

BEACON POINTE

ADVISORS

**BEACON POINTE RESEARCH
WHITE PAPER**

**MUTUAL FUND MARKET TIMING
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Introduction

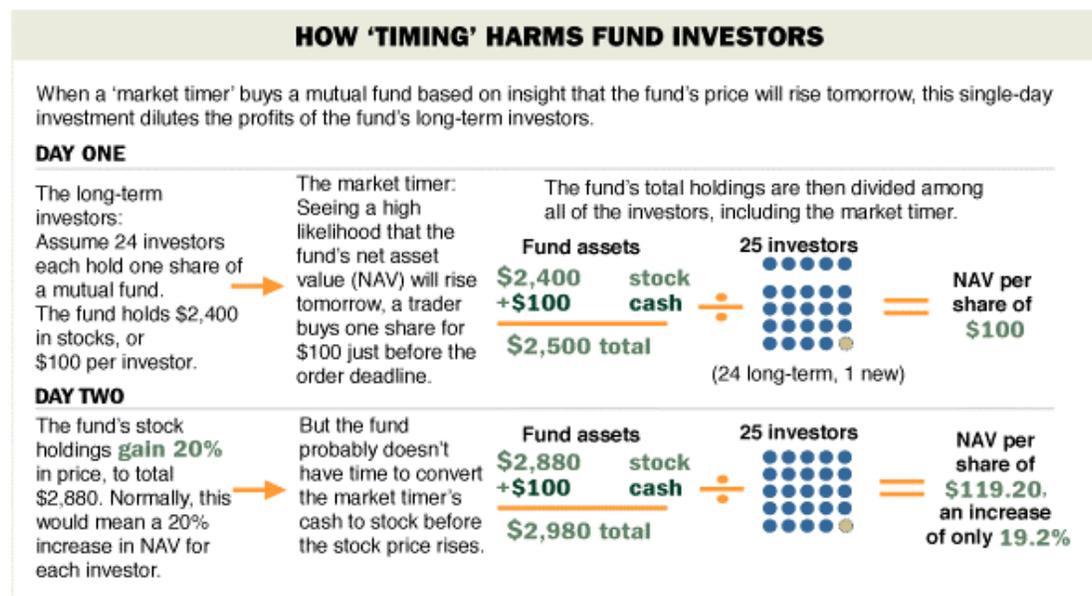
Mr. Elliot Spitzer, well known for his investigations regarding the conflicts of interest existing within the investment banking world, which resulted in over a billion dollars in payouts from the prominent investment banks, is back in the news again. This time his investigations are centered around illegal and/or improper trading activities. There were two types of trading that were the focus of the investigation – illegal “late trading” of fund shares after the close of the market and the frequent in-and-out “market timing” trades that may violate a fund’s operating policies. Both types of dealings are detrimental to existing long-term holders of the mutual funds.

How does this illegal trading work and what is impact on long-term holders?

Several prominent mutual funds have been tarnished by news in the media indicating their complicity in the illegal trading of their funds through a tacit understanding with hedge funds and investment banks that facilitate these trades.

The whole incident received prominence when Mr. Spitzer reached a settlement with a hedge fund, Canary Capital Partners LLC, which participated in these illegal and/or improper trading activities. Mr. Spitzer alleged that several mutual fund firms allowed Canary to practice questionable illegal “late trading” of mutual fund shares after the 4 PM Eastern time order deadline and also in frequent, albeit legal even if improper, in-and-out market timing trades that may violate a firm’s operating policies. Short-term traders siphon off some of the profits that would otherwise have gone to the funds’ long-term investors.

According to published research, fund returns decrease 1% to 2% due to the dilution from late trading and/or from other inappropriate trading. A recent article in the Wall Street Journal illustrated how dilution impacts portfolio returns as a result of these trading activities.



Source: Wall Street Journal, dated Sep 19, 2003 – “Timing at Mutual Funds Can Cost 2% a year.”

Investors engage in late trading due to a particular insight that could originate from corporate earnings announcements or other news events after the close of the stock markets. For instance, if a bellwether technology company would announce or pre-announce quarterly earnings after the market close indicating a big surprise in earnings, then the rest of the companies in the sector could also benefit from a stock market perspective. Similarly, if large cyclical company report strong earnings, investors may take that to mean a turnaround in economy and invest in funds that have overweight positions in cyclicals as these holdings benefit from a turnaround in economy. By allowing investors to illegally place their trade after close at a price for the same day's closing price, which is likely to be lower than the next day's price, investors are like to reap a tidy profit from such activities.

Short-term trading also imposes other costs on funds besides dilution. These costs include transaction costs if portfolio managers are constantly buying and selling securities in response to inflows and outflows. Other managers may instead hold a larger cash cushion, which serves as a drag on performance when security prices rise.

The firms involved

Several firms have been named in the investigation and, as it progresses, it appears that more and more firms are being implicated in these illegal activities. Bank of America, Janus Capital, One Group, and Strong are mutual funds that have been identified as some of the firms involved in late trading. In another investigation in Massachusetts, Putnam is also being investigated for their role in these illegal and/or improper trading activities.

Bank of America runs a number of the Nations Funds and one of their funds, Nations International Equity, is on our recommended list. The Nations International Equity fund has been named as one of the funds subject to market timing by Canary. However, Bank of America has asserted that the funds run by the firm have never been authorized for late trading since it is illegal. Other funds that may have been affected by market timing through Canary include: Nations Convertible Securities, Emerging Markets, Small Company, SmallCap Index, MidCap Index, LargeCap Index, Managed Index (now known as LargeCap Enhanced Core), Value, and Strategic Growth Funds. In addition, Bank of America has indicated that Canary also maintained longer-term investments in the Nations Short-Intermediate Government, Short-Term Income, and Government Securities and invested in the Nations Prime and Cash Reserve Funds.

Some of our clients are also invested with Janus funds and Janus has taken the same stance as Bank of America - denying any involvement in late trading although they have admitted that Canary may have used market timing with some of their funds.

Both Bank of America and Janus are cooperating with governmental and regulatory authorities and have indicated that they will institute appropriate employee disciplinary actions if there are any breaches in employee conduct. Beacon Pointe Advisors will continue to monitor the progress of these investigations and will provide updates and recommendation when more information becomes available.

Conclusion

- Mr. Spitzer's investigation and settlement with a hedge fund brought to light two types of dealings that hurt existing mutual fund holders – illegal “late trading” and frequent, albeit legal, in-and-out “market timing” trading of mutual funds.
- Five mutual fund firms have already been named that were alleged to support these activities including some used by Beacon Pointe clients such as the Nations Funds run by Bank of America, several of the funds run by Janus, and some of the funds managed by Putnam.
- At this time, investigations are in progress and we will strive to keep you posted regarding any new developments and their impact on our clients.
- Please contact your Beacon Pointe consultant should you have any questions.