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Costly investments: How market timers and late traders impact other investors

By Lori Pizzani

We've all read (and in some cases written) news articles discussing just how harmful unbridled market timers and late traders have been to long-term mutual fund investors. But the actual ramifications that can occur as a consequence of these actions is not as easy to understand. So The Financial Journalist spoke with Brian C. Breidenbach, who holds the CFA charter and is a CPA, as well as the managing principal of Breidenbach Capital Consulting in Louisville, Ky., (www.4bcap.com) to discuss several examples of market timing and late trading and what the monetary result is to the other investors left behind in the fund.

Scenario #1 – A Post-Mortem on the Single Trade

Let's look at Fund A, a fictitious international equity mutual fund, which currently has $500 million in assets. The fund has a rather good day, and sees a 1 percent one-day rise in value. Then, in comes an illegal after-hours trade in the amount of $25 million.

The fund's assets now include the original $500 million, the 1 percent or $5 million, appreciation for the day on the fund's $500 million, and the added late purchase of $25 million. Total fund assets have now risen to $530 million.

Had the illegal $25 million trade not been allowed, each original fund investor would have seen a similar 1 percent gain on their fund investment. But with the addition of that $25 million purchase, that 1 percent appreciation must now be shared by all of the owners of the fund's higher asset level. That overall $5 million one-day gain now must be divided by the larger $525 million in assets, meaning that instead of a 1 percent gain, each investor would only see a gain of .95 percent, less than 1 percent, which is also referred to as 95 basis points.

"Investors got a haircut of .05 percent because of the inclusion of that additional $25 million trade," says Breidenbach. The fund's interloping investor, however, just netted a cool $237,500 ($25 million multiplied by that .95 percent gain). That one-day net gain equals the amount that was taken from the fund's other investors, he adds.

But that's just one solitary trade, Breidenbach reminds. Multiply that 5 basis point haircut by lots of trades and the money really adds up. After 30 trades using similar assumptions, the stakes rise to a cool $7.1 million risk-free net for that one offender.

And if you add in the significant effects of compounding, such as the next, perhaps larger, trade may be based on an even larger asset base, you can see how quickly that damage can multiply.

Scenario #2 -- Factoring Opportunity Costs - Holding Cash Can Affect Returns

Fund portfolio managers who have to accommodate frequent market timing trades often must adjust their fund's cash balance, so as to have enough cash or cash-equivalent securities on hand to meet unexpected large daily redemptions.

Let's assume that the manager of another fictitious equity fund, Fund B, ratchets up the fund's normal 5 percent cash position to 9 percent. That means that an extra 4 percent of the fund's assets are now held in cash.

Holding those extra dollars may mean that the manager has to sacrifice investing in some interesting securities. If the manager receives a modest 1 percent investment return on that cash portion, and the average return on equities is presumed to be 10 percent, the fund manager has just given up a 9 percent return in the form of opportunity costs, which is the difference between the 1 percent return on cash and the possible 10 percent return.

Assuming that Fund B has $500 million in assets, that extra 4 percent cash position or $20 million, could have theoretically been earning 9 percent more had it been invested in equities instead. That translates to a hefty $1.8 million in lost opportunity, or about .36 percent per year in return that is lost due to the need to hold excess cash in the fund, explains Breidenbach.

Of course, in a down or slipping market, the case can be made that holding the excess cash actually helped the fund by buffering it from losses it would have otherwise suffered had those dollars been invested in equities, Breidenbach notes.

Scenario #3 -- Staying Fully Invested Can Mean Extra Costs and Capital Gains

On the other hand, those fund managers who shy away from maintaining cash and prefer to stay fully invested may cause funds being market timed to suffer a double whammy -- extra transaction costs and extra capital gains. If securities have to be sold to realize the cash necessary to redeem shares for market timers, investors essentially got burned, notes Breidenbach.

Again, let's assume that an equity fund, in this case faux Fund C, has $500 million in assets. Also assume that the fund holds 100 equal positions, which means that each position represents 1 percent of the fund. This means that $5 million is invested in each stock. At an average price of $20 per share, there are a total of 250,000 shares owned by this fund across various securities.

A fully invested fund manager finds that he must liquidate, say, 4 percent of the fund to allow a market timer to exit the fund, which would be the equivalent of a $20 million liquidation. Assuming that the trading costs realized are one cent per share, this would translate into a total trading cost equal to .05 percent, or 5 basis points, that will have to be shared by all investors, notes Breidenbach.

On a pro-rated basis, however, the slick market timer actually incurs only a small fraction - 0.2 basis points - of those trading costs, leaving the remaining 4.8 basis points for the other, long-term fund investors to bear the cost of. "Regular shareholders pay the brunt," Breidenbach admits. "It's like every other shareholder getting out of the fund and you are alone, getting hit with almost all of the capital gains."

What's worse, for investors of taxable accounts such as non-tax-deferred retirement plan accounts, the manager's sale of securities to realize cash may have triggered capital gains, which the fund will distribute to investors. Fund investors, in turn, will then have to settle up with Uncle Sam for any taxes due.

In 2001 alone, the overall damage to mutual fund investors was a collective loss of $4.9 billion as a result of market timers, according to an October 2002 report from Stanford Graduate School of Business Professor Eric Zitzewitz. That translates to a $40.9 billion charge to investors over a 10-year period, versus the average annual return of 9.21% earned by fund investors for each of the past ten years ending March 31, 2004, for all U.S. diversified equity, sector equity and world equity funds, according to fund data provider Lipper, Inc.

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