



SEPTEMBER 12, 2003

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CANARY IN A COAL MINE

In the last few weeks New York State Attorney General Eliot Spitzer has settled a criminal charge against a hedge fund named Canary Capital. Since the details are rather complicated, and we don't really know the full extent of what transpired, it has received little reporting in the press. Nevertheless, it is very important to investors everywhere because for the first time it reveals the complicity of some mutual fund managers in the morally suspect adventures revealed by the recent stock market implosion.

Hedge funds are investment pools, similar to mutual funds. They differ from mutual funds because, aside from the confines of legality and morality, there are virtually no restrictions on how they can operate.

Since hedge funds are private partnerships, they do not usually disclose their practices to either investors or the public. Hedge fund operators are famous for their secretive and complicated investment strategies, their immense expenses, and their investing machismo. Sometimes they have delivered bogglingly good returns in the short run. As a result, some hedge fund managers have achieved rock star status in the financial media. Two famous examples are frenetic media star James Cramer (revealed in the must-read book "Trading With The Enemy" by Nicholas Maier) and occasional philanthropist and currency-wrecker George Soros.

Picture a mutual fund with only the wealthiest clients, virtually no financial controls, and almost no reporting, and you have a hedge fund. The dubious opportunity to invest in hedge funds is one perquisite of the wealthy. Complex and opaque investments such as hedge funds are also a major reason why the financial elite seldom stay affluent for more than two generations. Wealthy investors tend to invest in the latest hot investment, like the rest of us. Unlike the rest of us, who lack an unctuous posse of professional flatterers, they often ride a hedge fund or a trend until it self-destructs. Call it financial Darwinism.

Since the stock market meltdown began in 2000, more and more hedge funds have imploded, suddenly transmogrifying from vast successes into reeking sinkholes of financial disaster. Since they do not have to report results very often, their demise is usually unexpected.

Along with their destruction of immense wealth, these recent failures have often revealed the dirty little secret of how hedge funds sometimes obtain their immense results: they cheat. Hedge fund operators occasionally employ tactics that would send the rest of us to jail. They do not often go to jail because they spend immense amounts of money courting the well-connected and the politically powerful.

The star of the scam du jour is Edward J. Stern. Mr. Stern is heir to the Hartz Mountain pet supply empire. In fact, he named his company "Canary Capital" in memory of his grandfather's first business venture, which was selling canaries and canary food. Now Mr. Stern is short \$40 million dollars of pocket change in fines, the hedge fund investors have their money back, and subpoenas are flying like birdseed throughout the mutual fund world.

Attorney General Spitzer's criminal complaints are quite damning. He alleges, and Mr. Stern implicitly agrees, that Canary Capital had a criminal relationship with thirty or more mutual fund companies. In return for placing millions of dollars of his clients' money with these mutual funds, Mr. Stern was allowed to place trades in these mutual funds after the close of the market.

In other words, Mr. Stern was able to buy and sell when you and I could not. He was able to bet on the football game after it was over. He was able to wager at the blackjack table after seeing the dealer's cards. Other small-fry investors in the mutual fund paid for his privilege because we absorbed the extra trading costs and trading losses.

Furthermore, our elegant Mr. Stern was able to do this on a daily basis. In other words, in return for placing millions of dollars of client money with a mutual fund, for which the mutual fund was able to charge fees and trading expenses, Mr. Stern was able to get an essentially guaranteed day-trade return. This was most effectively done via “time zone arbitrage”, by trading international mutual funds that were invested in overseas markets, which had already been closed for hours. Now we know where his market-beating results came from.

Some mutual fund companies successfully attempted to prevent their funds from being abused like this. For example, Vanguard funds have a 3% redemption fee to discourage short term trading. But other fund companies seemed all too ready to join in the criminal enterprise.

Bank of America’s Nations Mutual Funds are mentioned in the criminal charges as being especially egregious. Apparently, Bank of America even had computers installed in the Canary Capital offices to permit access to the mutual fund’s internal computer system. This allowed Mr. Stern to place trades through special “back-door” channels. In addition, they loaned Canary Capital about \$300 million to set up this felonious enterprise. In essence, the bank was complicit in its own robbery.

Strong Mutual Funds apparently gave Canary Capital unusually late day-trading opportunities in return for profit-sharing kickbacks. Of course, Mr. Stern’s profits came directly from the pockets of the Strong Mutual Fund shareholders. The mutual fund managers got a kick-back for turning over their trusting clients for the mugging.

Janus is among the other mutual fund companies that apparently shared a less-than-healthy relationship with Canary Capital. At this point I don’t know exactly what happened between Janus and Canary Capital, but the fact that Janus was mentioned in the initial indictment is not a positive indicator. Of course we are breathing a sigh of relief here at Andresen and Associates, since we sold almost all our Janus and Strong holdings in 1999.

Expect this to become a very big deal, as it should be. It’s like finding a cockroach in your kitchen: there’s never only one. Edward Stern was not alone in his misuse of the system. Also expect to see mutual funds investigated by the bushel, the innocent and the guilty alike. The mutual funds who avoided this kind of slime should do very well. The funds who participated in ripping off their own clients will spend lots of money on marketing to snare new rubes.

I would expect to see mutual fund management companies with high trading volume involved in this sort of scheme. The more a fund company has celebrity “insider” managers, such as at Janus, the more likely they are to be found complicit. When you study the list of culprits, what leaps off the page is how involved in the Wall Street system they are. Eliot Spitzer’s criminal complaint is a “who’s who” list of go-go fund managers of the late 1990’s. We don’t usually invest in this kind of fund to begin with, since costs are usually higher and it is normally more difficult to find out what the fund manager is doing.

Value-driven fund managers who view themselves as independent outsiders such as John Bogle of Vanguard, Jean Marie Eveillard of First Eagle, or Charles Royce of the Royce Funds, are much less likely to be involved in criminal behavior. These managers view Wall Street as the three-dog circus that it is, and as a result, view themselves as adversaries of the establishment. Having denounced the system as rigged, they are not likely to entangle themselves in insider shenanigans.

Funds with a lower turnover ratio, that is, funds which do not do a lot of trading, would not be attractive to tapeworms such as Edward Stern because these funds don’t have enough internal turbulence to mask illegal trading.

This scandal will also have immense populist political ramifications as well. If the insiders of Wall Street are increasingly revealed as having the ethics of an Amsterdam bordello, then the SEC, by not protecting investors proactively, is revealed as being as empowered as the bordello’s toy poodle: dominated, petted, and fed by the very deviants it has sworn to defend us against.

Stay tuned. This is going to get interesting. Meanwhile let’s stay diversified and focus on the long term plan.

Meanwhile the financial markets continue to improve. It would be a superb year if it ended now. The S&P 500 is up 17% year to date and the NASDAQ is up 45%. Actually I think the NASDAQ is a bit ahead of itself. You may have noticed I am reducing NASDAQ and technology stock exposure. The numbers suggest that a *surprisingly strong* economic recovery is just beginning. Watch as we continue to reduce exposure to long bonds and other interest-sensitive investments.

I will be out of the office from September 17th through September 24th. Please call the office before then if you have any pressing issues or questions.