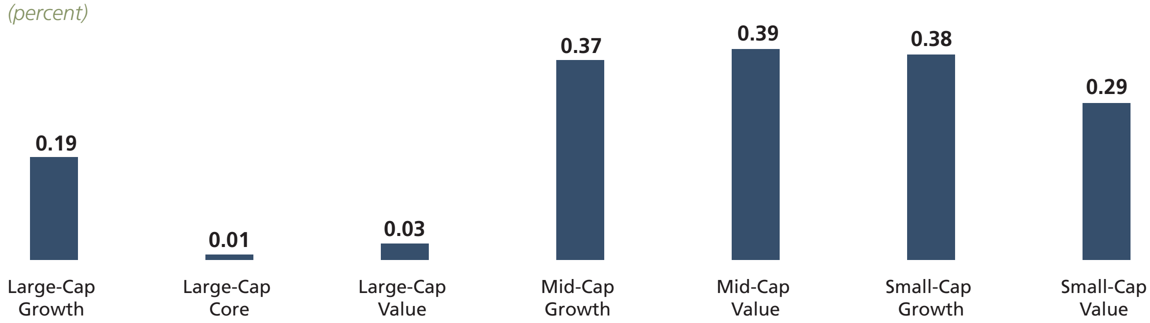
Background

The practice of portfolio pumping is illegal and has been the subject of successive SEC examinations. Beginning in 2000, for example, the SEC undertook a detailed examination of the trading activity of mutual funds and other institutional investors.[2] The purpose of the SEC's examination was to identify cases of market manipulation and take appropriate action.[3] To date, the SEC has reported no enforcement actions involving mutual funds, although it has brought actions against others involved in such conduct including at least one hedge fund operator.[4]

FIGURE 1

One-Day Return Differential of Lipper Mutual Fund Indexes Versus the S&P 500 Index on June 30, 2004

(percent)



Sources: Lipper and Bloomberg

[1] Comments of Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission, before the ICI 2000 Investment Company Directors Conference, November 14, 2000.

[2] Paul F. Roye, *supra*, note 1.

[3] See "The Other Mutual Fund Charade," *Bloomberg Markets*, February 2004, quoting Douglas Scheidt, Chief Counsel, SEC Division of Investment Management.

[4] See *In the Matter of Oechsle International Advisers, LLC*, SEC Release No. IA-1966 (Aug. 10, 2001); *In the Matter of Andrew Parlin,* SEC Release Nos. 34-44679, IA-1967 (Aug. 10, 2001); *In the Matter of ABN AMRO, Incorporated*, SEC Release No. 34-44677 (Aug. 10, 2001); *In the Matter of Angelo Ianonne,* SEC Release No. 34-44678 (Aug. 10, 2001); and *Securities and Exchange Commission v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC,* SEC Litigation Release No. 18226 (July 10, 2003).

Do Funds Have an Incentive?

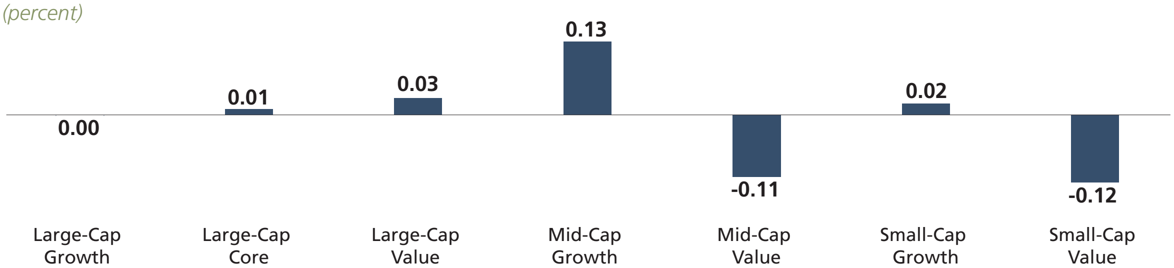
Contrary to the implication of the MarketWatch story, it is not apparent that mutual funds have the incentive to mark the close that some other market participants may have. For example, the practice, if undertaken, would be unlikely to improve a mutual fund's Morningstar "star" ratings, which are based upon three-, five-, and ten-year returns and, thus, are not highly sensitive to a fund's return on a single day. Moreover, Morningstar ratings are now assigned on the basis of fund performance relative to comparable funds. A small-cap fund, for instance, would not necessarily receive a high rating by outperforming the S&P 500 index. In addition, while some institutional money managers, such as hedge fund advisers, often reward portfolio managers for shorter-term gains; mutual fund advisers more typically compensate their portfolio managers on the basis of longer-term performance, generally over three or four years. Thus, it would appear that neither a mutual fund's adviser nor its portfolio manager would stand to gain by engaging in portfolio pumping.

Moreover, the evidence cited in the CBS item is not compelling. Because fund ratings and the compensation of fund managers are tied to performance in relation to peer funds or comparable indexes, it is inappropriate simply to compare the returns of all funds with the S&P 500 index, as Hulbert has done. Instead, mutual fund returns should be compared with a group of peer funds or a comparable index, such as comparing the return of a small-cap growth fund with that of the Dow Jones small-cap growth index. Such a comparison shows that the returns of mutual funds differed little from the returns on comparable market indexes on June 30 (Figure 2).

FIGURE 2

One-Day Return Differential of Lipper Mutual Fund Indexes Versus Comparable Indexes* on June 30, 2004

(percent)



**The S&P 500 equally-weighted total return index is used as a comparable index for the large-cap growth category. The S&P 500 market-weighted total return index is used as a comparable index for the large-cap core and value categories. The Dow Jones total return mid-cap growth, mid-cap value, small-cap growth, and small-cap value indexes are used, respectively, for the remaining categories.*

Sources: Lipper and Bloomberg

An Alternative Explanation

Finally, it is useful to consider alternative explanations for the pattern involving quarter-end returns of mutual funds.

A benign alternative is that the returns of mutual funds are boosted over quarter-ends simply because of movements in the stock markets themselves. The returns of small- and mid-cap stocks often are higher over quarter-ends relative to the return on the S&P 500 index, and this June 30 was no exception. The higher performance of small- and mid-cap stocks causes mutual funds with concentrations in these stocks to outperform the S&P 500 index at quarter-ends. Circumstantial evidence in support of this view is provided by the returns of index and exchange-traded funds. The sponsors of these funds clearly have limited ability and little incentive to engage in portfolio pumping. Nevertheless, the returns of small- and mid-cap index mutual funds and exchange-traded funds rose substantially on June 30 relative to the S&P 500 index, and those gains were reversed the next business day.

It is not clear why small- and mid-cap stocks outperform at quarter-ends, but the MarketWatch story provides no evidence that this is a result of the trading activity of mutual fund portfolio managers. Such evidence would depend on an analysis of the actual stock trades of funds on a particular day: analysis of the sort presumably undertaken by the SEC in its reported examinations of mutual funds previously. Continued SEC oversight of this kind would seem to be appropriate to guard against manipulative conduct by investment managers more generally.