

Unequal Daily Pricing of Mutual Fund Shares

The total amount that was lost by the investors in the infamous Bernard Madoff ponzi scandal is estimated to total \$17 billion. This doesn't remotely approach the amount that is now being lost by existing mutual fund shareholders due to the errant daily unequal mispricing of mutual fund shares. This mispricing of shares is costing these shareholders a staggering amount estimated at a total of \$20 billion a year.

Currently, when mutual funds price their shares at the close of each trading day, they inadvertently allow new investors who are purchasing shares and current shareholders who are liquidating shares avoid paying their portion of the trading commissions that were previously paid to assemble the mutual fund's current portfolio. These portfolio trading commissions were previously deducted from the assets of the mutual fund and therefore are not accounted for in computing that day's closing price. This means that the new investors and liquidating shareholders are not allocated their portion of the inherent portfolio trading commission costs. They are getting a free ride by avoiding paying their portion and transferring their cost to the existing shareholders, most of them who are long term investors. The longer mutual fund shareholders are invested in the fund the more they are cumulatively transferring a portion of their wealth to the buying and liquidating shareholders.

This is all documented by the research paper ***Mutual Fund Liquidity and Conflicts of Interest*** written by Dr. Miles Livingston of the University of Florida and Dr. David Rakowski of the University of Texas that was published in ***The Journal of Applied Finance***. Their \$20 billion estimate is based on calculations using independent data from the Investment Company Institute's ***Investment Company Fact Book*** and various SEC public documents.

There is a solution. I was issued a U.S. patent that is basically an algorithm that adjusts this uneven pricing of mutual fund shares by charging a specified fee to the purchasers and liquidators of the fund's shares and then directing these fees back into the assets of the fund, so as to compensate the existing shareholders, thus creating a fair price and establishing a level playing field for all. The fees charged are related to the trading commission's costs of the portfolio.

This algorithm adjustment also has the effect of reducing short-term trading by mutual fund investors thereby increasing portfolio performance. I refer to SEC Investment Company Act release 26782, dated March 22, 2005, that states “that excess trading can harm long-term investors because the fund manager must hold extra cash or sell investments at inopportune times to meet redemptions”. This is referred to as “market impact costs”. Not only will this patent create a fair price for all and increase market performance, it will also be cost effective to the mutual funds and to their management companies.

Drs. Livingston and Rakowski write in their research paper that the portfolio trading commissions costs for equity funds approximate an average of .15% to .20% of total assets. It should be noted that only equity funds are required to report the amount of their portfolio trading commissions to the SEC. Other types of funds, such as bond, balanced, hybrid, etc are not required to do so. They do not include in their computations the inherent differential spread costs between the bid and ask prices of the portfolio’s securities.

They also write that “market impact costs” add an additional cost of .20% to .40% of assets. They add that many published research reports put this at a much higher amount.

Mr. John Bogle, founder and former Chief Executive of the Vanguard Group, in his research paper ***The Arithmetic of “All-In Investment Expenses***, believes that the average portfolio trading commissions for all mutual funds equal .50% of assets. These amounts include the differential spread costs between the bid and ask prices of the portfolio securities. (Mr. Bogle has written to me in referring to our patent - “You have an interesting and important idea....”).

In the mutual fund “late trading scandals” of the early 2000’s, the various regulatory agencies assessed fines and restitution on some of the funds’ management companies totaling in the billions, some paying as much as \$150 million. The estimate is that it cost mutual fund shareholders a total of \$400 million a year.

Over the past two years I have notified the Commissioners and other various divisions of the SEC to inform them of the above, including notifying two Dodd-Frank committees. I have also formally filed, under SEC rules, a Petition for Rulemaking requesting that under the “full disclosure” and “disclaimer” provisions of the SEC Securities Act of 1933, that mutual funds should be required to inform the public by including this unequal pricing information in their current prospectuses. The Investment Company Institute and most mutual fund management companies have also been notified of this discrepancy.

Over 90 million Americans own \$15 trillion in mutual funds, which include \$6 trillion in retirement related accounts. U.S. mutual fund households hold a medium of \$100,000 in fund assets. Using the amount of portfolio trading costs at .5%, each mutual fund household are incurring an estimated loss to them of \$1,200 a year, or if held long term, a total of \$6,000 for 5 years and \$12,000 for 10 years, not counting for any appreciation or depreciation of their holdings.

Seymour Sacks

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Seymour Sacks is the President of Sacks Equalization Model Inc., the owner of the patent