

FOCUS

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Mutual funds run amok?

The financial press has been full of stories recently about trading “scandals” at several mutual fund organizations including Putnam, Janus, Franklin and others. If you own mutual funds, should you be concerned? If the sponsor of your fund is involved, should you consider switching? What exactly is going on?

First, let’s describe the problem. The key issues are “market timing,” “late trading” and trading on “stale prices” in certain mutual funds by a small number of hedge funds. In the case of market timing trades, these hedge funds traded large positions in mutual fund shares over short periods of time, betting that certain information to which only they had access would result in those shares going up or down quickly. This frequent trading increased costs for all shareholders of the funds and in some cases violated the provisions of the funds’ prospectuses.

Late trading allowed hedge funds to buy shares after the 4PM (Eastern) cutoff. Such trades enabled hedge funds to capitalize on announcements made after the market close (such as earnings announcements) that would cause shares of the fund to rise or fall the next day.

Stale pricing occurs primarily in international funds. Overseas markets close before ours; therefore, traders here traded shares of foreign funds with the knowledge that the underlying shares would be either up or down because the funds had not yet re-priced their portfolios to reflect the changes in the overseas markets that would occur the following day.

Were mutual fund shareholders damaged by these transactions? Probably. However, the magnitude of their losses is a small fraction of those incurred in the Enron, WorldCom,

and other scandals. Nevertheless, many fund companies are making reparations to shareholders, and more probably will.

Should you avoid funds that allowed these trading abuses? The current investigations will probably result in all such abuses being eliminated. Therefore, your decision to invest or remain in a fund whose sponsor was involved in these activities should be based solely on the investment merits of the fund and on your goals and objectives, including your diversification needs.

But there is a bigger issue for you to consider. If you invest in funds, what type of fund makes the most sense for you? If you only hold funds in your 401(k), you probably have no say in which funds are in the plan. Therefore, if your company makes no changes in the fund lineup, your selection should be based on the factors listed above. If you are in management and do have a say, your decision should also be based on the investment factors and on the diversification mix, for the same reasons.

For investors using funds outside of a retirement plan, where taxes are an issue, there is a relatively new type of fund that may be a better choice than traditional, open-end funds. These new funds are called Exchange Traded Funds, or ETFs. They go by names like Spyderys, Diamonds, iShares, etc. Why may they be a better choice? They track an index, so your results will closely match those of the index. They have very low fees. And, they are very tax efficient. For most investors in funds, ETFs are probably the best choice today. For further information, a Google search on “exchange traded fund” will yield a wealth of results.

As an aside, we have initiated a program for accounts below our normal \$2 million minimum using ETFs as the primary investment vehicle. If you would like information about this program, please contact Leslie Beck.

(This article by Morgan White appeared recently in the *Wealth and Estate Planning* section of *Valley Scene* magazine.) 

**Tax
simplification,
puhleeez!**

As reported in the *Wall Street Journal* recently, the level of complexity of the tax code continues to rise at an astounding rate. CCH is the primary source for guides that explain the tax code for professionals. In 1995, its guides totaled 40,500 pages in 22 volumes. In 2003, there were 25 volumes totaling 54,800 pages. This year, the page count has risen to 60,400. That's a 50% increase in nine years. To put this in even more perspective, twenty years ago, in 1984, the guides totaled 26,300 pages. Thirty years ago, there were only 19,500 pages. Enough already!

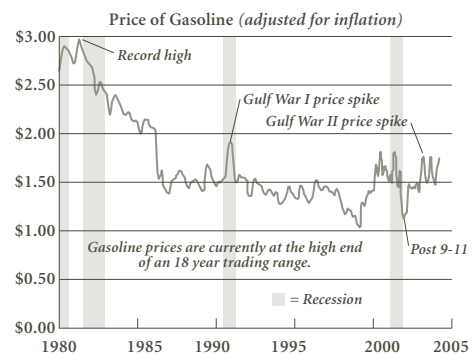
We still think that the way to get the tax code simplified quickly is to force all elected officials at the state and federal level to prepare their own tax returns without the help of software or tax professionals, a proposal we floated some years ago. Politically, this won't fly, of course. However, if we can recall a Governor and pass initiatives like Proposition 13 (that capped property tax rates), we should certainly be able to get some sort of initiative on the ballot. And California isn't the only state with the initiative process available to the voters. Anyone out there care to take this on?

Reality bites

Gasoline prices are high, right? At record levels. Sound bytes on the news proclaim that the oil companies are gouging us. OPEC is cutting production. What's the real story?

First, adjusted for inflation, gasoline prices are, on average, no higher than they have been over the last 20 years and well below the record levels set in the early 1980s. The accompanying chart documents this point well. (courtesy *Chart of the Day*)

There are numerous causes of the current "spike" we are experiencing. First, there have been no new refineries built in the U.S. since the early



1980s. What's worse, over 100 refineries have been closed due to obsolescence or environmental issues, thus reducing capacity significantly. Furthermore, different states have mandated different blending requirements, thereby making it difficult if not impossible to move supplies to where they are needed. Finally, just-in-time inventory methods make it very difficult to adjust to a sudden drop in the availability of crude or to disruptions in the transportation system for oil and gas.

The good news is that this spike also signifies an increase in demand, which reflects growth in economic activity here in the US. From a global perspective, China's demand for oil is exploding as its economy booms and as its citizens drive more and more vehicles. With Shell and other oil firms announcing reductions in proven reserves, it is highly likely that we will sooner than later experience a significantly more painful rise in energy prices. Some of you remember the gas lines of the 1970s. We think it could be worse next time.

The economics of obesity

Fat is getting a lot of press lately. According to the Center for Disease Control, obesity is now the number one health threat in the U.S. The *Journal of the American Medical Association* reports that a day's worth of meals and snacks back in the 1970s typically provided 1,790 calories. By the mid-1990s, daily intake increased 195 calories to some 1,985 calories, or nearly 11 percent more. Recently, the House passed a bill to block lawsuits against the fast-food industry by people who eat too much and develop medical woes such as diabetes, heart disease, high blood pressure, and cholesterol. One of the rationales was that 12 million people work in the fast-food industry, and their jobs would be put at risk by massive class action suits by trial lawyers. The Health and Human Services Department revealed a series of public service ads targeting our expanding waistlines.

All this consternation has us pondering just how the

government could get people to stop eating so much. They could set up a color-coded notification system to warn the populace whenever this particular threat to their health was imminent. This system would have more gradations than the now ubiquitous tobacco warnings, which simply predict death for smokers. For example, the ice cream bin at the local super market might be color-coded orange, but the vegetable aisle a pleasant and relaxing green or blue. Your local donut shop might sport a bright red “obesity warning indicator.” All of these measures might help to reduce the fat problem just as the tobacco effort is producing results over time. Oddly, no one has given any attention to possible economic implications of a successful assault on eating.

Stay with us here, as the assumptions will fly fast and furious. According to the U.S. Department of Commerce’s Bureau of Economic Analysis, food accounts for \$1.1 trillion of U.S. GDP annually or about 9.7 percent. Suppose that the 195-calorie average daily increase cited above were actually reversed by the entire population. Total spending on food would drop \$121 billion, reducing overall GDP by a little more than one percent. All those predictions of robust 4.5 percent GDP growth for this year would suddenly fall to a sub-par 3.4 percent. Thus, we conclude that, economically speaking, this is not a great time to diet. Remember that during WWII, buying government bonds was a patriotic duty. Similarly, today we might consider supporting the economy and hence the war on terrorism as being equally as important as was buying bonds in WWII. So the next time you see that Krispy Kreme sign looming ahead in the early morning light of your daily commute, take a moment, pull in, and pick up a dozen for your colleagues. Our economy needs your commitment to growth.

(Reprinted courtesy of Editor, SVB Securities *Investment Strategy Outlook*) 

*Farmers at
the trough*

To: Honorable Secretary of Agriculture,
Washington, DC

Dear Sir:


My friend Ed Peterson over in Wells, Iowa, received a check for \$1,000 from the federal government for not raising hogs. So, I want to go into the “not raising hogs” business too. In your opinion, what is the best kind of farm not to raise hogs on, and what is the best breed of hogs not to raise? I want to be sure that I approach this endeavor in keeping with all governmental policies. I would prefer not to raise razorbacks, but if that is not a good breed not to raise, then please tell me which is the best. As I see it, the hardest part of this program will be keeping an accurate inventory of how many hogs I haven’t raised.

My friend Peterson has been raising hogs for twenty years, and the best he ever made on them was \$422 in 1968, until this year when he got your check for \$1,000 for not raising hogs. If I get \$1,000 for not raising 50 hogs, will I get \$2,000 for not raising 100 hogs? I plan to hold myself down the first year to about 4,000 hogs not raised, which will mean about \$80,000. Then I can afford an airplane.

Also, these hogs I will not raise will not eat 100,000 bushels of corn. I understand that you also pay farmers for not raising corn. Will I qualify for payments for not raising corn not to feed the 4,000 hogs I am not going to raise?

In view of these circumstances, you understand that I will be totally unemployed and plan to file for food stamps and unemployment. **Be assured you will have my vote in the coming election.**

Signed: Apathetic and Dependent

[Comment: The loose fiscal policies practiced by our politicians, with our money, could lead to the eventual erosion of our democracy. An article on this theme will follow in the next *FOCUS*.] 

Inside Woodside


We are saddened to report that after almost 12 years with Woodside, Claudia Belmessieri, our operations manager, will be leaving us. Initially, she will be working as the controller for Alliant Partners, Silicon Valley Bank's merger and acquisition subsidiary. If that position turns out not to be permanent, she is hoping to land a position within the bank or with another advisory firm. Claudia's loyalty, dedication and effort have been key elements in keeping things running smoothly behind the scenes here and thus key factors in our success. We wish her nothing but the best in her next endeavor.

Also of note is that our website is undergoing a significant overhaul to make it easier for users to navigate and easier for us to maintain and keep current. We'll alert our clients and referral sources as soon as the makeover is complete.

And, speaking of getting our message out, we finally have our new marketing materials, which include both a capabilities brochure and a "FAQ" (frequently asked questions) booklet. If you would like a copy of these materials, or would like us to send them to one or more individuals, please let us know.

As a reminder, our offices will be closed on Monday, May 31 in celebration of Memorial Day. 

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The Bank has 11 offices throughout California and operates regional offices in Phoenix, Arizona; Boulder, Colorado; West Palm Beach, Florida; Atlanta, Georgia; Chicago, Illinois; Boston, Massachusetts; Minneapolis, Minnesota; New York, New York; Durham, North Carolina; Portland, Oregon; Philadelphia, Pennsylvania; Austin, Texas; Dallas, Texas; Northern Virginia; and Seattle, Washington. More information on the Bank can be found at www.svb.com

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