



## Stock-market playing field tilted to favor big players

The stock market is supposed to be an auction market where investors bid against one another on a level playing field. Unfortunately, individuals seem to operate at a disadvantage to the big players: mutual funds, hedge funds and inside players. The newspapers have been filled with more accounts of how some people, due to their "access" to privileged information, have been able to receive special favors, all at the expense of individual investors.

The first kind of infraction is when some, maybe many, of the big players in the mutual-fund industry, household names like Putnam, Fidelity and Janus, are able to submit orders to buy or sell in the market after the closing bell has rung and final prices for the day have been fixed. Many large

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tutional investors have more time and information than the public. This allows them to determine whether to put more or less money in the market, taking advantage of common patterns or correlations between the closing prices and the next move up or down.

The funds move huge amounts

of stock to take advantage of small discrepancies in closing prices. This hurts small investors because it generates huge fees, which, for the most part, go unreported and unnoticed by individual shareholders of the funds. The motivation of bankers and brokers who helped with these kinds of unethical mutual- and hedge-fund trades was to garner commissions for themselves. After-hour trades are almost certain to generate significant profits because such large amounts of money are involved.

Apparently, insider information has also been used by mutual-fund portfolio managers to benefit their personal trading accounts, again at the expense of you and me. This takes place through the existence of "information" gaps. This gap is the difference between what

the managers know to be the true value of the securities in their portfolios and what information is available to the public. Securities are "marked to market," or priced at the end of each day. Sometimes, the computer services that perform this function do not have the most up-to-date information and inside managers are aware of this discrepancy. They know that in a few days the information will get factored into the price and advanced knowledge of the direction of the change is therefore valuable.

The government agency responsible for investigating breaches in the handling of stock and bond trading is the Securities and Exchange Commission.

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There appears to be a feud going on between the SEC and the office of New York Attorney General Eliot Spitzer. Spitzer is championing himself as the protector of individual investors and upstaging the SEC by uncovering and aggressively pursuing possible offenders. This is good, but knowing Spitzer is angling to run for public office himself makes me nervous, as when politician's lips are moving, trouble is brewing.

The SEC has sent out over 80 requests to brokers, funds and institutions for information about possible abuses. Initial reports indicated that over half the respondents to the SEC letters uncovered possible "market timing." Market timing, in this context, is not jumping in and out of the markets but is a form of "arbitrage," which is when one party can quickly buy and then sell the same stock or bond at a "guaran-

teed" profit.

Why would pillars of the investment community, people who already possess considerable wealth, do such things? Putnam, for example, has professed since 1981 to be a leader in the mutual-fund industry's efforts to prevent such abuses. In 2000, when advised that this kind of activity was taking place, Putnam chose to only ask the offenders to cease their activities. Not until faced with public exposure three years later did they fire these managers.

During the boom years of the late 1990s, investment bankers and brokerage firms showered favors on corporate executives that brought business to their firms. Hot stocks, called Initial Public Offerings, known to be heavily oversubscribed, were given to people within corporations so they could book quick profits; in return, the banks and brokers got a shot at that company's corpo-

rate business. Then, when brokers, advisers and investors heard about these investments, they were grossly overpriced and most of the time ended up dropping precipitously.

Besides some notable exceptions, few white-collar criminals have gone to jail. The rules that govern financial transactions are complex, and smart and expensive lawyers are adept at befuddling citizen juries. Frank Quattrone, one of Silicon Valley's most powerful investment bankers, who led the technology IPO market, might not even face a slap on the wrist for his alleged involvement in a long series of IPOs that went bust. His obstruction-of-justice and witness-tampering trial recently ended in a mistrial with the jury unable to reach a verdict. Quattrone, by the way, was paid \$120 million in 2000.

What is being done to protect investors? Some mutual funds, such

as Vanguard and TIAA-CREF, pride themselves on being advocates for fair treatment of the small investor. Our government passed the Sarbanes-Oxley Act of 2002 to prohibit corporate-accounting watchdogs from taking consulting jobs from the very people they are auditing, another area of widespread abuse in the 1990s. Still, no requirements exist for rotation of auditors to prevent such cozy relations popping-up again.

People in the financial industry realize that public confidence and trust are among the most important conditions for their success. Big players continue to say that the "markets should dictate limits to their power." The fact is that "free" markets require free information. If there's one lesson we can learn from the many aspects of the still unfolding story of abuses in the mutual-fund industry, it is that peo-

ple on the inside continue to have more free information than you or I. No amount of government legislation, regulation, or accounting will change this fact.

When the best and brightest young people go into public service instead of private industry, things may change. Until then, you can best protect your assets by finding the lowest cost, most tax-efficient, highly diversified and appropriately allocated investment approach that is available to you. These vehicles are out there. Just don't expect them to come to your attention on TV, in a slick brochure, or at a free lunch.

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