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INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION

VOLUME 2

CONSISTING OF

INTRODUCTION TO PART TWO OF THE STUDY: INSTITUTIONS AS INVESTMENT MANAGERS, AND THE FOLLOWING CHAPTERS:

CHAPTER IV.—INVESTMENT ADVISORY COMPLEXES

CHAPTER V.—BANK TRUST DEPARTMENTS

CHAPTER VI.—INSURANCE COMPANIES

OF THE INSTITUTIONAL INVESTOR STUDY REPORT, BEING A STUDY AND INVESTIGATION OF THE PURCHASE, SALE AND HOLDING OF SECURITIES BY INSTITUTIONAL INVESTORS OF ALL TYPES, PURSUANT TO SECTION 19(e) OF THE SECURITIES EXCHANGE ACT OF 1934 (PUBLIC LAW 90-438, 91-410)

MARCH 10, 1971.—Referred to the Committee on Interstate and Foreign Commerce and ordered to be printed

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Introduction to Part Two: Institutions as Investment Managers

A. Institutional Managers and Managed Portfolios

Part One (Chapters II and III; NBER Report) has examined long-term trends in the structure of national balance sheets and flows of funds through financial institutions. Broad changes in the composition of the financial asset holdings of major financial institutions and portfolios have been traced. Part Two (chapters IV through IX) examines in greater detail the recent organization and behavior of those institutional managers active in the equity securities market.

In performing this analysis the Study has attempted to maintain a clear distinction between the institutional managers, on the one hand, and, on the other, the institutional portfolios being managed. The principal institutional managers are studied. They are investment advisory firms (chapter IV), bank trust departments (chapter V) and insurance companies (chapter VI). Certain substantial portfolios, including some pension and profit-sharing plan assets and educational and foundation endowments, are not externally managed but rather are administered by personnel of the funding employer, or officers or affiliated persons of the educational institutions and foundations. These "self-administered" portfolios are examined in chapter VIII and compared to similar portfolios managed by bank trust departments and investment advisory firms.

Among the types of managed portfolios considered in Part Two are various commingled funds, such as mutual funds and hedge funds (chapter IV), offshore funds (chapter VII), common trust funds (chapter V), pooled employee-benefit funds (chapter V) and life insurance and property and liability insurance company investment accounts (chapter VI). Also examined are various management or advisory accounts (chapters IV and V), personal trusts (chapter V), endowments and foundations (chapter VIII), and retirement plans (chapter VIII). The distribution and characteristics of common stocks held in portfolios of institutions are considered in chapter IX.

In general, the Study selected institutional and portfolio groups for analysis because they were: (1) large holders of equity securities, (2) active traders of equity securities, or (3) had displayed the potential interest and ability to become significant factors in equity security markets. Thus, bank trust departments and investment advisory firms qualified because they constitute the largest classes of institutional asset managers investing significantly in equity securities. Among the portfolios studied, corporate pension benefit plans and investment companies are the largest investors in common stock. Offshore funds (chapter VII) and hedge funds (chapter IV) receive attention because of their propensity to trade equity securities actively. Life insurance companies and state and local government retirement systems qualify as institutions and portfolios respectively because of the mag-

nitude of the assets under their control and their developing interest in equity security investments.[1]

An approximate measure of the assets and common stock which came under the Study's purview is provided in Tables 1 and 2. These tables attempt to classify assets (and common stock) under management by both type of manager and type of portfolio. This is a difficult task because of the process of financial integration that has developed increasingly during recent years—that is, institutions moving into related activities have blurred conventional institutional category distinctions. Thus, for example, where insurance companies have acquired control of investment advisory complexes it is not obvious whether the mutual funds and other portfolios managed by the advisory complex should be regarded as managed by the insurance or by the investment advisory industry.[2] Identification of portfolio managers also is made difficult by the use of multiple advisers by some portfolios and the wide variance in investment responsibility and discretion granted by beneficial owners or controlling persons to some types of investment managers. These practices make some double counting of assets unavoidable.

In order to provide a measure of the problem, Tables 1 and 2 show an estimate of the total assets for which investment advisory firms provide investment advice or management and in parentheses the portion of those assets over which investment advisers have sole investment discretion. The amount of assets managed exclusively by investment advisers in each category is somewhere between the two numbers shown. A somewhat similar problem exists in bank-managed accounts; a description of the extent of banks' investment discretion is provided in chapter V for a sample of accounts from the 50 largest bank trust departments. The amounts of insurance company assets which also are counted elsewhere is believed to be relatively inconsequential.[3]

Assets shown in Table 1 are estimated at market value, except for the greater portion of the assets of insurance companies. Most assets managed by insurance companies, other than common stock and assets of registered investment companies, are valued at amortized cost. All common stock estimates in Table 2 are at market value.

Tables 1 and 2 necessarily make some ad hoc allocations of assets between common stock and debt securities. For example, a portion of insurer-managed assets and common stocks is allocated to the interests of employee-benefit plans. This is done by allocating insurers' general account assets to employee-benefit plans in the ratio of reserves for these plans to total insurance reserves. All such allocations are detailed in footnotes to Tables 1 and 2.

Of the $714 billion total assets in 1969 shown in Table 1, about 44 percent are invested in common stocks. This proportion is reduced by

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[1] Among managers and portfolios excluded from the Study's coverage are mutual savings banks, which have modest common stock investments, law firms, which manage or advise a substantial, but unknown, amount of funds, religious organizations and brokerage accounts where (even when transactions are discretionary or solicited) no direct compensation for investment advice is assessed.

[2] In this case the tables allocate these portfolios to the investment advisory industry and only assets of investment companies which represent separate accounts registered under the Investment Company Act of 1940 and mutual funds created by insurers are counted as insurer managed.

[3] Chapter IV provides estimates of the amount of insurer assets receiving investment advice from investment advisory firms.

the large fraction of insurance company general account assets held in debt securities. Excluding insurer assets, about 62 percent of the remaining assets managed by institutional types covered by the Study are invested in common stock.

B. THE INSTITUTIONS DURING THE 1960'S: THEIR ACTIVITIES AND THE ISSUES

In conducting its analyses of institutional organization and behavior the Study was particularly conscious of several frequently mentioned trends in institutional activity. These include the movement of some institutions and portfolios into equity securities, the increased emphasis on investment performance accompanied by a greater willingness to accept investment risks, and the process of financial integration (or diversification).

The movement toward equities was especially prominent, for example, in life insurance company portfolios, primarily through the development of equity separate accounts as funding media for pension-benefit plans, and in state and local government retirement system portfolios. Other types of portfolios which previously had held significant amounts of equity securities increased the proportion of their common stockholdings. Part Two of the Study describes these movements and some of the pressures and incentives responsible for the increased interest in equities.

Investment performance consciousness developed at a number of levels. In some cases it meant that beneficial owners or other controlling interests came to recognize that professional investment management offered a possibility of increasing investment return from what previously had been essentially unmanaged portfolios. In some cases, performance consciousness meant a new concern with total investment return, including realized and unrealized capital gains (losses) rather than a focus upon current income, and investment policies were changed accordingly. Financial pressures on some affected parties, such as universities and other nonprofit institutions and employers required to fund retirement benefits promised in collective-bargaining agreements, led to their exercising closer scrutiny of investment managers, shifting portfolios to other investment managers and, in some cases, splitting assets among several investment managers.

In order to appraise the investment results produced by these managers, an interest in better measures of performance evolved, and much has been accomplished technically in developing such measures. Whereas some portfolio owners and managers have simply attempted to increase investment return by increasing risk, others have been conscious of risk-return relationship and some portfolio managers are being evaluated on the basis of return adjusted for risk. Finally, performance consciousness in some cases has been identified with very active short-term trading, leveraging and speculation in equity issues of thinly capitalized enterprises.

At each of these levels of performance consciousness it appeared that an increased interest in investment return was accompanied by increases in the turnover of equity security portfolios. These turnover rate increases were significant for many types of portfolios. In

Part Two, turnover rates during 1965 to 1969 are computed and analyzed for a wide variety of institutional manager and portfolio classes. For limited types of accounts it is possible to investigate the relationship between realized investment performance, volatility and turnover rates.

The process of financial integration began to have major effects upon the structure and behavior of financial institutions during the 1960's. Some institutions, such as commercial banks, have integrated numerous financial services for many years. Even banks, however, have desired to add additional services, such as commingled agency accounts, and through holding companies have established affiliations with investment advisory firms and insurance companies. Insurance companies, in addition to placing greater emphasis upon the investment management of assets generated by insurance operations, have affiliated with mutual funds and investment advisory firms. Some brokers have expanded into the investment advisory and mutual fund businesses. Part Two attempts to deal with some of the implications of these developments.

One of the effects of financial integration is that it tends to create or increase potential conflicts of interest and problems of equitable treatment when many customers' investment and other financial needs are being serviced. Potential conflict situations are created when institutions, through their asset management activities (1) are simultaneously creditors to and shareholders in a corporation, (2) are brokers and investment advisers, (3) accept deposits and manage portfolis, or (4) offer insurance or other financial services and provide investment management.

The chapters include material bearing on these trends and issues. They explore the nature and intensity of competition among investment managers, economies of size realized at the manager or account level and the extent to which realized economies are passed on to customers, the influence of other financial services offered by institutions upon investment selections, trading decisions and the viability of competion among investment managers, and managerial policies and practices developed to deal with conflict of interest questions.

Although data and information utilized in Part Two were derived from many sources, the primary source in each chapter was information obtained through the Study's questionnaires. These were of three basic types: (1) survey questionnaires, (2) institutional "intrinsics" questionnaires, and (3) portfolio or account questionnaires. Survey questionnaires were utilized to establish some knowledge of the universe of institutions or portfolios where no satisfactory information existed. Thus, one such questionnaire provided something approaching a census of investment advisory firms. Another provided a basis for sampling bank trust department accounts, and other survey questionnaires provided a census of large pension-benefit plans, state and local government retirement systems and educational endowments.

Institutional intrinsics questionnaires were sent to bank trust departments, investment advisory firms, insurance companies and some self-administered portfolios. These questionnaires elicited information on the investment organization and structure of the managers, services offered, affiliations and other data intrinsic to the institutional class.

Account questionnaires produced data on individual accounts, including detailed asset composition, holdings of individual equity securities, purchases and sales of common stocks, management fees charged and other characteristics of the accounts. Some of these account samples were drawn from the groups of managers—that is, from banks, investment advisory firms and insurance companies—and some from their clients, the portfolio's beneficial owners—that is, from pension plans, universities, foundations, etc. The structure of these questionnaires assured a substantial degree of uniformity in the treatment of these data in each of the various chapters.

TABLE 1.—TOTAL ASSETS OF PORTFOLIOS CLASSIFIED BY MANAGER TYPE—Continued

[In millions of dollars—1969 [1]]

Manager class	Portfolio type: Foundation	Educational endowment	Employee benefit plans	Insurance accounts other than pensions or mutual funds	Registered investment companies	Personal trust and estates	Personal advisory accounts	Other	Total
Self-administered foundation	[2] 15,210	None	None	None	None	None	None	None	[2] 15,210
Self-administered educational endowment	None	[3] 4,710	None	None	None	None	None	None	[3] 4,710
		(7,830)							(7,830)
Self-administered employee benefit plan	None	None	[3] 57,810	None	None	None	None	None	[3] 57,810
			(73,080)						(73,080)
Property and liability insurance group	None	None	None	[4] 48,940	([5])	None	None	None	[4] 48,940
Life insurance company	None	None	[6] 47,130	[7] 149,810	[8] 680	None	None	None	197,620
Investment adviser [9]	[2] 1,420	5,660	19,600	4,110	63,280	([5])	[10] 25,650	14,500	134,230
		(2,540)	(4,330)	(380)	(57,040)		(9,620)	(3,880)	(79,210)
Bank	[2] 3,650	[11] 2,430	[12] 81,120	([5])	([5])	[12] 122,180	([5])	[13] 45,790	[12] 255,170
Total	[14] 20,280	[14] 12,800	[15] 205,660	202,860	63,960	[12] 122,180	[10] 25,650	60,300	713,700
				(199,130)	(57,720)		(9,620)	(49,680)	(677,080)

[1] Year-end data except for the investment adviser category which represents June 30, 1969. All assets at market value except insurance company assets most of which are valued at amortized cost. Details may not add to totals due to rounding.

[2] Estimated using percentages derived from the study's data on management of large foundations (see table VIII–184). The self-administered category includes foundations whose principal asset is the common stock of 1 firm and can be considered as requiring no investment management.

[3] Residual. The 2 figures represent limits for the range of assets that are presumed to be self-managed. The maximum (figure in parentheses) is derived by subtracting bank-managed assets and assets over which investment advisers report discretionary authority from the estimate of all assets in the category. The minimum figure is derived using all assets of investment advisers regardless of investment discretion.

[4] Adjusted to eliminate the stockholdings of property and liability groups in affiliated insurance companies.

[5] Not available.

[6] Estimated by applying the proportion of insured pension reserves to total reserves (37,900/158,550) against total life insurance assets (197,208).

[7] Residual.

[8] Represents only assets of mutual funds (413,000) or variable annuity separate accounts (264,000) originated by insurance companies, not those management companies that have been acquired. Approximately 8,000,000 of recently acquired investment company assets have been considered here as managed by investment advisers.

[9] Numbers in parentheses are discretionary assets reported by investment advisers and can be considered the minimum of assets in each category. (See instructions for form 1–5 in supplemental vol. II for the definition of discretionary assets.)

[10] Includes personal trusts.

[11] Estimated using a percentage derived from the study's data on bank management of large educational endowments. (See table VIII–148.)

[12] Adjusted to take account of situations in which the bank neither has investment discretion nor gives investment advice. 15 and 8 percent reductions for employee benefit and personal trust and estate accounts, respectively. (See table V–7.)

[13] Includes personal advisory accounts and some institutional agency accounts; includes some accounts where the bank neither has investment discretion nor gives investment advice.

[14] Estimated using techniques described in app. III of supplementary vol. 1, NBER report.

[15] Total employee benefit plans estimated as the sum of 3 components: (1) insured plans of all types (47,133), (2) noninsured State and local plans (51,000) and (3) noninsured corporate and multiemployer plans (107,529). The noninsured corporate and multiemployer plans figure is the SEC preliminary 1969 data for pension and profit-sharing plans (91,400, at market value) and an estimate for other types of employee benefit plans such as, thrift plans, vacation plans, etc. (16,129).

Note: This table supersedes that printed in text of ch. 6.

TABLE 2.—COMMON STOCK OF PORTFOLIOS CLASSIFIED BY MANAGER TYPE

[In millions of dollars—1969 [1]]

Manager class	Portfolio type: Foundation	Educational endowment	Employee benefit plans	Insurance accounts other than pensions or mutual funds	Registered investment companies	Personal trust and estates	Personal advisory accounts	Other	Total
Self-administered foundation	[2] 11,620	None	None	None	None	None	None	None	[2] 11,620
Self-administered educational endowment	None	[3] 2,570 (4,550)	None	None	None	None	None	None	[3] 2,570 (4,550)
Self-administered employee benefit plan	None	None	[3] 13,390 (20,730)	None	None	None	None	None	[3] 13,390 (20,730)
Property and liability insurance group	None	None	None	[4] 11,720	([5])	None	None	None	[4] 11,720
Life insurance company	None	None	[6] 4,390	[7] 5,720	[8] 530	None	None	None	10,640
Investment adviser [9]	[2] 1,070	3,610 (1,620)	9,940 (2,600)	1,270 (200)	51,610 (47,960)	([5])	[10] 20,200 (7,650)	7,760 (2,470)	95,470 (63,580)
Bank	[2] 2,600	[11] 1,540	[12] 50,370	None	([5])	[12] 81,360	([5])	[13] 29,260	[12] 165,140
Total	[14] 15,290	[14] 7,720	[15] 78,100	18,710 (17,650)	52,140 (48,480)	81,360	20,200 (7,650)	37,020 (31,730)	310,550 (287,980)

[1] Yearend data except for the investment adviser category which represents June 30, 1969. All common stock is reported at market value Details may not add to totals due to rounding.

[2] Estimated using percentages derived from the Study's data on management of the common stock of large foundations (see Table VIII-189). The self-administered category includes foundations whose principal holding is the common stock of one firm and can be considered as requiring no investment management.

[3] Residual. The 2 figures represent limits for the range of common stock assets that are presumed to be self-managed. The maximum (figure in parentheses) is derived by subtracting bank-managed common stock and common stock over which investment advisers report discretionary authority from the estimate of all common stock in the category. The minimum figure is derived using all common stock of all investment advisers regardless of investment discretion.

[4] Adjusted to eliminate the common stockholdings of property and liability insurance groups in affiliated insurance companies.

[5] Not available.

[6] Estimated using 2,700,000 of common stock reported in separate accounts (primarily employee benefit plans) plus 1,690,000 estimated as general account common stock supporting general account pension plan assets. The general account common stock associated with pension plans is derived by applying the proportion of general account pension reserves to total general account reserves (34,400/155,050) to general account common stock (7,618).

[7] Residual.

[8] Estimated on the assumption that the common stock to total assets ratio of registered investment companies originating with investment advisers (0.78) holds for registered investment companies originated by life insurance companies. Approximately 6,000,000 of stock held in recently acquired management companies have been considered here as managed by investment advisers.

[9] Numbers in parentheses are common stockholdings over which investment advisers report they have legal discretion. The instructions for Form 1-5 in Supplemental Vol. II defines legal discretion.

[10] Includes personal trusts.

[11] Estimated using a percentage derived from the Study's data on management of the common stock of large educational endowments. (See Table VIII-153.)

[12] Adjusted to take account of situations which the bank neither has investment discretion nor gives investment advice; 15 percent and 8 percent reductions for employee benefit and personal trust and estate accounts respectively. (See table V-7.)

[13] Includes personal advisory accounts and some institutional agency accounts; includes some accounts where the bank neither has investment discretion nor gives investment advice.

[14] Estimated using techniques described in app. III of Supplementary Vol. I: NBER report.

[15] Total employee benefit plans estimated as the sum of 3 components: (1) insured plans of all types (4,390), (2) noninsured State and local plans (5,827) and (3) noninsured private plans (67,882). The noninsured private plans figure is the SEC preliminary 1969 data for corporate and multiemployee pension and profit sharing plans (57,670 at market value) and an estimate for other types of employee benefit plans (10,212).

Sources for Tables 1 and 2:

1. Foundations: Supplemental Vol. I: NBER Report app. III. Total assets data were extrapolated from Table AIII-1, 5 and the common stock was extrapolated from Table AIII-3, 8.
2. Educational endowments: Supplemental Vol. I: NBER Report, app. III. Total asset and common stock data were extrapolated from Table AIII-5, 13.
3. Employee benefit plans: Insured plans, Institute of Life Insurance, Life Insurance Fact Book, 1970, 38; noninsured State and local plans, Board of Governors of the Federal Reserve System, et al., "Financial Assets and Liabilities as of Dec. 31, 1969," "Flow of Funds," statistical release, May 15, 1970, 2; noninsured corporate plans, Securities and Exchange Commission, Office of Policy Research.
4. Property and liability insurance groups: A. M. Best Co., Best's Aggregates and Averages—Property and Liability 1970, 1, 52, 152.
5. Life insurance companies: Institute of Life Insurance, Life Insurance Fact Book 1970, 70 84, 85.
6. Investment advisers: Institutional Investor Study, ch. IV, Table IV-1. Securities and Exchange Commission, 35th annual report of the Securities and Exchange Commission, 125.
7. Banks: Board of Governors of the Federal Reserve System, et al., Trust Assets of Insured Commercial Banks 1969, Table 1, 5.

Note: This table supercedes that printed in text of ch. 6.

CHAPTER IV

INVESTMENT ADVISORY COMPLEXES

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CHAPTER IV

Investment Advisory Complexes

A. THE INVESTMENT ADVISORY INDUSTRY

1. Overview of the Industry

The Investment Advisory Industry is one of the largest United States financial industries. It is probably the largest for which so little aggregate information has been publicly available. As of December 1970, the industry is composed of approximately 3,500 advisory firms which provide professional investment advice to a wide array of corporate, institutional and individual clients. As of June 30, 1969, assets under advisement of one type or another ("advisory assets") totalled $130 billion, of which $54 billion was that of registered open-end investment companies ("mutual funds"). Firms in the industry range from several billion dollars of advisory assets and several thousand advisory clients to firms whose sole activity is publication of investment news letters.

As defined in Section 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-2(a)(11) (Supp. V., 1965-1969), the term "Investment Adviser" means:

> Any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business issues or promulgates analyses or reports concerning securities.[1]

For the purposes of this chapter only those advisers with "investment advisory clients" have been considered. Advisers whose sole service consists of issuing written reports which are distributed to a wide number of clients (for example, investment newsletters) are excluded.[2]

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[1] The act then excludes the following from the definition: (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company; (B) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; (E) any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchhange Act of 1934, as exempted securities for the purposes of that Act; or (F) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

[2] The publication oriented advisers were considered in ch. III of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1 at 330-386 (1963) ("Special Study").

This chapter considers both registered and non-registered investment advisers.[3] Among the non-registered advisers included are advisers whose only clients are mutual funds, the officers of several internally managed closed-end registered investment companies, the general partner(s) of a number of private investment partnerships ("hedge funds") and the advisers to several offshore funds. Specifically excluded from this chapter were bank trust departments and insurance companies, which are considered in chapters V and VI of the Study.

The variety of advisory firms is as great as the variety of clients, and the variety of services and facilities of these firms covers a wide range. The origin of the investment adviser can be traced to the professional trustee who early in this century performed the role of family financial counsellor. Gradually, some of these trustees joined together, and from these groups the profession of investment counsel evolved after World War I. In general, investment counsel firms and individual investment counsellors follow professional standards and are either exclusively or primarily engaged in rendering (on a continuing basis) advice "as to the investment of funds on the basis of the individual needs of each client." [4] Historically, they had little or no affiliation with brokers, bankers or underwriters and their compensation was designed to be independent of the number or frequency of transactions and unrelated to a share of capital gains of the client.[5]

In addition to investment counselors other sources of investment advice developed. Brokerage firms historically rendered investment advice to their customers, generally with payment in the form of commissions on transactions. Others have historically through the publishing business provided a general investment research service on a subscription basis rather than "investment supervisory services." [6]

Finally, registered open end management type investment companies ("mutual funds") grew over the same period particularly since World War II, and provided a vehicle for more direct investment management. There were thus four separate roots from which the present investment advisory industry developed.

These varied forms of investment advisers have in turn developed at an accelerated pace in different directions. Some counselors have remained independent entities advising individuals and institutions. A number of formerly independent investment counsel firms [7] were acquired by brokerage firms and investment advisory departments were organized by other brokerage firms. Many of the publishing firms developed investment supervisory facilities. Bank and insurance company holding companies and even individual corporations have entered

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[3] Registration under the Investment Advisers Act has not been required for:

(1) Advisers whose only clients are investment companies and insurance companies;

(2) Advisers who have fewer than 15 clients and who do not hold themselves out generally to the public as investment managers.

Investment Advisers Act, sec. 203(b), 15 U.S.C. § 80b-3(b) (1964). The Investment Company Amendments Act of 1970, Pub. L. No. 91-547, signed into law on December 14, 1970, modifies this exemption. See subsec. 3 below.

[4] See the definition of "investment supervisory services" in sec. 202(a)(13) of the Investment Advisers Act, 15 U.S.C. 80b-2(a)(13) (1964).

[5] See Standards of Practice for Member Firms of the Investment Counsel Association of America.

[6] Investment Advisers Act, sec. 208(c)(2), 15 U.S.C. 80b-8(c)(2) (1964).

[7] Section 208(c) of the Investment Advisers Act, 15 U.S.C. 80b-8(c) (1964), prohibits any registered investment adviser from representing that he or it is an "investment counsel" unless (1) his or its business consists of acting as investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services.

the area through acquisitions and the organization of new firms. Also, in the recent past, many firms which were formerly entirely or primarily investment company advisers or managers have diversified through seeking other advisory clients, notably large institutional advisory clients. Other investment advisers entered the investment company area for the first time.

The advisory clients can be divided into three basic categories:

(a) Investment companies;
(b) Institutional and corporate accounts; and
(c) Individuals and personal trusts.

The investment company category is comprised of registered investment companies and several types of non-registered companies, the most prominent of which are offshore funds and private investment partnerships ("hedge funds"). Offshore investment companies are mutual funds whose shares are available only to non-U.S. citizens and residents, and which invest all or a substantial part of their funds in U.S. securities. These funds are typically resident in a "tax haven" and pay no U.S. tax on capital gains realized.[8]

The institutional and corporate accounts include employee benefit plans, college endowments, religious organizations, insurance companies and various types of non-financial corporate accounts. The final category is individual and personal trust accounts. All these different types of accounts can be advised on a separate or joint basis.

Tables IV-1 and IV-2 provide a breakdown of advisory assets as of June 30, 1969. The tables were prepared from data collected through the use of Study Questionnaire I-5.[9] The tables represent data from 1,343 firms which, to the extent possible to ascertain, represent all the significant advisory firms in the industry.

The data show that the largest single account category is registered open-end investment companies. They represent $54.7 billion of the $130 billion total, or 42.0 percent of industry assets. Individuals and personal trusts, while accounting for 82 percent of the number of accounts managed, represent only 19.6 percent of assets. Employee benefit plans, including state and local retirement systems, are the next major category and represent 15 percent of total industry assets.

Of the $130 billion of assets, $78 billion is listed as discretionary and $52 billion as non-discretionary.[10] The major portion of the discretionary assets are made up of registered investment companies (open end and closed end), which account for $55.7 billion [11] of such assets.

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[8] See ch. VII of the Study for a discussion of offshore funds.

[9] For a discussion of the respondent universe for the various investment adviser questionnaires, see app. IV.A.

[10] "Discretionary" was defined to include any account for which the advisory firm or its affiliate has legal authority to select the securities bought or sold, without obtaining the consent of the client or another person or firm before the transaction is effected, whether or not consent is customarily obtained.

"Affiliate" was defined to include any general partner, director, officer, or employee of the firm or a person or firm that directly or indirectly controls, is controlled by, or is under common control with, the firm, except that no bank or insurance company was to be deemed an affiliate.

[11] Registered investment companies are typically advised by a management company whose employees are also officers of the investment company. The high proportion of discretionary fund assets resulted from questionnaire instructions rather than adviser response. Instructions to respondents provided "if your firm is the investment adviser of a registered management investment company, treat the account as discretionary, but if your firm merely furnishes recommendations to another firm which in turn acts as investment adviser to the investment company, treat the account as non-discretionary."

Thus from the tables it is seen that $2.3 billion of registered investment company assets were advised on the non-discretionary basis described.

The institutional and corporate accounts totalled approximately $40 billion of which $31 billion were non-discretionary. A major portion of individual and personal trust assets ($16 billion of $26 billion) were also designated as non-discretionary advisory assets.

Tables IV–3 through IV–8 provide data on the composition of advisory assets within advisory complexes as well as the growth rates of the number of accounts and value of assets under advisement during the five year period 1964–1969. The data represent responses of a sample of 120 advisory firms to Study Questionnaire I–65.[12]

In much of the statistical data in this chapter, the responding firms were stratified by their major type of advisory activity and by size of advisory assets as of December 31, 1969. The activity stratification was into "fund" and "non-fund" advisory complex. A "fund" complex is defined as an advisory firm where more than one-third of assets being advised (as of September 30, 1969) were represented by assets of registered investment companies. All other advisory firms were classified as "non-fund" complexes. This was done in order to separate the essentially mutual fund advisory firms from the investment counsel firms.[13] An advisory firm was classified as "large" if it provided advice for more than $100 million of advisory assets as of December 31, 1969.[14] All other advisory firms were classified as "small."

Tables IV–3 and IV–4 provide data for large and small fund complexes. Tables IV–5 and IV–6 present non-fund advisory complex data and Tables IV–7 and IV–8 combine the two types of advisory complexes.

The data indicate a rapid rate of growth of assets under advisement in the sample of firms. For large firms, the five year rate of growth of total advisory assets was 14.4 percent per year (Table IV–7). For small firms the growth rate was 19.0 percent per year (Table IV–8). During the period large non-fund complexes had a

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[12] See app. A for a description of the respondent group for form I–65.

[13] The structure of the mutual fund industry was described in ch. XI of the Special Study and in ch. II of the Commission's Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 45–59 (1966) ("Public Policy Report"), and a detailed discussion is not called for here.

In summary, it may be said that most mutual funds contract out their principal functions to other organizations that work for them on a fee basis. This externalization of management is the most striking feature of the mutual fund industry's organizational pattern. This external manager is known as the fund's "investment adviser" and the fund pays the adviser an "advisory fee."

The investment adviser usually has organized and remains closely affiliated with the fund. The adviser selects the fund's portfolio and operates or supervises most other aspects of its business. While a mutual fund adviser can be an individual, most are partnerships or corporations. A mutual fund investment adviser may have no nonfund clients, or it may combine its mutual fund activities with a general investment counseling and/or securities business.

Many mutual fund advisers organize and manage a number of funds which have different types of investment policies. This enables the mutual fund adviser to reach a broader cross section of potential investors and to offer each investor the opportunity to apportion his aggregate mutual fund investment among several funds with different investment objectives all managed by the same adviser.

[14] In the classification of firms by asset size several points should be noted. First, size of assets in the advisory industry should not be compared directly with size of such institutions as banks trust department or insurance companies because the relationship is essentially advisory and most often terminable at the client's option on short notice. Second, the composition of advisory assets can vary significantly among firms if there is a different composition in clients. For example, large institutional clients may have a substantially higher proportion of bonds than aggressive individual accounts. Third, the degree of influence of an investment adviser over assets on which he provides investment advice may vary significantly, particularly with respect to such matters as a placement of brokerage and the voting of proxies in portfolio securities.

substantially higher rate of growth than large fund complexes (21 percent per year vs. 9.5 percent per year).

The fastest growing advisory account was that of non-registered investment companies other than offshore funds. As indicated previously, this category is comprised mostly of private investment partnerships ("hedge funds"). While all small advisory complexes as a whole were growing at a yearly rate of 19.0 percent, accounts of non-registered investment companies other than offshore funds advised in such complexes were growing at the rate of 152.7 percent per year (Table IV–8). This account category was also the fastest growing with respect to all large advisory complexes, growing at the rate of 39.9 percent as opposed to the total per year growth rate of all large advisory complexes as a whole of 14.4 percent (Table IV–7).

2. Concentration of Advisory Assets

Table IV–9 shows the cumulative distribution of advisory assets by numbers of advisory complexes. Of the $130 billion of total advisory assets reported by the 1,343 respondents to Study Questionnaire I–5, 23.5 percent of these assets were concentrated in five advisory firms. The largest 25 firms advised 60.3 percent of assets, the top 50 firms 75.6 percent.

For the $78.0 billion of discretionary advisory assets reported, the distribution was somewhat more concentrated. The top five firms advised 26.9 percent of discretionary assets, the top 25 firms 63.4 percent and the top 50 firms 78.9 percent of discretionary assets.

When the common stock portion of advisory assets was examined, a degree of concentration similar to that for total assets was found. Also the discretionary common stock component of advisory account assets was more concentrated by advisory firm than total common stock holdings.

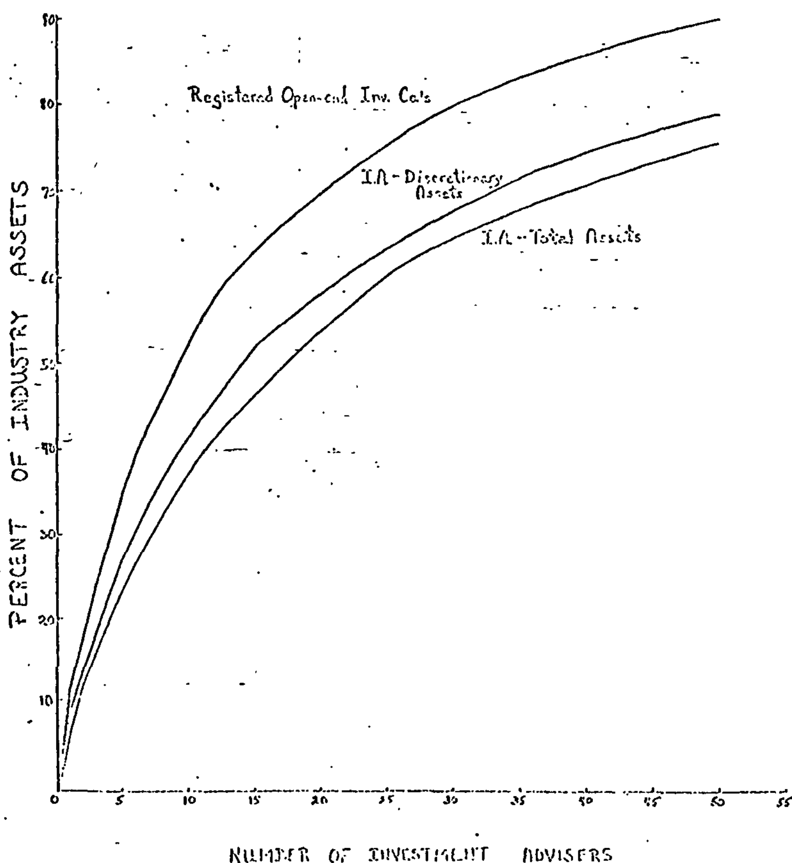
Registered open-end investment company assets were found to be the most highly concentrated. When advisory complexes were ranked by their total mutual fund assets, the top five firms advised 34.6 percent of these assets, the top 25 firms 75.4 percent and the top 50 firms 90.0 percent of mutual fund assets.

The above results are shown graphically in Figure IV a–1, where the cumulative percentage of various categories of advisory assets is plotted against the number of advisory complexes.

Table IV–10 presents similar concentration statistics for the various classes of advisory asssets reported on Form I–5. The statistics were obtained by ranking the advisory complexes by the amounts of assets advised in *each* category. For separately managed individual and personal trust accounts, 22 percent of assets were advised by five firms, 62.0 percent by 25 firms and 77.3 percent by 50 firms. Institution and corporate advisory assets were found to be most highly concentrated. The ten largest advisory firms for *each* type of client were found to advise 66.5 percent of employee benefit plans, 84.6 percent of life insurance company accounts and 81.0 percent of university and college endowments.

Figure IV a-1

Cummulative Percentage of Advisory Assets by Number of Advisory Complexes



3. Regulatory Pattern

a. Registered investment advisers

With minor exceptions, Section 203(a) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(a) (1964), makes it unlawful for any investment adviser, unless registered with the Commission, to make use of the mails or any means or instrumentality of interstate commerce (the "jurisdictional means") in connection with the adviser's business. Investment adviser is defined broadly to include, among other things, any person who, for a fee, engages in the business of advising others with respect to securities.[15]

[15] Section 202(a)(11), 15 U.S.C. 80b-2(a)(11) (1964). This section excludes from the definition of an investment adviser, among others, "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."

However, exempted from the registration requirement are, among others, investment advisers "whose only clients are investment companies and insurance companies." [16] These advisers, however, are affected by certain provisions of the Investment Company Act.

Registration under the Investment Advisers Act is accomplished by filing with the Commission a form which contains items pertaining to the name and form of organization of the investment adviser; education and prior business affiliations of its principals; the nature of the adviser's business; the scope of its authority; the basis of compensation, and other specified information.

Thereafter, the registered investment adviser becomes subject to special regulation governing his contracts; the maintenance and preservation of specified kinds of books and records,[17] and other regulatory provisions relating to the conduct of his business. Thus, the Investment Advisers Act prohibits any investment adviser, unless exempt from registration pursuant to Section 203(b), from using the jurisdictional means with respect to any investment advisory contract which (1) "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client," [18] or (2) "fails to provide, in substance, that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract." [19]

The Investment Advisers Act also contains sections prohibiting fraudulent, deceitful and manipulative conduct,[20] and prohibiting misstatements or omissions of a material fact in any registration application or report required to be filed with the Commission.[21] These antifraud provisions apply to all investment advisers, whether or not they are required to be registered.

Pursuant to the provisions of Section 206, the Commission has adopted a rule containing specified prohibitions and related requirements governing the publication, circulation or distribution of any advertisement by any investment adviser.[22] Among other things, the rule (1) prohibits any advertisement which refers to any testimonial of any kind concerning any adviser or his advice; (2) requires the investment adviser to furnish a list containing specified information respecting all recommendations made by the investment adviser during the past year if he refers in the advertisement to any past specific recommendations that would have been profitable; (3) prohibits him from representing that any graph, chart, formula or other device

[16] Section 203(b)(2), 15 U.S.C. 80b-3(b)(2) (1964). The Investment Company Amendments Act of 1970 removes the exemption for investment company advisers effective December 14, 1971, by deleting the words "investment companies and" from Section 203(b)(2) of the Investment Advisers Act.

[17] Section 204 of the Investment Advisers Act, 15 U.S.C. 80b-4, and Rule 204-2 thereunder, 17 CFR 275.204-2.

[18] Section 205(1), 15 U.S.C. 80b-5(1). Investment advisers whose only clients are investment companies have not been covered by this provision, and the charging of a "performance fee" by such advisers has become common. The Investment Company Amendments Act changes this situation effective December 14, 1971, by deleting the exemption from registration now enjoyed by such advisers, and by prohibiting such fee arrangements unless the fee increases or decreases proportionately on the basis of investment performance against an appropriate index of securities prices or other appropriate measure of performance. See sec. F of this chapter for a discussion of performance fees.

[19] Section 205(2), 15 U.S.C. 80b-5(2).

[20] Section 206, 15 U.S.C. 80b-6.

[21] Section 207, 15 U.S.C. 80b-7.

[22] Rule 206(4)-1, 17 CFR 275.206(4)-1. Advertisement is defined broadly in the rule to cover communications by radio, television or in writing.

being offered can in and of itself be used to determine investment decisions, without prominently disclosing in the advertisement the limitations and difficulties with respect to its use; (4) prohibits any statement to the effect that any report, analysis or service will be furnished free of charge unless there is in fact no condition or obligation, directly or indirectly; and (5) prohibits statements which are otherwise false or misleading.

There is no requirement in the Investment Advisers Act for the filing of financial statements or periodic or other reports with the Commission by investment advisers. Hence the Commission normally has no information available to it as to the size of investment advisory organizations, both in terms of personnel and amount of assets being advised; the number of advisory clients; the amount of assets being advised on a discretionary as opposed to nondiscretionary bases; the range of advisory fees being charged; and other pertinent data.

b. Investment advisers acting exclusively for investment companies

As stated above, investment advisers who act exclusively for investment companies have been exempt from those provisions of the Investment Advisers Act which apply to investment advisers required to be registered under that Act. However, these investment advisers are affected by certain provisions of the Investment Company Act.

Section 9 of that Act, 15 U.S.C. 80a–9, prohibits persons convicted or enjoined from unlawful conduct involving securities from being an investment adviser to any registered investment company, unless such persons receive an exemption from the Commission. At least 40 percent of the board of directors of a registered investment company must consist of persons who are unaffiliated with its investment adviser,[23] thus requiring that there be a substantial minority (or majority) of "independent" members of the fund's board of directors. In the statutory sense, however, unaffiliated does not mean completely unrelated. Directors unaffiliated with the investment adviser may have strong ties with the fund's managers. For example, a director is presently deemed unaffiliated even though he owns up to 4.99 percent of the adviser's stock, has substantial business or professional relationships with the investment company or its adviser, or is closely related by blood, marriage or friendship to the fund's managers.[24]

Transactions in which investment companies engage in joint transactions with, lend money to, sell property to, or buy property from investment advisers, or affiliated persons of an investment adviser, are prohibited unless Commission approval has first been obtained.[25]

In addition, the Investment Company Act requires that the investment company's contract with its adviser be in writing and that the

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[23] Section 10(a), 15 U.S.C. 80A–10(a). The Investment Company Act provides its own definition of "investment adviser" in Section 2(a)(19), 15 U.S.C. 80a–2(a)(19).

As a practical matter, most investment companies are required to have a majority of their board unaffiliated with the investment adviser. The reason for this is that most investment companies have as a principal underwriter (1) a company which is also the investment adviser, or (2) a company which has officers and directors affiliated with the investment company. Section 10(a)(2) requires that a majority of the board of the investment company by unaffiliated with the principal underwriter.

[24] See the definition of "affiliated person" in Section 2(a)(3) of the Investment Company Act. See also *Acampora* v. *Birkland*, 220 F. Supp. 527, 535–536, (D. Colo. 1963). Effective December 14, 1971, the Investment Company Amendments Act improves protection in this area by requiring that at least 40 percent of the investment company's board of directors be persons which are not "interested persons," a term which is defined more broadly than "affiliated persons."

[25] Section 17 of the Investment Company Act, 15 U.S.C. 80a–17.

adviser's compensation thereunder be precisely described. Before an advisory contract can become effective, it must be approved by the holders of a majority of the investment company's outstanding voting securities. Investment advisory contracts may be continued beyond two years only if approved annually by either (a) the board of directors as a whole, including a majority of the unaffiliated directors, or (b) the vote of the holders of a majority of the outstanding voting securities. An investment company has the right to terminate an advisory contract on 60 days notice at any time, without penalty, and such a contract is automatically terminated in the event of its assignment.[26]

Section 31 of the Investment Company Act, 15 U.S.C. 80a–30, requires the investment adviser to keep certain books and records as prescribed by rule by the Commission, and the Commission has adopted such rules comparable to the rules adopted under the Investment Advisers Act.[27] Finally, the Commission is empowered to bring suit to enjoin an investment adviser from gross misconduct or gross abuse of trust.[28]

c. Federal income tax considerations

A fund may qualify as a regulated investment company under Section 851 of the Internal Revenue Code.

A regulated investment company must distribute to its shareholders at least 90% of its net investment income. Moreover, it must derive less than 30 percent of its gross income for the taxable year from the sale or other disposition of stock or securities which were held for less than three months.

As a regulated investment company, a fund pays no Federal income tax on the net investment income and realized capital gains which it distributes to its shareholders. Any distribution paid from the excess, if any, of a fund's net realized long-term capital gains over its net realized short-term capital losses is taxable to the shareholders as a long-term capital gain. Dividends from net investment income (including net short-term capital gains) normally are taxable to recipients at ordinary rates and will, to the extent permitted by the Internal Revenue Code, qualify for the exclusion from gross income of the first $100 of dividends received by the shareholders during the year. Such exclusion is not available with respect to the capital gains distribution. Section 19 of the Investment Company Act, 15 U.S.C. 80a–19 (1964) requires a fund to notify its shareholders as to the source of every dividend and distribution paid.

Net gain on the sale of portfolio securities, if both realized and distributed (actually or constructively), is taxable as capital gain to the shareholder. If the net asset value of shares were reduced below a shareholder's cost by distribution of gain realized on the sale of securities, such distribution would be a return of capital invested though taxable as stated above.

Any dividend or distribution paid shortly after a purchase of shares by an investor will have the effect of reducing the per share net asset

[26] Section 15, 15 U.S.C. 80a–15.
[27] Rules 31a–1 and 31a–2. 17 CFR 270.31a–1, 270.31a–2.
[28] Section 36, 15 U.S.C. 80a–35. The Investment Company Amendments Act changes this provision effective May 14, 1972, by authorizing a suit by the Commission to enjoin a "breach of fiduciary duty involving personal misconduct." The new Section 36 also specifies that the adviser has a fiduciary duty with respect to the receipt of compensation, and that the Commission or an investment company shareholder may bring an action alleging breach of this duty.

value of his shares by the per share amount of the dividend or distribution. Furthermore, such dividends and distributions, although in effect a return of capital, are subject to tax.

4. Organization Forms, Age and Affiliations of Advisory Firms

The purpose of this section is to present data concerning a number of physical characteristics of advisory firms. These include the organizational form of the firms (partnership, corporation, etc.), the age distribution of advisory firms, the types of affiliations between advisory firms and other institutions, and data on the proportion of the revenue that the advisory firm and its affiliates obtained from investment advisory and broker-dealer functions. The data were collected via the I–65 Investment Adviser Intrinsics Questionnaire.

a. Organizational form

The I–65 respondents were asked to specify a code designating the organization form of their firms. The choices were (a) sole proprietorship, (b) partnership, (c) corporation, (d) other. The distribution of responses is given in Table IV–11. The predominant organizational form is the corporation (approximately 70 percent of all firms). No fund complexes were sole proprietorships, while 11 percent of nonfund complexes took this form.

b. Age distribution of advisory firms

The respondents were asked to specify the year during which their firms entered the advisory business (including any predecessors of the current firm). The distribution of responses is given in Table IV–12. The average age for all firms in the sample was 19 years. The average age for large firms was 26 years. This is approximately the same for fund and nonfund advisory complexes. The average age for small nonfund advisory complexes was 16 years, which is substantially older than for small fund complexes which average 3.5 years old. This later difference reflects the surge of entries into the mutual fund industry during the last half of the nineteen sixties.

c. Affiliations of advisory firms

The advisers were asked to specify if they were affiliated [29] with any of the following entities as of September 30, 1969:

(a) A broker-dealer;
(b) A life insurance company;
(c) A nonlife insurance company;
(d) A bank or trust company;
(e) Other investment adviser(s);
(f) An investment partnership; and
(g) Others.

The distribution of responses is given in Table IV–13. Thirty-five percent of all the firms indicated affiliations with broker-dealers. When broken down, the figures are 59 percent for fund complexes and 24 percent for nonfund complexes. Twenty-five percent of the total sam-

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[29] An "affiliated company" was defined for the purposes of this question to include any company that directly or indirectly controls, is controlled by or is under common control with the respondent firm. A "company" was defined to include a corporation, a partnership, an association, a joint stock company, a trust, a fund, or any organized group of persons whether incorporated or not.

ple indicated affiliations with other investment advisers, while 14 percent indicated affiliations with insurance companies (8 percent life, 6 percent nonlife). However, these insurance company relationships are highly concentrated within the fund complex portion of the sample, specifically large firms. Thirty percent of such large firms indicated life insurance affiliations while 26 percent indicated affiliations with nonlife insurance companies. Interviews with large fund complexes indicated that this trend toward such financial amalgamation had substantially accelerated in the later half of the nineteen sixties.

The 131 respondent firms indicated a total of 157 affiliations or an average of 1.2 affiliations per firm.

d. Sources of advisory complex revenue

To measure the significance of the above affiliations, the advisers were asked to indicate the percentage of their firm and the firm's designated affiliates' 1968 consolidated gross income that was derived from each of the above sources. Table IV–14 presents the responses for the two most significant sources of consolidated gross income, investment advisory services and broker-dealer functions. Revenue from broker-dealer functions includes brokerage commission on customer transactions as well as *net* underwriting revenues (net of dealer discounts) obtained from principal underwriting services provided to affiliated mutual funds.

For the total sample the average proportion of 1968 consolidated gross income from advisory services was 54 percent versus 30 percent for broker-dealer functions. The proportion for fund complexes was lower (38 percent) for advisory services than nonfund complexes (61 percent) but higher than nonfund complexes for broker-dealer functions, 34 percent as against 28 percent. Small fund complexes received 62 percent of 1968 consolidated gross income from broker-dealer functions as opposed to 28 percent from advisory services. The remaining 10 percent of their 1968 consolidated gross income came from sources other than investment advisory services and broker-dealer functions.

TABLE IV-1

INVESTMENT ADVISORY INDUSTRY SURVEY
(JUNE 30, 1969)

Category of Advisers' Account	Number of Accounts (Thousands)			Assets (Millions of Dollars)			Common Stock (Millions of Dollars)		
	Discretionary	Non-Discretionary	Total	Discretionary	Non-Discretionary	Total	Discretionary	Non-Discretionary	Total
Registered Management Investment Companies:									
Open End	495	214	709	52,332	2,358	54,690	42,709	2,104	44,813
Closed End	135	49	184	3,449	960	4,409	2,670	825	3,495
Non-Registered Investment Companies:									
Offshore Funds	73	39	112	947	610	1,557	667	424	1,091
Other Investment Funds	564	710	1,274	612	221	833	403	162	565
Institutional and Corporate:									
Employee Benefit Plans	2,170	2,167	4,337	4,228	8,902	13,130	2,525	5,900	8,425
State and Local Pension	33	158	191	116	6,356	6,472	79	1,441	1,520
University and College Endowment	136	341	477	2,537	3,128	5,665	1,625	1,985	3,610
Religious Organizations	94	367	461	245	845	1,090	157	530	687
Other Non-Profit Organizations	430	923	1,353	650	2,917	3,567	432	2,011	2,443
Insurance Companies (Life)	34	171	205	81	1,798	1,879	30	443	473
Insurance Companies (Other)	46	188	234	296	1,939	2,235	172	622	794
Other Corporate Accounts (Financial)	107	615	722	510	4,378	4,888	122	936	1,058
Other Corporate Accounts (Other)	616	828	1,444	420	1,214	1,634	318	932	1,250
Individuals and Personal Trusts:									
Separately Managed	35,566	29,350	64,916	9,116	13,860	22,976	7,238	11,064	18,302
Jointly Managed	2,030	2,677	4,707	505	2,166	2,671	413	1,485	1,898
Other	2,057	784	2,841	333	436	769	264	298	562
Investment Advisers' Own Portfolio	804	0	804	1,585	0	1,585	1,178	0	1,178
TOTALS	45,390	39,581	84,971	77,962	52,088	130,050	61,002	31,162	92,164

Number of Investment Advisers or Advisory Firms: 1,343.

TABLE IV-2

INVESTMENT ADVISORY INDUSTRY SURVEY
(JUNE 30, 1969)
(PERCENTAGES)

Category of Advisers' Accounts	Number of Accounts			Assets			Common Stock		
	Discretionary	Non-Discretionary	Total	Discretionary	Non-Discretionary	Total	Discretionary	Non-Discretionary	Total
Registered Management Investment Companies:									
Open End	0.58	0.25	0.83	40.24	1.81	42.05	46.34	2.28	48.62
Closed End	0.16	0.06	0.22	2.65	0.74	3.39	2.90	0.90	3.79
Non-Registered Investment Companies:									
Offshore Funds	0.09	0.05	0.13	0.73	0.47	1.20	0.72	0.46	1.18
Other Investment Funds	0.66	0.84	1.50	0.47	0.17	0.64	0.44	0.18	0.61
Institutional and Corporate:									
Employee Benefit Plans	2.55	2.55	5.10	3.25	6.84	10.10	2.74	6.40	9.14
State and Local Pension	0.04	0.19	0.22	0.09	4.89	4.98	0.09	1.56	1.65
University and College Endowment	0.16	0.40	0.56	1.95	2.41	4.36	1.76	2.15	3.92
Religious Organizations	0.11	0.43	0.54	0.19	0.65	0.84	0.17	0.57	0.75
Other Non-Profit Organizations	0.51	1.09	1.59	0.50	2.24	2.74	0.47	2.18	2.65
Insurance Companies (Life)	0.04	0.20	0.24	0.06	1.38	1.44	0.03	0.48	0.51
Insurance Companies (Other)	0.05	0.22	0.28	0.23	1.49	1.72	0.19	0.67	0.86
Other Corporate Accounts (Financial)	0.13	0.72	0.85	0.39	3.37	3.76	0.13	1.02	1.15
Other Corporate Accounts (Other)	0.72	0.97	1.70	0.32	0.93	1.26	0.34	1.01	1.36
Individuals and Personal Trusts:									
Separately Managed	41.86	34.54	76.40	7.01	10.66	17.67	7.85	12.00	19.86
Jointly Managed	2.39	3.15	5.54	0.39	1.67	2.05	0.45	1.61	2.06
Other	2.42	0.92	3.34	0.26	0.34	0.59	0.29	0.32	0.61
Investment Advisers' Own Portfolio	0.95	0.0	0.95	1.22	0.0	1.22	1.28	0.0	1.28
TOTALS	53.42	46.58	100.00	59.95	40.05	100.00	66.19	33.81	100.00

Number of Investment Advisers or Advisory Firms: 1,343.

TABLE IV-3

ADVISORY ASSET COMPOSITION AND GROWTH RATE

LARGE FUND COMPLEXES ($100 MILLION AND OVER)

Category of Account	1964				1969				Growth Rate % Per Annum	
	No. of Accounts	(%)	Market Value ($mil)	(%)	No. of Accounts	(%)	Market Value ($mil)	(%)	No. of Accounts	Market Value
Investment Cos.:										
Registered Investment Companies	61	2.5	13,015.7	83.5	106	3.2	20,201.6	82.3	11.1	9.2
Offshore Funds	2	0.1	38.3	0.2	10	0.3	75.1	0.3	35.1	14.4
Other Non-registered Investment Companies	5	0.2	14.7	0.1	17	0.5	65.7	0.3	29.2	34.8
Institutional and Corporate:										
Employee-Benefit Plans	124	5.1	704.3	4.5	291	8.8	1,200.4	4.9	18.4	11.3
Insurance Company	24	1.0	41.0	0.3	36	1.1	99.3	0.4	7.8	19.3
Nonprofit Organization	80	3.3	527.9	3.4	158	4.8	1,113.5	4.5	14.4	16.1
Other Inst. and Corporate	44	1.8	113.5	0.7	99	3.0	171.5	0.7	17.6	8.6
Total Inst. and Corporate	272	11.2	1,386.7	8.9	584	17.7	2,584.6	10.5	16.4	13.3
Individuals or Personal Trusts	2,079	85.4	1,082.5	6.9	2,569	77.8	1,539.6	6.3	4.3	7.3
Advisers' Own Portfolio	15	0.6	45.7	0.3	17	0.5	68.5	0.3	5.2	8.4
Totals	2,434	100.0	15,583.7	100.0	3,303	100.0	24,535.1	100.0	6.2	9.5

NUMBER OF RESPONDENTS: 24 (1964);26 (1969)

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TABLE IV-4

ADVISORY ASSET COMPOSITION AND GROWTH RATE
SMALL FUND COMPLEXES (UNDER $100 MILLION)

Category of Account	1964				1969				Growth Rate % Per Annum	
	No. of Accounts	(%)	Market Value ($mil)	(%)	No. of Accounts	(%)	Market Value ($mil)	(%)	No. of Accounts	Market Value
Investment Cos.:										
Registered Investment Companies	29	75.0	59.6	77.8	20	18.2	323.6	88.3	46.1	40.3
Offshore Funds	0	0.0	0.0	0.0	1	0.9	0.1	0.0	0.0	0.0
Other Non-registered Investment Companies	10	0.0	0.0	0.0	7	6.4	6.6	1.8	0.0	0.0
Institutional and Corporate:										
Employee-Benefit Plans	10	0.0	0.0	0.0	5	4.5	0.8	0.2	0.0	0.0
Insurance Company	0	0.0	0.0	0.0	0	0.0	0.0	0.0	0.0	0.0
Nonprofit Organization	0	0.0	0.0	0.0	1	0.9	0.3	0.1	0.0	0.0
Other Inst. and Corporate	0	0.0	0.0	0.0	1	0.9	0.2	0.0	0.0	0.0
Total Inst. and Corporate	0	0.0	0.0	0.0	7	6.4	1.3	0.4	0.0	0.0
Individuals or Personal Trusts	0	0.0	0.0	0.0	73	65.5	9.8	2.7	0.0	0.0
Advisers' Own Portfolio	10	25.0	17.0	22.2	3	2.7	25.1	6.9	24.6	8.2
Totals	39	100.0	76.6	100.0	111	100.0	366.6	100.0	94.0	36.8

NUMBER OF RESPONDENTS: 3 (1964); 14 (1969).

TABLE IV-5

ADVISORY ASSET COMPOSITION AND GROWTH RATE
LARGE NON FUND COMPLEXES ($100 MILLION AND OVER)

Category of Account	1964 No. of Accounts	1964 No. of Accounts (%)	1964 Market Value ($mil)	1964 Market Value (%)	1969 No. of Accounts	1969 No. of Accounts (%)	1969 Market Value ($mil)	1969 Market Value (%)	Growth Rate % Per Annum No. of Accounts	Growth Rate % Per Annum Market Value
Investment Cos.:										
Registered Investment Companies	18	0.2	763.2	8.3	34	0.2	1,892.8	7.9	13.2	19.9
Offshore Funds	0	0.0	0.0	0.0	17	0.1	79.1	0.3	0.0	0.0
Other Non-registered Investment Companies	35	0.4	14.9	0.2	84	0.5	93.0	0.4	19.5	44.3
Institutional and Corporate:										
Employee-Benefit Plans	247	2.8	1,672.2	18.2	1,023	6.1	6253.6	26.1	32.9	30.2
Insurance Company	44	0.5	449.8	4.9	117	0.7	2,110.0	8.8	20.7	36.2
Nonprofit Organization	352	4.0	1,316.8	14.3	1,006	6.0	3411.9	14.3	23.5	21.0
Other Inst. and Corporate	123	1.3	341.8	3.7	285	1.7	1,518.3	6.3	20.3	34.8
Total Inst. and Corporate	766	8.6	3787.8	41.2	2,431	14.5	13,310.8	55.6	24.0	28.6
Individuals or Personal Trusts	7,971	90.6	4,597.1	50.1	14,186	84.6	8486.2	35.5	11.7	13.0
Advisers' Own Portfolio	18	0.2	26.6	0.3	17	0.1	86.3	0.4	4.0	26.5
Totals	8,808	100.0	9184.3	100.0	16,769	100.0	23932.3	100.0	13.8	21.1

NUMBER OF RESPONDENTS: 24 (1964); 32 (1969).

TABLE IV-6

ADVISORY ASSET COMPOSITION AND GROWTH RATE
SMALL NON FUND COMPLEXES (UNDER $100 MILLION)

Category of Account	1964 No. of Accounts	1964 No. of Accounts (%)	1964 Market Value ($mil)	1964 Market Value (%)	1969 No. of Accounts	1969 No. of Accounts (%)	1969 Market Value ($mil)	1969 Market Value (%)	Growth Rate % Per Annum No. of Accounts	Growth Rate % Per Annum Market Value
Investment Cos.:										
Registered Investment Companies	0	0.0	1.0	0.1	0	0.0	9.0	0.6	14.9	55.2
Offshore Funds	0	0.0	0.0	0.0	9	0.1	88.9	6.1	0.0	0.0
Other Non-registered Investment Companies	0	0.0	0.2	0.0	18	0.2	13.2	0.9	58.5	133.0
Institutional and Corporate:										
Employee-Benefit Plans	35	0.7	26.9	3.9	168	1.9	103.9	7.1	34.9	31.1
Insurance Company	5	0.1	2.9	0.4	9	0.1	14.7	1.0	7.4	38.4
Nonprofit Organization	40	0.8	49.2	7.2	53	0.6	38.9	2.7	8.5	-4.6
Other Inst. and Corporate	30	0.6	44.1	6.4	71	0.8	57.5	3.9	17.4	5.5
Total Inst. and Corporate	110	2.2	122.9	17.9	301	3.4	213.0	14.6	21.5	11.6
Individuals or Personal Trusts	4,854	97.4	513.1	74.5	8,470	95.9	1,006.2	68.8	11.9	14.4
Advisers' Own Portfolio	20	0.4	51.2	7.4	35	0.4	130.0	8.9	12.5	20.5
Totals	4,984	100.0	688.5	100.0	8,833	100.0	1,462.4	100.0	12.2	16.3

NUMBER OF RESPONDENTS: 28 (1964); 48 (1969)

TABLE IV-7

ADVISORY ASSET COMPOSITION AND GROWTH RATE
ALL LARGE ADVISORY COMPLEXES ($100 MILLION AND OVER)

Category of Account	1964				1969				Growth Rate % Per Annum	
	No. of Accounts		Market Value		No. of Accounts		Market Value		No. of Accounts	Market Value
		(%)	($mil)	(%)		(%)	($mil)	(%)		
Investment Cos.:										
Registered Investment Companies	79	0.7	13,778.9	55.6	141	0.7	22,094.3	45.6	11.6	9.9
Offshore Funds	0	0.0	38.3	0.2	20	0.1	154.2	0.3	58.5	32.1
Other Non-registered Investment Companies	34	0.3	29.6	0.1	100	0.5	158.6	0.3	21.0	39.9
Institutional and Corporate:										
Employee-Benefit Plans	371	3.3	2,376.4	9.6	1,304	6.5	7,454.0	15.4	28.7	26.7
Insurance Company	67	0.6	490.8	2.0	161	0.8	2,209.4	4.6	16.9	35.1
Nonprofit Organization	427	3.8	1,844.8	7.4	1,164	5.8	4,525.3	9.3	22.0	19.7
Other Inst. and Corporate	157	1.4	455.3	1.8	381	1.9	1,689.8	3.5	19.6	30.0
Total Inst. and Corporate	1,022	9.1	5,174.5	20.9	3,010	15.0	15,895.4	32.8	22.2	25.2
Individuals or Personal Trusts	10,075	89.7	5,679.6	22.9	16,757	83.5	10,025.8	20.7	10.4	12.0
Advisers' Own Portfolio	22	0.2	72.3	0.3	40	0.2	154.7	0.3	4.6	16.4
Totals	11,232	100.0	24,768.0	100.0	20,068	100.0	48,467.4	100.0	12.3	14.4

NUMBER OF RESPONDENTS: 48 (1964); 58 (1969).

TABLE IV-8

ADVISORY ASSET COMPOSITION AND GROWTH RATE
ALL ADVISORY COMPLEXES UNDER $100 MILLION

Category of Account	1964 No. of Accounts	1964 No. of Accounts (%)	1964 Market Value ($mil)	1964 Market Value (%)	1969 No. of Accounts	1969 No. of Accounts (%)	1969 Market Value ($mil)	1969 Market Value (%)	Growth Rate % per annum No. of Accounts	Growth Rate % per annum Market Value
Investment Cos.:										
Registered Investment Companies	5	0.1	60.6	7.9	27	0.3	332.6	18.2	36.8	40.6
Offshore Funds	0	0.0	0.0	0.0	9	0.1	88.9	4.9	0.0	0.0
Other Non-registered Investment Companies	0	0.0	0.2	0.0	27	0.3	19.8	1.1	68.3	152.7
Institutional and Corporate:										
Employee-Benefit Plans	35	0.7	26.9	3.5	170	1.9	104.7	5.7	35.7	31.3
Insurance Company	5	0.1	2.9	0.4	9	0.1	14.7	0.8	7.4	38.4
Nonprofit Organization	40	0.8	49.2	6.4	54	0.6	39.2	2.1	8.8	-4.5
Other Inst. and Corporate	30	0.6	44.1	5.8	71	0.8	57.7	3.2	17 7	5.5
Total Inst. and Corporate	110	2.2	122.9	16.1	304	3.4	214.3	11.7	22.1	11.7
Individuals or Personal Trusts	4,837	97.3	513.1	67.1	8,526	95.5	1,016.1	55.6	12.0	14.6
Advisers' Own Portfolio	20	0.4	68.2	8.9	36	0.4	155.1	8.5	13.2	17.8
Totals	4,972	100.0	765.1	100.0	8,929	100.0	1828.9	100.0	12.4	19.0

NUMBER OF RESPONDENTS: 31 (1964; 62 (1969).

TABLE IV-9

ADVISORY ASSET CONCENTRATION BY ADVISORY COMPLEX

Category of Advisory Asset	Cummulative Percentage Managed by Number of Firms					
	5	10	15	25	50	100
Total Assets	23.5	37.2	46.4	60.3	75.6	87.2
Discretionnary Assets	26.9	41.2	52.0	63.4	78.9	89.5
Total Common Stock	22.5	36.2	45.5	59.3	74.6	86.6
Discretionnary Common Stock	28.5	43.2	53.2	64.5	79.8	89.9
Registered Open End Investment Companies	34.6	52.4	63.2	75.4	90.0	97.7

TABLE IV-10

TOTAL ADVISORY ASSET CONCENTRATION BY CLIENT TYPE

Category of Account	Cumulative Percentage of Total Assets by Number of Firms*					
	3	5	10	15	25	50
Registered Investment Company -- Open End	24.3	34.6	52.4	63.2	75.4	90.0
Registered Investment Company -- Closed End	32.7	43.6	62.8	73.9	88.1	99.3
Employee Benefit Plans	39.8	54.3	66.5	74.5	84.5	94.0
State and Local Pension Systems	79.5	91.7	98.3	99.5	100.0	100.0
University and College Endowments	46.0	65.3	81.1	88.9	95.5	99.6
Religious Organizations	52.0	65.5	81.0	86.5	92.9	98.8
Other Nonprofit Organizations	35.8	44.4	59.6	69.3	80.3	92.2
Offshore Funds	53.0	60.2	73.4	82.3	91.9	99.8
Other Nonregistered Investment Companies	24.4	36.9	52.4	64.7	78.5	90.4
Life Insurance Companies	64.7	74.7	84.6	89.7	94.9	99.5
Nonlife Insurance Companies	41.5	58.2	78.4	88.4	95.6	99.9
Other Financial Corporations	55.6	73.7	89.8	92.8	96.2	99.3
Other Nonfinancial Corporations	43.2	54.6	64.8	72.3	82.7	93.2
Individuals -- Separately Managed	22.0	29.7	42.4	51.2	62.0	77.3
Individuals -- Jointly Managed	40.2	50.9	72.6	86.1	93.0	97.5
Advisers Own Portfolio	46.7	57.5	70.9	77.6	85.3	93.2
Total Advisory Assets		23.5	37.2	46.4	60.3	75.6

*The advisory firms which comprise the number of firms shown are not necessarily the same for each category of account. Thus, for example, 50 firms advise 90 percent of registered open end investment company accounts, and 50 perhaps totally different firms advise 99.5 percent of life insurance company accounts.

TABLE IV-11

Organizational Forms of Advisory Firms

Type of Firm	Size of Firm	Number of Firms	Distribution of Responses by Category (%)			
			Sole Proprietorship	Partnership	Corporation	Other
Fund Complex	Large	27	0.0	11.11	85.19	3.70
	Small	14	0.0	7.14	92.86	0.0
	Total	41	0.0	9.76	87.80	2.44
Nonfund Complex	Large	38	0.0	34.21	63.16	2.63
	Small	52	19.23	17.31	61.54	1.92
	Total	90	11.11	24.44	62.22	2.22
Total Sample	Large	65	0.0	24.62	72.31	3.08
	Small	66	15.15	15.15	68.18	1.52
	Total	131	7.63	19.85	70.23	2.29

TABLE IV-12

Year of Entry Into Advisory Industry

Type of Firm	Size of Firm	Number of Firms	Distribution of Responses by Category (%)					Average Age of Firm (Years)
			Before 1931	1931-1950	1951-1960	1961-1964	1965-1969	
Fund Complex	Large	26	15.38	53.85	11.54	3.85	15.38	27.1
	Small	13	0.0	0.0	0.0	15.38	84.62	3.5
	Total	39	10.26	35.90	7.69	7.69	38.46	19.3
Nonfund Complex	Large	38	15.79	42.11	15.79	2.63	23.68	25.4
	Small	52	7.69	25.00	15.38	9.62	42.31	16.1
	Total	90	11.11	32.22	15.56	6.67	34.44	19.1
Total Sample	Large	64	15.62	46.88	14.06	3.12	20.31	25.6
	Small	65	6.15	20.00	12.31	10.77	50.77	12.8
	Total	129	10.85	33.33	13.18	6.98	35.66	19.1

TABLE IV-13

Affiliations of Advisory Firms
(September 30, 1969)

Type of Firm	Size of Firm	Number of Firms	Percentage of Responses Indicating Affiliation With Following Entities						
			Broker Dealer	Life Ins. Co.	Nonlife Ins. Co.	Bank or Trust Co.	Other Investment Adviser	Investment Partnership	Others
Fund Complex	Large	27	56	30	26	15	33	15	44
	Small	14	64	7	0	0	35	21	21
	Total	41	59	22	17	10	34	17	37
Nonfund Complex	Large	38	37	5	3	11	37	5	34
	Small	52	15	0	0	6	10	13	6
	Total	90	24	2	1	8	21	10	18
Total Sample	Large	65	45	15	12	12	36	9	38
	Small	66	26	2	0	5	15	15	9
	Total	131	35	8	6	8	25	12	24

TABLE IV-14

Percentage of 1968 Advisory Complex Consolidated Gross Income from Specific Sources

Income Source	Type of Firm	Size of Firm	Number of Firms	Distribution of Responses by Category (%)					Average % of Consolidated Gross Income
				0 - 20%	21 - 40%	41 - 60%	61 - 80%	81 - 100%	
Investment Advisory Services	Fund Complex	Large	27	37.04	14.81	7.41	18.52	22.22	43.44
		Small	14	64.29	7.14	7.14	0.0	21.43	27.86
		Total	41	46.34	12.20	7.32	12.20	21.95	38.12
	Nonfund Complex	Large	38	31.58	2.63	7.89	0.0	57.89	62.71
		Small	52	36.54	5.77	0.0	0.0	57.69	60.40
		Total	90	34.44	4.44	3.33	0.0	57.78	61.38
	Total Sample	Large	65	33.85	7.69	7.69	7.69	43.08	54.71
		Small	66	42.42	6.06	1.52	0.0	50.00	53.50
		Total	131	38.17	6.87	4.58	3.82	46.56	54.10
Broker Dealer Functions	Fund Complex	Large	27	62.96	14.81	14.81	0.0	7.41	19.44
		Small	14	28.57	7.14	7.14	7.14	50.00	62.07
		Total	41	51.22	12.20	12.20	2.44	21.95	34.00
	Nonfund Complex	Large	38	73.68	2.63	5.26	7.89	10.53	19.92
		Small	52	78.43	0.0	0.0	5.88	15.69	33.25
		Total	90	76.40	1.12	2.25	6.74	13.48	27.56
	Total Sample	Large	65	69.23	7.69	9.23	4.62	9.23	19.72
		Small	66	67.69	1.54	1.54	6.15	23.08	39.46
		Total	131	68.46	4.62	5.38	5.38	16.15	29.59

B. CHARACTERISTICS OF ADVISORY ACCOUNTS

1. Introduction

The purpose of this section is to describe the types of accounts which are advised in investment advisory complexes. The account characteristics analyzed include age of the account, asset size, portfolio composition, investment objective, trading and brokerage allocation status and portfolio turnover during the September 1968-September 1969 period.

The data were obtained using the I-14 Account Description Questionnaire which was sent to 158 large and small advisory firms. The responses contained data on all accounts advised by these firms—a total of 42,118 advisory accounts. While the number of accounts surveyed represent only 50 percent of the estimated total number of advisory accounts, (based on I-5 questionnaire responses), the aggregate advisory assets of the surveyed accounts represent approximately 83 percent of total industry advisory assets.

Of the 42,118 accounts in the sample, 320 were registered investment companies, 7,269 were institutional or corporate accounts and 34,529 were individual or personal trusts.

The average registered investment company account had $174 million of assets as of September 30, 1969, was 74 percent invested in common stock, was 14 years old, had a growth oriented investment objective and a common stock turnover rate of 57 percent for the 12 months ending September 30, 1969. The average institutional and corporate account, on the other hand, had $2.0 million of assets, was 66 percent invested in common stock, was 7 years old, had an income-growth oriented objective and a turnover rate of 23 percent. The average individual account had $0.6 million of assets, was 79 percent invested in common stock, was 9 years old, had a growth-income investment objective and a turnover rate of 20 percent.

2. Data Organization

While various groupings of account types will be used in summarizing the account data, the basic information was collected using 27 primary account identification codes. These account types were organized into eight account groups which are used in presenting data in the remainder of this section. The account types included in these eight groups are given below:

1. Registered investment companies: Open end companies (mutual funds); closed end companies.
2. Nonregistered investment companies: Offshore funds; investment partnerships (hedge funds).
3. Employee benefit plans: Single employer plans; multi-employer plans; pooled plans; HR 10 accounts (aggregated for each firm); State and local government retirement systems.
4. Insurance companies: Life insurance company accounts; non-life insurance company accounts.
5. Non-profit organizations: Educational endowment accounts; religious organization accounts; foundation accounts; other non-profit organizations.

6. Corporate accounts: Corporate account—non-financial corporation; corporate account—financial corporation.
7. Individuals and personal trusts: Individual account—separately managed; individual account—jointly managed.
8. Other accounts: Adviser's own portfolio; investment clubs; venture capital funds; other accounts.
9. Total accounts: All of the above categories.

In addition, a further aggregation of account types will be used from time to time. This is the three category group discussed above, Registered Investment Companies, Institutional and Corporate Accounts and Individuals and Personal Trusts. The Institutional and Corporate category will include account groups 2, 3, 4, 5, 6, and 8 in the above listing.

In the following discussions the data from the 158 advisory firms have been aggregated and presented as if from a single advisory firm of 42,118 accounts.[30]

3. Age of Advisory Accounts (Refer to Tables IV–15 and IV–16)

The average advisory account is 8.4 years old. The average registered investment company account is 14.0 years old, being founded in 1956. Institutional and corporate accounts range from an average age of 4.4 years for non-registered investment companies to 8.6 years for the accounts of non-profit organizations and corporations. The average institutional and corporate account was approximately 7.0 years old. Individual and personal trust accounts average 8.6 years old.

The growth of advisory clientele is indicated by an examination of the distribution of account ages. Fifty-six percent of all registered investment company accounts were started in 1960 or later, with 34 percent having been started between 1967 and 1969. A substantially higher proportion of institutional and corporate accounts were started in the nineteen sixties. Ninety percent of nonregistered investment companies, 89 percent of employee benefit plans, 75 percent of corporate accounts, 74 percent of insurance company accounts, and 68 percent of non-profit organization accounts were started between 1960 and 1969, with an accelerating pace toward the later years. Seventy-two percent of all individual and personal trust accounts were begun in the nineteen sixties, with 38 percent started between 1967 and 1969.

4. Size of Advisory Accounts (Refer to Tables IV–17 and IV–18)

The average advisory account contained $2.6 million as of September 30, 1969. The average registered investment company account contained $173.8 million of assets. The average size of institutional and corporate accounts ranged from $2.4 million for non-registered investment company accounts to $12.7 million for insurance company accounts. The average institutional and corporate account contained $2.0 million of assets. The average individual and personal trust account contained $0.6 million of assets.

Approximately 48 percent of all registered investment company accounts had in excess of $50.0 million of assets, with 8.7 percent with

[30] The analysis of account turnover rates however does consider various adviser characteristics in explaining differences in turnover rates.

assets in excess of $500.0 million. On the other hand, 75 percent of individual and personal trust accounts had assets less than $0.5 million and only 11 out of 34,529 of such accounts had assets in excess of $50.0 million.

5. Asset Composition of Advisory Accounts (Refer to Tables IV–19 and IV–20)

The asset structure of the average advisory account was composed of 8.4 percent cash and short-term debt securities, 9.6 percent non-convertible debt and preferred stock, 4.3 percent convertible debt and preferred stock, 76.5 percent common stock and was 1 percent invested in other portfolios (such as mutual funds) advised by the adviser.

The average registered investment company account contained 72.9 percent common stock. Institutional and corporate account holdings of common stock ranged from a low of 39.9 percent for the insurance company accounts to a high of 77.6 percent for non-registered investment companies. The average institutional and corporate account contained 66 percent common stock. Individual and personal trust accounts held an average of 78.6 percent of assets in common stock as of September 30, 1969.

Approximately two-thirds of all registered investment company accounts held more than 70 percent of assets in the form of common stock. Approximately 75 percent of all individual and personal trust accounts held more than 70 percent of assets in the form of common stock. Approximately 53 percent of all non-registered investment company accounts held more than 80 percent of assets in the form of common stock.

6. Investment Objective (Refer to Tables IV–21 and IV–22)

The adviser was asked to select one of the following four investment objectives for each advisory account which best described the objective of the account as of September 30, 1969.[31]

1. Maximal Capital Gain—Capital appreciation is the sole objective and high risks will be taken to achieve it.
2. Growth—Primary objective is capital appreciation, but characterized by less willingness to bear high risk and a higher degree of price stability than maximal capital gain.
3. Growth/Income—Combined objective of capital appreciation and current income.
4. Income—Primary objective is to provide as liberal a current income as possible.

The typical advisory account had a growth-income oriented investment objective. Registered investment companies tend to have more growth oriented objectives. Fifty-six percent of registered investment companies have either maximal capital gain or growth objectives. The typical institutional and corporate account tends to have an income-growth investment orientation. However, substantial differences exist among objectives of the account types which make up this category.

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[31] The adviser responded by specifying a code (1 through 4) which corresponded to the maximum capital gain through income objective range.

The typical individual and personal trust account had a growth-income orientation.

7. Valuation Frequency (Refer to Table IV–23)

Eighty-five percent of all advisory accounts are valued quarterly or more frequently. Ninety-three percent of all registered investment company accounts were valued on a monthly or more frequently basis (typically daily for mutual funds). Typically 90 percent of all institutional and corporate accounts are valued quarterly or more frequently. Eighty-three percent of individual and personal trust accounts were valued quarterly or more frequently, with 70 percent specifying a quarterly valuation period.

8. Investment Discretion (Refer to Table IV–24)

The advisers were asked to specify a code for each advisory account which best described the adviser-client relationship from the point of view of the degree of discretion of the adviser to make portfolio decisions for the account. The following response options were available:

1. The investment adviser has sole investment authority to select the securities bought or sold and never (or rarely) consults with the client prior to execution of trades.
2. The investment adviser sometimes consults with the client or other parties prior to execution of trades.
3. The investment adviser frequently consults with the clients or other parties prior to execution of trades.
4. The investment adviser has no investment authority for this account and must always obtain approval from client prior to execution of trades.

The responses indicate that registered investment companies allow the adviser the greatest degree of investment discretion, with 75 percent of responses in this category indicating the adviser had sole investment authority. This response would appear to represent a practical rather than a formal view of the typical mutual fund-adviser relationship. Registered investment companies normally delegate day to day investment discretion to the adviser (usually called the "management company"). Employees of the adviser act as administrative and investment officers for the fund. The portfolio manager is an officer (and is sometimes the president) of the fund. However, approval of the board of directors of the fund is sometimes required for proposed changes in the fund's investment portfolio, and thus in these cases the portfolio manager (or adviser) does not have sole investment discretion. The Study's interviews indicated that the function of the board of directors appeared to be in formulation of an investment strategy for the fund, while leaving the portfolio manager a degree of discretion in implementing this program through the selection of types and amounts of various securities. As with all corporations, however, the ultimate responsibility for the investment company's activities lies with its board of directors.

The second highest proportion of complete authority relationships is for non-registered investment companies, where 56 percent of the hedge funds and offshore funds surveyed were found to delegate sole

responsibility to the adviser. The adviser, in the case of a hedge fund, was considered to be the general partner or partners who managed the fund. Thus in the case where the general partner was being advised by an investment adviser, the hedge fund would not have responded that it delegated complete authority to its adviser. Institutional and corporate accounts were typically advised on a non-discretionary basis, with 79 percent of insurance company accounts, 67 percent of non-profit organization accounts, 64 percent of corporate accounts, and 47 percent of employee benefit accounts indicating that the adviser had no authority to make investment decisions for the account. The accounts of individuals were also typically non-discretionary in nature, with 56 percent of accounts indicating no discretion, 8 percent indicating some discretion and 26 percent indicating complete discretion.

9. Federal Income Tax Liability for Individual and Personal Trust Accounts (Refer to Table IV–25)

The adviser was asked to categorize the federal tax bracket on ordinary income to which the account (if a trust) or other beneficial owner is subject. Approximately 25 percent of responses were in each of the categories (a) zero to 30 percent, (b) 30 percent to 50 percent, (c) greater than 50 percent and (d) unknown.

10. Number of Participating Accounts in Pooled (Jointly Managed) Accounts (Refer to Table IV–26)

If the advisory account was pooled (jointly managed), the adviser was asked to specify the number of participating accounts as of September 30, 1969. If the account was an investment company, the adviser was asked to enter the number of shareholders or limited partners of the fund.

Data were obtained from 1,593 jointly managed accounts, of which 308 were registered investment companies, 138 were non-registered investment companies, 884 were jointly managed individual or personal trusts and the remainder were institutional and corporate accounts. For all classes of accounts, except registered investment companies, more than 95 percent of all accounts contained less than 500 participating accounts. The average for employee benefit plans was 592 accounts; for nonprofit organizations 56; for corporate accounts 29; for individual and personal trust accounts 220. For registered investment companies, 50 percent of the responses indicate in excess of 10,000 shareholders. The average number of shareholders for the 308 registered company sample was 3,169.

11. Placing of Account Portfolio Orders (Refer to Table IV–27)

The adviser was asked to specify a code for each advisory account which best described the way in which orders to purchase or sell portfolio securities were transmitted to the executing broker-dealer.

1. Adviser's order department placed orders with broker-dealers for the account more than 50 percent of the time;

2. The account manager for the account placed orders with broker-dealers for the account more than 50 percent of the time;

3. Both the order department and the account manager placed orders with broker-dealers for the account, but each less than 50 percent of the time;

4. The order department never placed orders with broker-dealers for the account; the account manager does, but for less than 50 percent of the account's orders;

5. The account manager never placed orders with broker-dealers for the account; the order department does, for less than 50% of the account's orders;

6. Neither the order department nor the account manager placed orders with broker-dealers for the account.

The results indicate that the adviser places orders for virtually all registered investment company clients. The adviser in this case places orders more than 50 percent of the time for 90 percent of all registered investment company accounts. For other types of accounts, the adviser typically places a lower percentage of purchase and sell orders. For approximately one-third of all institutional and corporate, and individual accounts the adviser does not place purchase and sell orders. However, for the remaining accounts, the adviser in most cases places the orders for portfolio transactions more than 50 percent of the time.

12. Designation of Portfolio Brokerage (Refer to Table IV–28)

For accounts for which the advisory firm places some purchase or sell orders with broker-dealers, the adviser was asked to specify the code which best described the proportion of brokerage business which the client had designated to go to particular broker-dealers.

The designation categories specified were the following:

1. Brokerage commissions or portfolio transactions are not designated.

2. Some, but less than 15 percent of the brokerage commissions on portfolio transactions are designated (subject to variations necessary to achieve best execution).

3. At least 15 percent, but not more than 85 percent of the brokerage commissions on portfolio transactions are designated (subject to variations necessary to achieve best execution).

4. More than 85 percent of the brokerage commissions on portfolio transactions are designated (subject to variations necessary to achieve best execution).

5. Firm does not place or execute any orders for the account.

The responses show that 65 percent of brokerage business associated with advisory account securities transactions was designated by the client or was beyond the control of the adviser due to the fact that he did not place orders for purchases and sales of securities.

For registered investment companies the results were substantially different. In 65 percent of these cases, the adviser was free to allocate 100 percent of the brokerage business. The average percentage of brokerage designated by registered investment company clients was

53-940 O—71—pt. 2——4

27 percent. For institutional and corporate accounts, the client typically designated approximately two-thirds of the brokerage business, leaving the adviser complete discretion in only 25 percent of the cases. In individual and personal trust accounts the picture was similar to institutional and corporate accounts. On the average 65.4 percent of brokerage business was designated, with the adviser having full authority to allocate brokerage business for only 28.7 percent of such accounts.

13. Common Stock Turnover Rate (Refer to Table IV-29)

For each advisory account, the adviser was asked to estimate the annual turnover rate for the common stock portion of the account. The turnover rate was defined as the total cash purchases or total cash sales, whichever is smaller, of common stock during the 12 months preceding September 30, 1969, divided by the average market value of the common stock during the previous twelve month period. The following ranges were used to categorize the turnover rates.[32] (1) 0–10 percent; (2) 10–50 percent; (3) 50–100 percent; (4) over 100 percent.

The turnover rate for the common stock portion of the typical advisory account was found to be 21.3 percent per year. This varied substantially by type of advisory account. Registered investment companies had an average turnover rate of 56.7 percent. Unregistered investment companies turned over at a 47.1 percent rate.[33] The typical institutional and corporate account had a turnover rate of 23 percent ranging from a high of 27.7 percent for employee benefit plans to a low of 20.6 percent for insurance company accounts. The average individual and personal trust account had a turnover rate of 20.2 percent, with approximately 49 percent of accounts with rates less than 10 percent, and a further 46 percent of these accounts with rates less than 50 percent.

14. Factors Affecting Advisory Account Turnover Rates (Refer to Tables IV-30, IV-31, IV-32)

The above discussion of turnover rates points up differences in 1969 turnover rates among different account types, but a great deal of additional information is available when the relationships between account turnover rates and various characteristics of the account and the advisory firm are examined. For example, what is the effect of size of the advisory account on turnover rate, of investment objective or investment discretion allocated to adviser? Correspondingly, what impact does the size of the advisory firm have on turnover rates of client accounts? The above questions can be examined using the data from the I-14 account description questionnaire.

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[32] In the following discussions, responses in a particular category, for example 50 percent, were arbitrarily assigned the mid-range value (30 percent in the above case). For the over 100 percent turnover rate, responses in this category were arbitrarily assigned a 150 percent rate.

[33] This figure is probably unreasonably low due to the utilization of the classification technique described in the preceding footnote. More representative statistics for turnover of unregistered investment companies can be obtained from sec. H of this chapter with respect to hedge funds (annual turnover rate for 1968 of 317 percent) and from ch. VIII.H with respect to offshore funds (turnover rate of 121 percent in 1968 and 151 percent in 1969).

The joint effect of the following factors on advisory account turnover rate have been examined. The term "joint" refers to the fact that the effect of each factor has been measured while holding all other factors constant. Thus, the following question can be answered through this type of analysis—other factors being the same, what is the impact on portfolio turnover rate of a change in a specific factor?

(i) Age of Account (year) : The number of years since the account was established.

(ii) Total Assets of Account (ASST) : Total assets as of September 30, 1969.

(iii) Investment Objective (OBJT).

(iv) Investment Authority (AUTH) : A coded factor, ranging from 1 for complete discretion in the adviser to 4 for no investment authority in the adviser.

(v) Marginal Tax Position of Client (TAX) : The percentage of federal tax liability of account on ordinary income.

(vi) Broker-Dealer Affiliation of Adviser (BR. D) : A factor designating the affiliation of the adviser with a broker-dealer firm that executed security orders (as opposed to a mutual fund principal underwriter which is not considered to be a broker-dealer for the purposes of this analysis).[34]

(vii) Trading Authority of the Adviser (TRAD) : The percentage of account brokerage business that can be designated by the *adviser* (100 percent minus the percentage designated by client).

(viii) The Size of the Advisory Firm (SIZE) : The total assets advised in the advisory complex at September 30, 1969.

(ix) Fund Complex Factor (FUND) : A factor describing the composition of advisory assets within the complex. The fund complex factor designates more than ⅓ of advisory assets as being composed of registered investment companies.[35]

The marginal impact of each of these factors on the level of account turnover rates, both for the total number of accounts and for individual account types will now be considered.

a. Age of account

Older accounts typically have lower turnover rates. For the total group of accounts, a 100 percent increase in account age is associated with a 1.7 percentage point decrease in account turnover rate.[36] For registered investment companies the reduction in turnover rate is larger—a 100 percent increase in fund age is associated with a four

[34] If the adviser was affiliated with an active broker-dealer firm (as defined above) the variable BR. D was set equal to 1.0 in the regression analysis for all accounts; if not BR. D was set at zero.

[35] If more than 1/3 of advisory assets are composed of registered investment companies, the variable "fund" was set equal to 1.0 for all accounts of that adviser; if not "fund" was set equal to zero.

[36] The changes in the explanatory factors (1) age of account, (2) assets of account and (3) size of advisory firm will be presented as percentage change from a base amount. For example, a 100 percent increase in age would result from increasing the age of the account from 2 to 4 years, or 10 to 20 years. Changes in the turnover rate and the other seven factors will be discussed in terms of absolute changes. For example, a change in turnover rate from 20.0 to 22.0 would be described as a 2 percentage point increase in turnover rate.

For the age, asset and size variables, a 100 percent increase in the factor would result in a change in turnover rate equal to the regression coefficient of the factor times 0.7 (which is approximately the natural logarithm of 2).

percentage point reduction in turnover rate. The age effect for institutional and corporate accounts varies depending on the account type. The impact on portfolio turnover of doubling account age varies within a plus or minus one percentage point range. The effect of age on individual and personal trust account turnover rate is the same as for the total number of accounts.

b. Total account assets

The impact of account size on turnover rate differs among the various account types. The relationship between these two factors is typically not statistically significant, except for individual and personal trust accounts, in which case a 100 percent increase in asset size is associated with a 0.2 percentage point reduction in account turnover rate.

c. Investment objective

For all types of accounts, a strong relationship was found between the advisory account turnover rate and investment objective. Accounts with more aggressive investment objectives experience higher turnover. For the total number of accounts, the difference between the average turnover rate for maximal capital gain oriented accounts and accounts with income objectives is 29 percentage points. The result is particularly large for registered investment companies, where the difference in turnover rates between maximal capital gain oriented accounts with income objectives is 72 percentage points. For institutional and corporate accounts the difference ranges from 20 percentage points for insurance company accounts to 32 percentage points for employee benefit accounts. For individual and personal trust accounts the difference is 28 percentage points.

d. Investment authority

Accounts where the adviser has sole authority to make portfolio changes tend to turn over more rapidly than accounts for which the adviser has limited or no discretionary authority. For the total number of accounts, the difference in turnover rates between accounts where the adviser has complete investment authority and no authority is 10 percentage points.

The direction of the effect is the same for all account types. The magnitude is 6.4 percentage points for registered investment companies, 11.0 for institutional and corporate accounts and 10.0 for individual and personal trust accounts.

e. Federal income tax liability

It is typically suggested that accounts of clients in high income tax brackets will have lower turnover rates in order to reduce, to defer or even through retention until death, to avoid the payment of capital gains taxes. The hypothesis is supported by the results for the total number of accounts, when taken as a whole, which show that higher Federal income tax brackets are negatively related to account turnover rates.

A 10 percent increase in Federal income tax bracket is, on the average, associated with a 0.5 percentage point reduction in turnover rate. This difference is largely due to the higher turnover rates of institu-

tional and corporate accounts of clients in low or zero tax positions relative to individual accounts, which on the average have lower turnover rates and high tax brackets.

The situation within various account types (where the range of tax position is typically much smaller than for the total number of accounts) shows little impact of taxes. In contrast to the totals for all accounts as a whole, in the cast of individual accounts the analysis shows that accounts of individuals in higher tax positions on the average have slightly higher turnover rates, indicating that the account of typically wealthier clients are being more actively managed.

f. Broker-Dealer affiliation

Accounts which are advised by advisory affiliates of firms doing a brokerage business tend to be turned over somewhat more rapidly than accounts advised by advisers not affiliated with firms doing a brokerage business. For the total number of accounts, all other factors being the same, a broker-dealer affiliated advised account will have a 1.7 percentage point higher turnover rate. The effect differs in size and magnitude among the various account types. Broker-dealer affiliated advised registered investment companies have a 3.7 percentage point higher turnover rate than those advised by an adviser not affiliated with a broker-dealer. For individual and personal trust accounts, the increase is 2.7 percentage points. Corporate and employee benefit accounts advised by broker-dealer affiliated advisers tend to have lower turnover rates than similar accounts whose advisers are not so affiliated.

Table IV–31 displays the turnover rates for broker-dealer and non-broker-dealer advised accounts. The average turnover rate for the non-broker-dealer accounts is 20.9 percent, as opposed to 22.9 percent for broker-dealer advised accounts. While Table IV–31 shows the differences in average turnover rates by type of adviser, the turnover differentials described above are better indicators of the impact of the brokerage affiliation than the distributions shown in the table. The reason is that the previous analysis controls for differences in other factors which are also related to turnover rate, such as investment objective and discretionary authority, which is not the case in Table IV–31.

g. Trading status of the account

The extent to which the adviser places purchase or sale orders for client accounts was in general unrelated to turnover rate for all account classes except individual and personal trust accounts. For this class of accounts, the difference in average turnover rate between accounts for which the adviser placed orders more than 50 percent of the time and accounts for which the client placed his own brokerage orders was approximately 2 percentage points. The higher turnover rates were, on the average, associated with accounts where the adviser placed the orders.

h. Allocation of brokerage

Greater authority delegated to the adviser to select broker-dealers for security transactions had a mixed effect on turnover rates among the various classes of accounts. Greater adviser freedom was associated

with increases in turnover rates for employee benefit and non-profit organization accounts and lower turnover rates for individual and personal trust accounts. The impact on turnover of this factor, while statistically significant, tends to be very small—less than 1/10 of a percentage point.

i. Size of the advisory complex

The size of total assets under advisement in the advisory complex was statistically significantly related to turnover rates for three classes of accounts—non-registered investment companies, employee benefit accounts and individual and personal trust accounts. In each case, accounts advised in large advisory complexes tended to have lower turnover rates. A 100 percent increase in size of the advisory complex was associated with a 3.0 percentage point reduction in turnover rate for non-registered investment companies, a 1.0 percentage point reduction for employee benefit plans and a 0.4 percentage point reduction for individual and personal trust accounts. The effects for other classes of accounts are small, of mixed direction and not statistically significant.

j. Mutual fund complex variable

The fund complex factor was included to assess any differences in turnover rates that existed for accounts advised in mutual fund complexes.[37] The results of the analyses indicate that accounts advised in mutual fund complexes tend to have substantially higher turnover rates. This finding holds for all classes of accounts. Were all other factors to be the same, registered investment companies in fund complexes would have a 27 percentage point higher turnover rate. For institutional and corporate accounts the rate increases range from 7.0 percentage points for employee benefit plans to 15.0 percentage points for insurance company accounts. Individual and personal trust accounts advised in fund complexes on the average had a 8.5 percentage point higher turnover rate. The average increase in turnover rate for the total number of accounts was 10.0 percentage points.

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[37] Fifty-three of the 158 respondent firms had more than one-third of the total dollar value of advisory assets represented by registered investment companies and were thus classified as fund complexes.

TABLE IV-15

AVERAGE AGES OF ADVISORY ACCOUNTS

ACCOUNT TYPE	NUMBER OF ACCOUNTS	AVERAGE AGE (YEAR)	STANDARD DEVIATION OF AGE (YEAR)
1. Registered Investment Companies	320	14.0	13.2
2. Nonregistered Investment Companies	187	4.4	5.8
3. Employee Benefit Plans	3027	4.8	4.9
4. Insurance Companies	347	7.8	8.1
5. Nonprofit Organizations	2063	8.6	8.3
6. Corporate Accounts	1058	8.6	10.0
7. Individuals and Personal Trust	34529	8.6	8.6
8. Other Accounts	587	8.1	9.3
9. Total Accounts	42118	8.4	8.5

TABLE IV-16

DISTRIBUTION OF ADVISORY ACCOUNT ESTABLISHMENT YEARS

ACCOUNT TYPE	PERCENTAGE OF ACCOUNTS ESTABLISHED BY YEAR									
	1969	1968	1967	1966	1965	1964	1963	1960-1962	1950-1959	1949 or before
1. Registered Investment Companies	7.8	15.0	10.9	7.2	4.7	2.8	1.2	6.6	15.0	28.7
2. Nonregistered Investment Companies	19.0	30.0	16.6	6.1	2.8	5.3	1.6	8.5	8.1	2.0
3. Employee Benefit Plans	20.0	21.8	14.8	9.3	6.5	4.0	4.3	8.3	9.7	1.4
4. Insurance Companies	15.8	16.9	12.3	5.2	6.3	3.7	3.2	10.9	16.3	9.5
5. Nonprofit Organizations	11.3	18.8	9.4	6.3	4.4	4.0	4.0	9.8	22.9	9.2
6. Corporate Accounts	12.5	19.5	12.6	7.1	6.2	4.0	3.6	9.2	14.8	10.3
7. Individuals and Personal Trust	11.0	15.6	11.1	8.0	5.9	4.8	4.1	10.9	18.2	10.4
8. Other Accounts	10.0	21.6	10.0	4.0	6.1	12.6	3.3	8.8	14.2	8.8
9. Total Accounts	11.8	16.5	11.4	7.9	5.9	4.8	4.0	10.5	17.6	9.7

TABLE IV-17

AVERAGE SIZES OF ADVISORY ACCOUNTS

ACCOUNT TYPE	AVERAGE GROSS INVESTMENT ASSETS (MILLIONS)	STANDARD DEVIATION (MILLIONS)
1. Registered Investment Companies	$173.8	365.3
2. Nonregistered Investment Companies	2.4	1.6
3. Employee Benefit Plans	5.4	27.1
4. Insurance Companies	12.7	2.2
5. Nonprofit Organizations	5.3	36.8
6. Corporate Accounts	3.0	2.1
7. Individuals and Personal Trust	0.6	2.5
8. Other Accounts	1.6	4.1
9. Total Accounts	2.6	37.6

TABLE IV-18

DISTRIBUTION OF ADVISORY ACCOUNT ASSET SIZES

ACCOUNT Type	PERCENTAGE OF ACCOUNTS BY SIZE CATEGORY (MILLIONS OF DOLLARS)									
	Less than 0-001	0-001-0.1	0.1 - 0.5	0.5 - 1.0	1.0-5.0	5.0 - 25.0	25.0-50.0	50.0 - 100.0	100.0 - 500.0	Greater Than 500.0
1. Registered Investment Companies	0.0	0.6	4.7	3.1	9.4	21.2	13.1	16.9	22.2	8.7
2. Nonregistered Investment Companies	0.8	7.3	27.1	19.8	8.3	13.0	3.2	0.4	0.0	0.0
3. Employee Benefit Plans	0.1	10.9	34.6	16.5	23.0	11.0	2.3	0.8	0.9	0.1
4. Insurance Companies	0.6	2.6	7.4	8.6	43.3	27.8	5.7	2.6	1.1	0.3
5. Nonprofit Organizations	0.0	9.8	32.5	17.7	27.7	9.7	1.1	0.7	0.6	0.0
6. Corporate Accounts	0.5	14.0	33.3	13.8	23.5	12.8	1.6	0.5	0.1	0.0
7. Individuals and Personal Trust	0.1	19.4	54.8	14.9	9.8	0.9	0.1	0.0	0.0	0.0
8. Other Accounts	2.1	18.3	38.9	16.4	18.5	4.2	1.5	0.2	0.0	0.0
9. Total Accounts	0.1	17.9	50.6	15.0	12.5	2.9	0.5	0.3	0.3	0.1

TABLE IV-19

ADVISORY ACCOUNT ASSET COMPOSITION

ACCOUNT TYPE	AVERAGE HOLDINGS BY ASSET TYPE-%				
	Cash and Short Term Debt Securities	Non-Conv-Debt and Preferred Stock	Conv Debt and Preferred Stock	Common Stock	Investment in Other Portfolios
1. Registered Investment Companies	13.8	6.6	6.6	72.9	0.0
2. Nonregistered Investment Companies	14.4	3.4	4.3	77.6	0.2
3. Employee Benefit Plans	11.6	13.3	6.7	67.5	0.9
4. Insurance Companies	8.7	44.6	6.6	39.9	0.3
5. Nonprofit Organizations	9.4	16.4	7.0	66.6	0.7
6. Corporate Accounts	11.8	16.7	4.9	66.1	0.6
7. Individuals and Personal Trust	7.9	8.4	3.9	78.6	1.1
8. Other Accounts	8.0	9.9	6.4	74.7	0.9
9. Total Accounts	8.4	9.6	4.3	76.5	1.0

TABLE IV-20

DISTRIBUTION OF ADVISORY ACCOUNT COMMON STOCK HOLDINGS

	PERCENTAGE OF ACCOUNTS WITH SPECIFIED COMMON STOCK HOLDINGS										
	0	0% - 10%	10% - 20%	20% - 30%	30% - 40%	40% - 50%	50% - 60%	60% - 70%	70% - 80%	80% - 90%	90% - 100%
1. Registered Investment Companies	4.1	0.6	0.9	1.9	0.9	5.6	6.9	14.1	18.5	23.8	22.6
2. Nonregistered Investment Companies	2.4	0.4	1.2	1.2	3.7	3.7	7.3	13.5	13.9	24.9	27.8
3. Employee Benefit Plans	3.7	1.6	1.3	1.9	3.3	6.6	11.7	17.7	19.5	17.0	15.9
4. Insurance Companies	12.3	15.8	12.0	10.3	7.2	6.9	4.3	6.6	5.2	3.7	15.8
5. Nonprofit Organizations	3.1	1.0	1.6	2.0	3.1	6.5	13.0	23.0	21.9	13.2	11.6
6. Corporate Accounts	11.9	1.8	1.4	2.7	3.6	3.8	6.6	8.8	14.7	16.9	27.7
7. Individuals and Personal Trust	1.1	0.3	0.6	1.0	1.5	2.9	5.8	12.5	20.6	22.0	31.6
8. Other Accounts	4.8	1.3	0.4	1.1	2.1	4.4	7.8	11.8	17.7	17.3	31.2
9. Total Accounts	1.9	0.6	0.8	1.2	1.8	3.5	6.6	13.2	20.2	20.9	29.1

Available Responses:

Code	Description
1.	Maximal Capital Gain
2.	Growth
3.	Growth-Income
4.	Income

TABLE IV-21

AVERAGE INVESTMENT OBJECTIVE OF ADVISORY ACCOUNTS

ACCOUNT TYPES	Average Investment Objective (Description)	Average Investment Objective (Coded)	Standard Deviation Of Coded Responses
1. Registered Investment Companies	Growth	2.36	0.87
2. Nonregistered Investment Companies	Growth	2.01	0.84
3. Employee Benefit Plans	Growth - Income	2.43	0.64
4. Insurance Companies	Income - Growth	2.88	0.68
5. Nonprofit Organizations	Income - Growth	2.80	0.61
6. Corporate Accounts	Income - Growth	2.60	0.82
7. Individuals and Personal Trusts	Growth - Income	2.49	0.68
8. Other Accounts	Growth	2.30	0.76
9. Total Accounts	Growth - Income	2.50	0.69

TABLE IV-22

DISTRIBUTION OF ADVISORY ACCOUNT INVESTMENT OBJECTIVES

ACCOUNT TYPES	PERCENTAGE OF ACCOUNTS BY INVESTMENT OBJECTIVE			
	Maximal Capital Gain	Growth	Growth-Income	Income
1. Registered Investment Companies	17.5	39.1	33.4	10.0
2. Nonregistered Investment Companies	32.4	42.5	20.6	4.5
3. Employee Benefit Plans	5.6	48.6	42.5	3.3
4. Insurance Companies	1.7	24.6	57.9	15.8
5. Nonprofit Organizations	3.0	23.2	65.0	8.9
6. Corporate Accounts	7.5	42.8	35.7	14.0
7. Individuals and Personal Trusts	6.2	43.5	45.6	4.7
8. Other Accounts	12.6	46.1	36.8	4.6
9. Total Accounts	6.3	42.7	45.8	5.2

TABLE IV-23

DISTRIBUTION OF VALUATION FREQUENCIES OF ADVISORY ACCOUNTS

ACCOUNT TYPE	PERCENTAGE OF ACCOUNTS WITH SPECIFIED VALUATION FREQUENCIES					Average Response
	Monthly Or More Freq. Response=1	Quarterly Response=2	Semi Annually Response=3	Annually Response=4	Less Freq. Than Annually Response=5	
1. Registered Investment Companies	93.1	6.2	0.3	0.0	0.3	1.08
2. Nonregistered Investment Companies	27.5	66.0	6.1	0.4	0.0	1.79
3. Employee Benefits Plans	25.1	66.0	6.8	1.8	0.4	1.86
4. Insurance Companies	23.8	66.2	5.2	4.9	0.0	1.91
5. Nonprofit Organizations	20.9	70.5	7.5	1.1	0.0	1.89
6. Corporate Accounts	17.1	68.0	13.7	0.9	0.3	1.99
7. Individuals and Personal Trusts	13.1	70.1	14.2	2.5	0.1	2.06
8. Other Accounts	26.3	59.2	10.7	3.2	0.6	1.93
9. Total Accounts	15.4	69.1	13.0	2.3	0.1	2.03

TABLE IV-24

DISTRIBUTION OF DISCRETIONARY AUTHORITY RESPONSES

ACCOUNT TYPE	PERCENTAGE OF ACCOUNTS WITH SPECIFIED DEGREE OF DELEGATED AUTHORITY TO ADVISER				Average Responses For Account Type	Standard Deviation Of Responses
	Complete Authority Response=1	Consults Sometimes Response=2	Consults Often Responses=3	No Authority Response=4		
1. Registered Investment Companies	75.3	1.9	1.6	21.2	1.7	1.2
2. Unregistered Investment Companies	55.9	6.9	9.7	27.5	2.2	1.3
3. Employee Benefits Plans	39.3	7.4	6.3	47.0	2.7	1.4
4. Insurance Companies	12.3	2.9	6.0	78.9	3.6	1.0
5. Nonprofit Organizations	21.1	5.9	6.2	66.8	3.2	1.2
6. Corporate Accounts	21.6	6.9	7.6	64.0	3.2	1.2
7. Individuals and Personal Trusts	26.2	8.0	9.8	56.1	3.0	1.3
8. Other Accounts	40.4	19.2	5.9	34.5	2.7	1.3
9. Total Accounts	27.4	7.8	9.1	55.6	2.9	1.3

TABLE IV-25

FEDERAL INCOME TAX LIABILITY

INDIVIDUAL AND PERSONAL TRUST ACCOUNTS

Federal Income Tax Bracket *	Number Of Accounts	Percentage Of Accounts
Tax Exempt (Zero)	329	1.0
0-30%	7255	21.0
30%-50%	10,969	31.8
50% and Above	7871	22.8
Not Known	8106	23.5

* Upper end of range included in range.

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TABLE IV-26

DISTRIBUTION OF NUMBER OF PARTICIPATING ACCOUNTS IN POOLED ACCOUNTS

ACCOUNT TYPE	No. of Pooled Accounts	NUMBER OF PARTICIPATING ACCOUNTS						Average Number Of Accounts
		1 - 500	500- 1000-	1000 - 5000	5000 - 10000	10000 - 20000	20000 and above	
1. Registered Investment Companies	308	52	20	57	24	46	109	3169
2. Unregistered Investment Companies	138	122	2	9	2	1	2	464
3. Employee Benefits Plans	69	62	1	1	3	1	1	592
4. Insurance Companies	1	1	0	0	0	0	0	96
5. Nonprofit Organizations	28	27	1	0	0	0	0	56
6. Corporate Accounts	31	31	0	0	0	0	0	29
7. Individuals and Personal Trusts	884	843	0	3	5	12	21	220
8. Other Accounts	134	132	0	0	0	1	1	139
9. Total Accounts	1593	1270	24	70	34	61	134	814

TABLE IV-27

DISTRIBUTION OF ADVISORY ACCOUNT TRADING ARRANGEMENTS

ACCOUNT TYPE	PERCENTAGE OF ADVISORY ACCOUNTS BY RESPONSE TYPE					
	Trading Dept > 50%	Account Mgr. > 50%	Trad. Dept. & Act. Mgr. 50%	Account Mgr. < 50%	Trading Dept < 50%	Do Not Trade
1. Registered Investment Companies	71.6	17.5	0.0	1.6	1.2	8.1
2. Unregistered Investment Companies	26.7	55.1	0.0	1.2	2.0	15.0
3. Employee Benefits Plans	21.5	45.8	1.2	2.5	4.2	24.8
4. Insurance Companies	20.1	22.9	3.2	6.6	6.0	41.3
5. Nonprofit Organizations	24.4	36.0	0.4	2.8	5.7	30.7
6. Corporate Accounts	15.3	34.0	0.5	9.0	2.7	38.2
7. Individuals and Personal Trusts	22.1	41.9	0.7	1.8	2.4	31.2
8. Other Accounts	13.1	59.0	1.1	1.9	2.7	22.1
9. Total Accounts	22.3	41.6	0.7	2.1	2.7	30.6

TABLE IV-28

DESIGNATION OF BROKERAGE BY ADVISORY CLIENTS

	PERCENTAGE OF ACCOUNTS DESIGNATING BROKERAGE					Average % Designated By Client	Standard Deviation Of Amount Designated
	0% Brokerage Designated	Less Than 15% Brokerage Designated	15-85% Brokerage Designated	More Than 85% of Brokerage Designated	Adviser Does Not Place Orders - 100% Designated		
1. Registered Investment Companies	65.0	3.4	7.8	19.7	4.1	27.0	40.5
2. Nonregistered	47.4	2.4	7.7	28.3	14.2	51.0	45.4
3. Employee Benefits Plans	27.4	2.3	7.8	40.3	22.2	63.1	42.0
4. Insurance Companies	20.9	3.4	8.6	28.9	38.1	72.4	39.6
5. Nonprofit Organizations	27.7	1.8	4.7	33.7	32.0	64.5	43.8
6. Corporate Accounts	19.1	1.2	4.4	39.0	36.2	75.4	38.2
7. Individuals and Personal Trusts	28.7	0.7	4.4	36.2	30.0	65.4	43.0
8. Other Accounts	36.0	1.0	2.5	40.4	20.2	59.4	45.6
9. Total Accounts	28.7	0.9	4.7	36.3	29.4	65.4	43.4

TABLE IV-29

DISTRIBUTION OF ADVISORY ACCOUNT TURNOVER RATES

	PERCENTAGE OF ACCOUNTS BY TURNOVER RATE				Average Turnover Rate-%	Standard Deviation Of Turnover Rates - %
	0 - 10%	10 - 50%	50 - 100%	Over 100%		
1. Registered Investment Companies	16.9	44.7	20.9	17.5	56.7	49.0
2..Nonregistered Investment Companies	18.2	51.8	15.4	14.6	47.1	43.3
3. Employee Benefits Plans	29.4	59.8	7.6	3.2	27.7	23.8
4. Insurance Companies	48.1	47.0	2.3	2.6	20.6	22.3
5. Nonprofit Organizations	45.7	49.0	3.9	1.4	21.1	20.4
6. Corporate Accounts	42.1	51.5	5.8	0.7	23.1	21.0
7. Individuals and Personal Trusts	49.1	46.4	4.0	0.5	20.2	19.4
8. Other Accounts	47.8	41.5	8.0	2.7	24.0	26.7
9. Total Accounts	46.9	47.6	4.5	1.0	21.3	20.8

TABLE IV-30

ANALYSIS OF ACCOUNT TURNOVER DATA

Category of Account		Regression Coefficients and T Values											CONST	R^2
		INDEP. VAR	YEAR	ASST	OBJT	AUTH	TAX	BR.D	TRAD	BROK	SIZE	FUND		
Reg. Inv. Co.	293	REG. COEF.	-5.8434	1.0795	-18.3410	-1.6469	-0.2239	3.7410	7.4057	0.0502	1.7699	27.8735	65.1	0.23
		T STAT.	-1.97	0.64	-5.50	-0.61	-0.65	0.44	1.17	0.67	0.80	3.91		
Non-Reg. Inv. Co.	187	REG. COEF.	3.8597	0.5938	-15.4881	-3.0104	-0.6178	12.9302	2.8461	0.0062	-4.1345	15.1596	106.25	0.41
		T STAT.	1.21	0.35	-4.19	-1.11	-4.05	1.86	0.60	0.09	-2.69	2.19		
Employee Benefit Plans	2716	REG. COEF.	-1.1823	0.4645	-8.0292	-1.9798	-0.0468	-1.3249	-0.6650	0.0802	-1.3250	6.9815	58.2	0.14
		T STAT.	-2.16	1.77	-11.38	-5.61	-0.60	-1.37	-1.15	7.12	-4.24	5.23		
Insurance Co.	320	REG. COEF.	-0.8702	-0.8396	-4.4365	-3.8949	-0.0228	3.3680	-1.8635	0.0723	0.0405	15.2187	47.8	0.15
		T STAT.	0.66	-0.99	-2.25	-2.86	-0.34	1.09	-1.13	1.82	0.04	3.50		
Non Profit Organizations	1662	REG. COEF.	-1.3563	0.4166	-6.1475	-2.9572	-0.0132	5.8340	-0.6670	0.0332	0.0797	9.1236	46.8	0.14
		T STAT.	-2.74	1.41	-7.82	-6.67	-0.16	4.86	-1.02	2.54	0.23	6.12		
Corporate Accounts	991	REG. COEF.	1.6654	0.4558	-6.3760	-3.0454	-0.0044	-3.3906	0.1918	0.0310	0.2616	9.6737	43.8	0.16
		T STAT.	2.48	1.09	-6.94	-4.61	-0.12	-2.12	0.21	1.60	0.56	5.50		
Individual & Personal Trusts	30952	REG. COEF.	-2.3628	-0.2923	-6.5568	-2.2880	0.0182	2.7201	0.9360	-0.0060	-0.4795	8.4872	45.6	0.18
		T STAT.	-22.51	-3.04	-42.88	-24.64	2.56	10.30	6.61	-2.08	-7.52	27.34		
Other Accounts	359	REG. COEF.	-4.2966	0.8946	-11.7409	-1.0921	0.0691	-14.1366	2.5000	-0.0511	-0.7131	13.3678	65.8	0.34
		T STAT.	-2.82	0.91	-6.07	-0.79	1.02	-4.15	1.18	-1.30	-0.76	2.23		
Total (All Accounts)	37480	REG. COEF.	-2.4910	1.0802	-7.1806	-2.4641	-0.0584	1.6653	0.4924	0.0104	-0.5110	9.9961	53.5	0.18
		T STAT.	-24.47	15.18	-48.80	-27.62	-11.49	6.62	3.55	3.76	-8.19	32.96		

REGRESSION EQUATION

$$TURN = CONST + b_1 \, LOG(YEAR) + b_2 \, LOG(ASST) + b_3 \, (OBJT) + b_4 \, (AUTH) + b_5 \, (TAX) + b_6 \, (BR.D) + b_7 \, (TRAD) + b_8 \, (BROK)$$

$$+ \, b_9 \, LOG(SIZE) + b_{10} \, (FUND)$$

TABLE IV-31

EFFECT OF BROKER-DEALER AFFILIATIONS ON TURNOVER RATES

ACCOUNT TYPE	NON BROKER-DEALERS			BROKER-DEALERS		
	No. of Advisers	No. of Accounts	Average Turnover (%)	No. of Advisers	No. of Accounts	Average Turnover (%)
1. Registered Investment Companies	62	262	57.9	19	42	49.9
2. Nonregistered Investment Companies	36	166	42.2	18	52	61.3
3. Employee Benefit Plans	64	2,007	27.7	27	812	27.8
4. Insurance Companies	41	256	20.0	13	73	23.9
5. Nonprofit Organizations	58	1,341	19.8	25	432	25.6
6. Corporate Accounts	54	794	23.6	20	234	21.4
7. Individuals and Personal Trust	84	25,052	19.7	29	7,536	22.0
8. Other Accounts	34	259	28.5	12	109	14.3
9. Total Accounts	118	30,137	20.9	39	9,290	22.9

TABLE IV-32

TURNOVER RATES FOR ACCOUNTS MANAGED IN MUTUAL FUND COMPLEXES

ACCOUNT TYPE	NON-FUND COMPLEX ACCOUNTS			FUND COMPLEX ACCOUNTS		
	No. of Advisers	No. of Accounts	Average Turnover (%)	No. of Advisers	No. of Accounts	Average Turnover (%)
1. Registered Investment Companies	28	69	35.9	53	235	62.9
2. Nonregistered Investment Companies	36	170	40.1	18	48	70.3
3. Employee Benefit Plans	70	2,468	26.3	21	351	37.6
4. Insurance Companies	42	301	19.3	12	28	37.3
5. Nonprofit Organizations	66	1,580	20.0	17	193	30.7
6. Corporate Accounts	56	864	20.8	18	164	35.0
7. Individuals and Personal Trust	90	28,787	18.8	23	3,801	31.2
8. Other Accounts	36	332	22.4	10	36	41.9
9. Total Accounts	105	34,571	19.6	53	4,856	33.8

Table IV-32 presents the average turnover rates for funds advised in non-fund and fund complexes. The average turnover rate for accounts in non-fund advisory complexes was 19.6 percent; the figure for accounts in fund complexes was 33.8 percent. As was discussed in the case of the broker-dealer affiliations of advisers, part of the differences between turnover rates shown in Table IV-32 can be explained in terms of differences in other factors between the two groups of accounts. The turnover rate differences obtained via the initial "other things the same" analysis are the most relevant for comparison purposes.

C. COMPETITION FOR NEW ACCOUNTS

1. Introduction

The purpose of this section is to describe the methods used by advisory firms to obtain new client accounts. The areas examined include the origin of new accounts, the successor advisory relationships of terminated accounts, restrictions placed upon minimum fee and asset sizes for new accounts and the importance of various promotional devices for obtaining new business.

The data were obtained from the I-14 and I-65 Investment Adviser Questionnaires. For each account in the I-14 sample which was started or terminated between January 1, 1969 and September 30, 1969, the adviser was asked to designate a code indicating the predecessor or successor account adviser. This information was obtained for 10,605 new accounts and 5,737 terminated accounts.

The remaining data are from the I-65 questionnaires. The 132 firms in that sample were asked to specify whether they required either a minimum size of asset or size of fee requirement for new accounts and if so, how much were the amounts. They were also asked to state the relative importance of the following promotional devices to obtain new accounts or additional subscriptions for existing accounts: (a) Advertising (Newspapers, TV, etc.); (b) Direct mail promotional literature; (c) Own retail sales force.

To gauge changes in the relative importance of these methods, the I-65 sample firms were requested to respond for both 1964 and 1969.

In addition, the advisers were asked to specify the importance of the following sources of client referrals to the achieving of new accounts for their firms: (i) Referrals by broker-dealers; (ii) Referrals by existing or former advisory clients. The importance of these categories was obtained for 1969 only.

The degree of importance used for responding to the above promotional questions were as follows:

1. Very important, always used.
2. Important, used often but not always.
3. Somewhat important, used sometimes but not frequently.
4. Not important, used only infrequently or rarely.
5. Unimportant, never used.

To supplement these quantitative responses, the advisers were requested in Part B of the I–65 questionnaire to submit a written description of the procedures used to attract new accounts and any major changes in promotional methods implemented during the past five years.

The responses to these questions are summarized in the following pages.

2. New and Terminated Accounts

The data on new and terminated accounts from the I–14 sample show a substantial movement of advisory accounts. The data are summarized in Table IV–33. The table presents the total number of I–14 accounts, the number of new accounts, the number of terminated accounts and a movement ratio for each account class. The ratio at which advisory clients move their accounts is computed by taking the lesser of new and terminated accounts divided by the total number of accounts as of September 30, 1969. The ratios have been normalized to a twelve-month base (i.e., multiplied by 1.33). The results indicate an average annual rate of movement of approximately 18 percent. Employee benefit accounts (one of the newer classes of adviser clients) show a higher than average movement rate. The results indicate a surprising degree of mobility on the part of institutional, corporate and individual clients.

3. Origin of New Accounts

Table IV–34 summarizes the data on the advisory status of the accounts previous to their becoming clients of the advisers responding to the questionnaire. The responding advisers were asked to indicate whether the account had come to them from a (an):

1. Individual or Non-financial Institution;
2. Bank or Trust Company;
3. Investment Advisory Firm;
4. Insurance Company;
5. Brokerage Firm not designated thereafter for brokerage from the account;
6. Brokerage Firm which thereafter received less than 50% of the brokerage from the account;
7. Brokerage Firm which thereafter received more than 50% of the brokerage from the account;
8. Other Financial Institution;
9. Unknown.

The primary observation from the table is that most advisers profess to be unaware of the previous advisory relationships of their new accounts. Significantly, however, a substantial portion of advisory

accounts whose previous adviser was identified came from bank advisers. This pattern is particularly pronounced for employee benefit accounts, where 19 percent of new employee benefit accounts were previously advised by banks. This figure represents approximately 60 percent of the employee benefit accounts where the responding adviser was able to specify the previous adviser.

4. Destination of Terminated Accounts

Table IV–35 summarizes the data on the advisory status of the accounts after they had ceased to be clients of the advisers responding to the questionnaire. The responding advisers were asked to indicate whether the account, upon leaving them, had gone to a (an):

1. Individual or Non-financial Institution;
2. Bank or Trust Company;
3. Investment Advisory Firm;
4. Insurance Company;
5. Brokerage Firm;
6. Other Financial Institution;
7. Death of Client—Successor adviser chosen;
8. Death of Client—Assets distributed;
9. Unknown.

Again, the most prominent observation is that the advisers profess to be largely unaware of the advistory status of their terminated accounts. Of the accounts for which designation was made, the most prominent successor category is another investment advisory firm, indicating again account mobility within this industry.

5. Minimum Asset and Fee Requirements for New Accounts

As previously indicated, for the tables produced from the I–65 data, the respondents have been stratified into "fund" and "non-fund" complexes and into "large" and "small" firms.

Table IV–36 presents the proportion of firms with minimum stated asset or minimum fee requirements for new accounts other than registered investment company accounts. The data indicate that large firms are more likely to have minimums than small firms. The data also indicate that some firms have both minimum asset and minimum fee requirements.[37a]

Tables IV–37 and IV–38 summarize the distribution of responses to the minimum asset and minimum fee questions. The tables indicate that fund complexes have higher minimum asset and minimum fee requirements for their non-fund clients than do non-fund complexes, and that small firms have lower minimum asset and minimum fee requirements than large firms. The minimum fee size averages $1,610 for fund complexes and $906 for non-fund complexes.

[37a] The Study's examination indicates that while many firms have substantial minimums for separately managed accounts, firms with such minimums also advise mutual funds which provide an advisory vehicle for clients with small amounts of savings. It is also common for the mutual funds managed by firms with large separately managed account operations to have no sales load. In these cases the funds are primarily a vehicle for "in-house" pooled management of small accounts rather than aggressively promoted (in terms of sales compensation) equity products.

6. Promotional Methods Used to Obtain New Accounts or Additional Subscriptions for Existing Accounts

Tables IV–39 through IV–41 present frequency distributions for the responses to the questions on the relative importance of specific promotional methods.

Table IV–39 contains the results on use of advertising during 1964 and 1969. The prominent result is the virtual lack of importance of advertising as a promotional method. Only approximately two percent of the respondents considered advertising to be very important in both 1964 and 1969 while more than half said that it was so unimportant that it was never used. Fund complexes rated advertising slightly more important to them than non-fund complexes. Since advertising is typically one of the lowest cost promotional devices for American business, the reasons for this lack of usage may be regulatory constraints.[38] Another reason may be that investment counsel consider themselves to be professionals and like lawyers, doctors, etc., do not consider it proper to advertise.

Table IV–40 summarizes the responses to the promotional literature question. Direct mail promotional literature is seen to be less frequently used than advertising. The reasons for this may be similar to those relating to advertising.

Table IV–41 summarizes the responses regarding the importance of the adviser's own retail sales force. For the entire sample, 56 percent of the advisers responded that for 1964 their own retail sales force was "unimportant, never used," while 48 percent made this response for 1969. To the extent that this promotional method is used, it appears that fund complexes rely more heavily on in-house sales forces than non-fund advisory complexes. The results show a somewhat greater relative importance of the adviser's own retail sales forces in 1969 compared to 1964.

7. Importance of Referrals

Table IV–42 presents the summary of responses to the question of the importance of referrals (a) by broker-dealers and (b) by existing or former clients to the achieving of new accounts for the responding advisory firms. The data are for 1969 only. Broker-dealer referrals are most important to fund complexes, and somewhat more important for larger vs. smaller advisory complexes. Client referrals are of greater importance for non-fund advisory complexes, particularly large firms in this category.

[38] The Commission's rules with respect to advertising by investment advisers are described in sec. A of this chapter. In addition to these rules, the Commission has issued a Statement of Policy concerning the use of advertising and supplemental sales literature in the sale of investment company shares. This Statement of Policy, which is reproduced at CCH Fed. Sec. L. Rep. at § 48.902, describes certain practices which the Commission will consider "materially misleading." Moreover, during the period between the filing of the registration statement covering mutual fund shares which are to be issued to the public and the date on which the registration statement becomes effective (the so-called "waiting period"). Rule 134 under the Securities Act of 1933, 17 CFR 230.134, limits the content of any advertisement or other communications with any person concerning the shares to be offered which may be made without being accompanied by a statutory prospectus.

TABLE IV-33

Rate at Which Advisory Clients Move Their Accounts

CLASS OF ACCOUNT	1 NUMBER OF ACCOUNTS (SEPT. 30, 1969)	2 NUMBER OF NEW ACCOUNTS (JAN.-SEPT. 1969)	3 NUMBER OF TERMINATED ACCOUNTS (JAN.-SEPT. 1969)	4 RATE (ANNUAL) %
Non Registered Investment Co.	358	104	43	16.0
Employee Benefit	3,027	1,181	608	26.7
Insurance Co.	347	113	66	25.3
Non Profit Organization	2,063	466	216	13.9
Corporate Accounts	1,059	539	211	26.5
Individual & Personal Trusts	34,529	8,124	4,545	17.5
Other	414	78	48	15.4
TOTAL *	41,797	10,605	5,737	18.3

* Registered investment companies rarely, if ever, change their investment adviser, and their movement rate would, therefore, be around zero. For a discussion of this phenomena, see the Commission's report on Public Policy Implications of Investment Company Growth, H.R Rep. No. 2337, 89th Congress, 2nd Session 125-132 (1966).

TABLE IV-34

ORIGINATION OF NEW ACCOUNTS

CATEGORIES OF PREVIOUS INVESTMENT ADVISER

1 Individual or Nonfinancial Institution
2 Bank or Trust Company
3 Investment Advisory Firm
4 Insurance Company
5 Brokerage Firm not designated thereafter for brokerage from the account
6 Brokerage Firm which thereafter received Less than 50% of the brokerage from the account
7 Brokerage Firm which thereafter received more than 50% of the brokerage from the account
8 Other Financial Institution
9 Unknown

ACCOUNT TYPE	NUMBER OF NEW ACCOUNTS	DISTRIBUTION OF RESPONSES BY CATEGORY OF PREVIOUS ADVISER (%)								
		CAT 1	CAT 2	CAT 3	CAT 4	CAT 5	CAT 6	CAT 7	CAT 8	CAT 9
Non. Reg. Inv. Co.	104	9.3	1.0	2.0	0	2.0	3.0	0	2.0	80.7
Employee Benefit	1,181	6.2	19.0	2.8	1.5	1.5	0.3	3.0	0.3	65.4
Insurance Co.	113	13.2	5.1	5.1	9.6	0.9	0	0.9	0	65.2
Non Profit Org.	466	14.1	12.4	3.4	0	1.3	0	3.1	0	65.7
Corporate Account	539	11.2	10.4	3.2	0.4	1.6	0	0.4	0	72.8
Ind. & Pers. Trusts	8,124	14.0	6.4	4.0	0	3.0	0.8	2.0	0.4	69.4
Other	78	13.5	6.0	5.0	0	0	1.0	0	0	74.5
TOTAL	10,605	13.1	8.4	4.0	0.3	2.7	0.5	2.2	0.4	68.4

TABLE IV-35

Destination of Terminated Accounts

CATEGORIES OF SUCCESSOR INVESTMENT ADVISER

1 Individual or Nonfinancial Institution
2 Bank or Trust Company
3 Investment Advisory Firm
4 Insurance Company
5 Brokerage Firm
6 Other Financial Institution
7 Death of Client--Successor Adviser Chosen
8 Death of Client--Assets Distributed
9 Not Known

ACCOUNT TYPE	NUMBER TERMINATED ACCOUNTS	DISTRIBUTION OF RESPONSES BY CATEGORY OF SUCCESSOR ADVISER (%)								
		CAT 1	CAT 2	CAT 3	CAT 4	CAT 5	CAT 6	CAT 7	CAT 8	CAT 9
Non Reg. Inv. Co.	43	9.2	5.0	14.2	0	2.5	2.5	2.5	0	64.10
Employee Benefit	608	1.5	6.0	4.0	1.0	1.0	0	0	0.5	86.00
Insurance Co.	66	1.5	4.5	8.5	1.5	7.0	1.5	0	0	75.50
Non Profit	216	3.0	4.0	8.0	0	3.0	0	0	1.0	81.00
Corporate Account	211	2.5	1.5	8.0	0	4.0	0.8	0	2.5	80.70
Ind. & Pers. Trust	4,545	10.0	3.8	5.4	0	3.8	0.8	0.8	3.1	72.30
Other	48	0	5.0	2.0	0	0	0	0	5.0	88.00
TOTAL	5,737	8.0	4.0	5.8	0.2	3.5	0.8	0.6	[illegible]	74.80

TABLE IV-36

MINIMUM STATED ASSET AND FEE REQUIREMENTS FOR NEW ACCOUNTS

TYPE OF FIRM	SIZE OF FIRM	NUMBER OF RESPONDENTS	PROPORTION WITH MINIMUM ASSET REQUIREMENT	PROPORTION WITH MINIMUM FEE REQUIREMENT
Mutual Fund Complex	Large	27	44%	48%
	Small	14	36	21
	TOTAL	41	42	39
Non Fund Complex	Large	38	76	87
	Small	52	46	58
	TOTAL	90	59	70
Total I-65 Sample	Large	65	63	71
	Small	66	44	50
	TOTAL	131	53	60

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TABLE IV-37

DISTRIBUTION OF MINIMUM ASSET SIZE FOR NEW ACCOUNTS

SIZE RANGE

Category 1 Greater than zero; less than $10,000
Category 2 Greater or equal to $10,000; less than $50,000
Category 3 Greater or equal to $50,000; less than $100,000
Category 4 Greater or equal to $100,000; less than $500,000
Category 5 Greater or equal to $500,000

TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY ASSET SIZE CATEGORIES (%)					AVERAGE FOR TYPE AND SIZE CLASSIFICATION (thousands of dollars)
			CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	
Mutual Fund Complexes	Large	12	57.69	0.0	0.0	19.23	23.08	359.62
	Small	5	71.43	14.29	0.0	14.29	0.0	17.50
	TOTAL	17	62.50	5.00	0.0	17.50	15.00	239.87
Non Fund Complexes	Large	29	23.68	2.63	0.0	52.63	21.05	341.18
	Small	24	59.62	9.62	1.92	23.08	5.77	125.60
	TOTAL	53	44.44	6.67	1.11	35.56	12.22	216.62
Total Sample	Large	41	37.50	1.56	0.0	39.06	21.88	348.67
	Small	29	62.12	10.61	1.52	21.21	4.55	102.67
	TOTAL	70	50.00	6.15	0.77	30.00	13.08	223.78

TABLE IV-38

DISTRIBUTION OF MINIMUM FEE SIZE FOR NEW ACCOUNTS

FEE CATEGORY

Category 1	Greater than zero; less than $1,000
Category 2	Greater or equal to $1,000; less than $1,500
Category 3	Greater or equal to $1,500; less than $2,500
Category 4	Greater or equal to $2,500; less than $5,000
Category 5	Greater or equal to $5,000

TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY FEE SIZE CATEGORIES (%)					AVERAGE FOR TYPE AND SIZE CLASSIFICATION (dollars)
			CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	
Mutual Fund Complex	Large	13	60.00	12.00	4.00	12.00	12.00	2,340.00
	Small	3	85.71	7.14	0.0	0.0	7.14	307.14
	TOTAL	16	69.23	10.26	2.56	7.69	10.26	1,610.26
Non-Fund Complex	Large	33	23.68	28.95	15.79	26.32	5.26	1,413.16
	Small	30	76.92	13.46	7.69	1.92	0.0	536.35
	TOTAL	63	54.44	20.00	11.11	12.22	2.22	906.56
Total Sample	Large	46	38.10	22.22	11.11	20.63	7.94	1,780.95
	Small	33	78.79	12.12	6.06	1.52	1.52	487.73
	TOTAL	99	58.91	17.05	8.53	10.85	4.65	1,119.30

TABLE IV-39

IMPORTANCE OF ADVERTISING FOR OBTAINING NEW BUSINESS

CATEGORIES OF AVAILABLE RESPONSES:
Category 1 Very important, always used
Category 2 Important, used often but not always
Category 3 Somewhat important, used sometimes but not frequently
Category 4 Not important, used only infrequently or rarely
Category 5 Unimportant, never used

YEAR	TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY IMPORTANCE CATEGORIES (%) CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	AVERAGE RESPONSE
1964	Mutual Fund Complex	Large	23	4.35	17.39	13.04	26.09	39.13	3.78
		Small	6	0.0	0.0	16.67	0.0	83.33	4.67
		TOTAL	29	3.45	13.79	13.79	20.69	48.28	3.97
	Non-Fund Complex	Large	31	0.0	0.0	12.90	25.81	61.29	4.48
		Small	41	2.44	9.76	2.44	9.76	75.61	4.46
		TOTAL	72	1.39	5.56	6.94	16.67	69.44	4.47
	Total Sample	Large	54	1.85	7.41	12.96	25.93	51.85	4.19
		Small	47	2.13	8.51	4.26	8.51	76.60	4.49
		TOTAL	101	1.98	7.92	8.91	17.82	63.37	4.33
1969	Mutual Fund Complex	Large	25	4.00	16.00	28.00	16.00	36.00	3.64
		Small	14	0.0	14.29	7.14	35.71	42.86	4.07
		TOTAL	39	2.56	15.38	20.51	23.08	38.46	3.79
	Non-Fund Complex	Large	38	0.0	0.0	13.16	39.47	47.37	4.34
		Small	51	3.92	3.92	7.84	13.73	70.59	4.43
		TOTAL	89	2.25	2.25	10.11	24.72	60.67	4.39
	Total Sample	Large	63	1.59	6.35	19.05	30.16	42.86	4.06
		Small	65	3.08	6.15	7.69	18.46	64.62	4.35
		TOTAL	128	2.34	6.25	13.28	24.22	53.91	4.21

TABLE IV-40

IMPORTANCE OF DIRECT MAIL PROMOTIONAL LITERATURE
FOR OBTAINING NEW BUSINESS

CATEGORIES OF AVAILABLE RESPONSES:
Category 1 Very important, always used
Category 2 Important, used often but not always
Category 3 Somewhat important, used sometimes but not frequently
Category 4 Not important, used only infrequently or rarely
Category 5 Unimportant, never used

YEAR	TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY IMPORTANCE CATEGORIES (%)					AVERAGE RESPONSE
				CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	
1964	Mutual Fund Complex	Large	23	0.0	4.35	17.39	30.43	47.83	4.22
		Small	6	0.0	0.0	0.0	16.67	83.33	4.83
		TOTAL	29	0.0	3.45	13.79	27.59	55.17	4.34
	Non-Fund Complex	Large	31	0.0	9.68	3.23	16.13	70.97	4.48
		Small	39	5.13	7.69	5.13	0.0	82.05	4.46
		TOTAL	70	2.86	8.57	4.29	7.14	77.14	4.47
	Total Sample	Large	54	0.0	7.41	9.26	22.22	61.11	4.37
		Small	45	4.44	6.67	4.44	2.22	82.22	4.51
		TOTAL	99	2.02	7.07	7.07	13.13	70.71	4.43
1969	Mutual Fund Complex	Large	28	0.0	3.85	30.77	23.08	42.31	4.04
		Small	14	7.14	0.0	7.14	28.57	57.14	4.29
		TOTAL	40	2.50	2.50	22.50	25.00	47.50	4.12
	Non-Fund Complex	Large	38	0.00	7.89	7.89	21.05	63.16	4.39
		Small	50	2.00	4.00	4.00	10.00	80.00	4.62
		TOTAL	88	1.14	5.68	5.68	14.77	72.73	4.52
	Total Sample	Large	64	0.0	6.25	17.19	21.88	54.69	4.25
		Small	64	3.12	3.12	4.69	14.06	75.00	4.55
		TOTAL	128	1.56	4.69	10.94	17.97	64.84	4.40

TABLE IV-41

IMPORTANCE OF OWN RETAIL SALES FORCE FOR OBTAINING NEW ACCOUNTS OR ADDITIONAL SUBSCRIPTIONS FOR EXISTING ACCOUNTS

CATEGORIES OF AVAILABLE RESPONSES:
Category 1 Very important, always used
Category 2 Important, used often but not always
Category 3 Somewhat important, used sometimes but not frequently
Category 4 Not important, used only infrequently or rarely
Category 5 Unimportant, never used

YEAR	TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY IMPORTANCE CATEGORIES (%) CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	AVERAGE RESPONSE
1964	Mutual Fund Complex	Large	23	26.09	8.70	8.70	0.0	56.52	3.52
		Small	6	33.33	0.0	0.0	0.0	66.67	3.67
		TOTAL	29	27.59	6.90	6.90	0.0	58.62	3.55
	Non-Fund Complex	Large	31	22.58	19.35	6.45	9.68	41.94	3.29
		Small	40	22.50	0.0	2.50	10.00	65.00	3.95
		TOTAL	71	22.54	8.45	4.23	9.86	54.93	3.66
	Total Sample	Large	54	24.07	14.81	7.41	5.56	48.15	3.39
		Small	46	23.91	0.0	2.17	8.70	65.22	3.91
		TOTAL	100	24.00	8.00	5.00	7.00	56.00	3.63
1969	Mutual Fund Complex	Large	26	23.08	11.54	15.38	3.85	46.15	3.38
		Small	14	71.43	0.0	0.0	0.0	28.57	2.14
		TOTAL	40	40.00	7.50	10.00	2.50	40.00	2.95
	Non-Fund Complex	Large	38	23.68	15.79	7.89	7.89	44.74	3.34
		Small	52	23.08	3.85	3.85	11.54	57.69	3.77
		TOTAL	90	23.33	8.89	5.56	10.00	52.22	3.59
	Total Sample	Large	64	23.44	14.06	10.94	6.25	45.31	3.36
		Small	66	33.33	3.03	3.03	9.09	51.52	3.42
		TOTAL	130	28.46	8.46	6.92	7.69	48.46	3.39

TABLE IV-42

IMPORTANCE OF REFERRALS FOR ACHIEVING NEW ACCOUNTS (1969)

CATEGORIES OF AVAILABLE RESPONSES:
Category 1 Very important, always used
Category 2 Important, used often but not always
Category 3 Somewhat important, used sometimes but not frequently
Category 4 Not important, used only infrequently or rarely
Category 5 Unimportant, never used

SOURCE OF REFERRAL	TYPE OF FIRM	SIZE OF FIRM	NUMBER OF FIRMS	DISTRIBUTION OF RESPONSES BY IMPORTANCE CATEGORIES (%)					AVERAGE RESPONSE
				CAT. 1	CAT. 2	CAT. 3	CAT. 4	CAT. 5	
Broker Dealers	Mutual Fund Complex	Large	25	16.00	16.00	32.00	12.00	24.00	3.12
		Small	12	0.0	8.33	8.33	16.67	66.67	4.42
		Total	37	10.81	13.51	24.32	13.51	37.84	3.54
	Non-Fund Complex	Large	38	5.26	5.26	26.32	50.00	13.16	3.61
		Small	49	4.08	16.33	22.45	18.37	38.78	3.71
		Total	87	4.60	11.49	24.14	32.18	27.59	3.67
	Total Sample	Large	63	9.52	9.52	28.57	34.92	17.46	3.41
		Small	61	3.28	14.75	19.67	18.03	44.26	3.85
		Total	124	6.45	12.10	24.19	26.61	30.65	3.63
Existing or Former Clients	Mutual Fund Complex	Large	24	25.00	29.17	16.67	8.33	20.83	2.71
		Small	13	15.38	0.0	30.77	7.69	46.15	3.69
		Total	37	21.62	18.92	21.62	8.11	29.73	3.05
	Non-Fund Complex	Large	38	47.37	31.58	21.05	0.0	0.0	1.74
		Small	52	36.54	32.69	9.62	3.85	17.31	2.33
		Total	90	41.11	32.22	14.44	2.22	10.00	2.08
	Total Sample	Large	62	38.71	30.65	19.35	3.23	8.06	2.11
		Small	65	32.31	26.15	13.85	4.62	23.08	2.60
		Total	127	35.43	28.35	16.54	3.94	15.75	2.36

D. ADVISORY FEES

1. Introduction

The purpose of this section is to present an analysis of the advisory fees charged by advisers to their various types of clients. The basic data consist of the advisory fees charged to the 42,118 accounts in the I–14 respondent group for calendar year 1969. This information was combined with the other items collected by that questionnaire to examine the relationship between fee rate, expressed as a percentage of total account assets as of September 30, 1969, and various characteristics of the client, the account and the advisory complex.

2. Services Supported by the Advisory Fee

The ability of the following analysis to explain differences in fee ratios by the various characteristics of the client, account and adviser will be reduced to the extent that the advisory fee supports different levels of tangible services, such as administrative expenses, custodian fees and so on. To the extent that the adviser provides special services or bears an unusual proportion of expenses associated with an advisory account, the advisory fee ratio would be expected to be higher, and vice versa. The analyses describe the typical allocation of account expenses between the adviser and the client for registered investment company and other types of clients.

The following, based on an examination of externally managed registered investment company prospectuses, are the typical division of expenses between the investment company and the adviser.[39]

TYPICAL DIVISION OF INVESTMENT COMPANY EXPENSES

Expenses of the Fund: Advisory Fee; Transfer Fees; Custodian Fees; Taxes; Interest and Insurance; Filing Fees; Legal and Auditing; Shareholder Reports (printing and postage); Stationary;* Director's Fees;* Registration Fees.*

Expenses of the Adviser (Supported by the Advisory Fee): Administrative, Clerical and Bookeeping; Office Rental and Equipment; Research and Statistical; Telephone and Utilities; Stationary;* Director's Fees;* Registration Fees.*

*Indicates an expense divided according to advisory contract.

For other types of accounts the definition of the level and quality of services provided becomes more difficult. Some advisory firms provide a wide variety of services which can have a distinct bearing on the total relationship with the client and advisory fee levels. The following are examples of services which are provided by a number of advisory firms to client accounts:

(i) Taxes—maintenance of tax records; preparation of income tax returns; advice on tax sheltered investing; advice on impacts of tax laws on investors.

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[39] The expenses in addition to the advisory fee borne by a group of 87 externally managed mutual funds with June 30, 1968 assets of $100 million and over, for their fiscal years ended between July 1, 1967 and June 30, 1968, averaged 0.14 percent of average net assets during the fiscal year (medium value=0.09 percent of average net assets). Source: Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737. Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 1st Sess., pt. 2, at 879–880 (1969). While the allocation of expenses shown in the display is typical of the fund industry, exceptions do exist. A small number of large fund complexes pay all expenses of their mutual fund advisory accounts.

(ii) Financial planning services—estate planning for individuals—employee benefit and corporate planning for institutional and corporate accounts.

(iii) Order placing—facilities for placing orders with broker-dealers and associated record-keeping.

(iv) Banking relationships—establishment of custodian, loan and other bank relationships.

(v) Other consulting advice—matters affecting institutional clients such as insurance company accounting and regulations, pension fund actuarial considerations, etc.

(vi) Special services—bond and mortgage supervision and other forms of active income and tax sheltered investing.

The advisory fee paid by the non-fund client typically supports all of the services provided by the adviser. There is no separate administrative expense charged to the account, as in the case of most registered investment company clients.

An exception to the above rules, however, are custodian fees. Advisory complexes typically do not maintain custody of client securities. Custodial services, in the cases of institutional, corporate and individual clients are usually contracted and paid for by the client. The magnitude of the custodian fees depends on the total assets of the account, the activity rate and the cash balances maintained. Those fees typically range from about 0.2 percent for small accounts (under $0.5 million) down to 0.05 percent for large accounts. Comparability in advisory fee data is maintained between mutual fund and other account types, however, since custodian fees are typically paid by the fund and not the adviser.[40]

3. Distribution of Advisory Fee Ratios (Refer to Tables IV–43 and IV–44)

The advisory fee ratio was computed by dividing the 1969 advisory fee by the total account assets as of September 30, 1969, and expressing the result as a percentage. Table IV–43 summarizes both the average of the account fee ratios and the total fees paid expressed as a percentage of the total assets for the accounts in the I–14 sample.[41]

The average fee ratio is an unweighted average of the individual account fee ratios, and thus reflects the fee paid by a typical account of that type. The total fees divided by the total assets for the account types reflects a dollar weighted average of fee ratios. The latter reflects the average fee obtained per dollar of advisory assets of the account types.[42]

The average fee ratio for the total number of accounts was 0.46 percent of assets. On a dollar weighted basis, the result is 0.28 percent of assets. The same ratios for registered investment companies were 0.45 percent and 0.39 percent of assets. The average fee ratios for institutional and corporate accounts range from 0.60 percent for

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[40] To support this assertion, the advisory contracts of a randomly chosen sample of 78 externally managed open-end investment companies were examined as of December 1, 1970. Of the 78 cases, the adviser paid the custodian fee in only three cases.

[41] The 42,118 accounts in the I–14 survey have been grouped into the same eight account types that were described in sec. B of this chapter.

[42] The unweighted average of advisory fee ratios will typically be larger than the dollar-weighted average due to the preponderance of smaller accounts with higher fee ratios in all of the account categories.

nonregistered investment companies down to 0.20 percent for insurance company accounts. The dollar weighted fee ratios for the same accounts were 0.66 percent and 0.07 percent of assets. For the accounts of individuals and personal trusts, the average fee ratio was 0.48 and the dollar weighted fee ratio was 0.29 percent.

The distribution of average advisory fee ratios show that 6.4 percent of all accounts paid no fees. Of the 2,691 accounts which paid no fees, 1,942 were small individual and personal trust accounts and were typically satellite accounts of larger accounts in the same category. Additionally 290 accounts of nonprofit organizations (14.1 percent of total nonprofit accounts) and 207 employee benefit plans (6.8 percent of the total) paid no fees.

For accounts where fees are paid, 13.8 percent had average advisory fee ratios between 0 and 0.2 percent, 24.3 percent had fee ratios between 0.2 percent and 0.4 percent, 39.9 percent were between 0.4 percent and 0.6 percent and 15.6 percent were above 0.6 percent.

The average advisory fee ratios for registered investment companies showed the strongest central grouping, with 54.1 percent of funds with fee ratios between 0.4 percent and 0.6 percent of assets. Individual and personal trust account fee ratios were also highly concentrated, with 43.0 percent of accounts with fee ratios between 0.4 and 0.6 percent of assets.

4. Advisory Fee Bases (Refer to Table IV–45)

For 78 percent of all advisory accounts, the adviser was compensated through an advisory fee which was based on a percentage of the assets under advisement. A further 17 percent of accounts compensated the adviser via either a flat fee which did not depend on annual variation in account size and/or activity, or a combination of a flat fee and a fee based on a percentage of assets.

For registered investment companies, 73 percent of advisory contracts provided for a percentage of assets advised type of fee. A further 17 percent of registered investment companies had incentive fee arrangements, of which the majority (43 out of 54) were based on the performance of the fund relative to a market index.

The absence of performance fee arrangements for non investment company accounts relates to the prohibition of such arrangements by the Investment Advisers Act, which continues in effect until December 14, 1971, the effective date of the amendment to Section 205 of that Act contained in the Investment Company Amendments Act of 1970. For a discussion of performance fees generally, see section F of this chapter.

5. Relationship of Fee Ratio to Account Size (Refer to Tables IV–46, IV–47 and IV–48)

The following display summarizes the average fee ratios for accounts in various size ranges for registered investment companies, institutional and corporate accounts and individual and personal trust accounts.[43]

[43] Institutional and corporate accounts include non-registered investment companies, employee benefit plans, insurance company accounts, nonprofit organization accounts, corporate accounts and other accounts.

Size range of account (dollars in millions)	Average fee ratios (percent)		
	Registered investment companies	Institutional and corporate	Individuals
0 to 0.25	0.85	0.64	0.55
0.25 to 1	.78	.42	.38
1 to 10	.40	.26	.19
10 to 100	.47	.12	.06
100 plus	.44	.03	.02

Average advisory fees for registered investment companies decline to 0.44 percent of assets for funds over $100 million of assets. This average is based on 94 companies with an average size of approximately $450 million.

Average fee ratios for institutional and corporate accounts decline to 0.03 percent of assets for accounts over $100 million of assets. This average is based on 41 accounts with an average size of approximately $250 million.

For individual and personal trust accounts, the situation is similar to the institutional and corporate accounts. For accounts over $100 million of assets (5 accounts with average size of $150 million) the average fee ratio for individual and personal trust accounts was 0.02 percent of assets advised.

The results indicate that economies of scale exist for all types of accounts and that some savings are being passed along to the investor via lower advisory fees for larger accounts. The results show, however, that substantially greater reductions in fee ratios exist for institutional, corporate and individual accounts, than for investment company accounts.

The results also indicate that the average fee ratios for institutional and corporate accounts are higher than for individual and personal trust accounts over the full range of account sizes.

6. Factors Affecting Advisory Fees

In order to examine the simultaneous relationships of various client, account and adviser relationships and advisory fee ratios, a more powerful technique must be used than the tabular presentations used in the above discussion of account size and fee ratios. The analytical technique employed was regression analysis, which allows the examination of the relationship of a single factor to fee ratio while holding all other factors that have been included in the analysis constant. This then allows "other things being the same" statements to be made about the impact of one explanatory factor on advisory fee ratios.

The following factors were included in the regression analysis to ascertain their statistical relationship to the advisory fee ratio.[44]

(i) Age of the Account (Year).
(ii) Account Valuation Frequency (VFR).
(iii) Total Assets of Account (ASST).
(iv) Investment Objective of Account (OBJ).
(v) Investment Authority of Adviser (AUTH).

[44] Refer to sec. B of this chapter for a description of these factors.

(vi) Federal Income Tax Bracket of Client (TAX).
(vii) Broker-Dealer Affiliation of Adviser (BR-D).
(viii) Account Trading Status (TRAD).
(ix) Designation of Brokerage (BROK).
(x) Size of Advisory Complex (SIZE).
(xi) Mutual Fund Complex Factor (FUND).
(xii) Turnover of Common Stock Portion of the Portfolio (TURN).

The expected relationship of each factor to advisory fees and the results obtained in the regression analysis are now discussed for each of the above factors.[45]

a. The age of the account (YEAR)

Advisory fee arrangements for accounts other than registered investment companies are typically not renegotiated every year.[46] Many advisory firms appear to be reluctant to change the terms of existing arrangements to conform to the fees charged to new accounts. Thus to the extent that any increase or decrease over time exists in the fee ratio charged to new accounts, the age of the account would probably be a significant factor in explaining differences in fee ratios on existing accounts.

For all types of accounts except investment companies, the age of the account was negatively related to the size of the fee ratio. For individual and personal trust accounts, for example, a 1 percent increase in account age is associated with a 0.07 percent decrease in advisory fee ratio. The effect for institutional and corporate accounts of a 1 percent increase in age ranges from a 0.09 percent reduction for employee benefit plans to a 0.27 percent reduction for insurance company accounts. The effect is in the opposite direction for investment companies (registered and non-registered), with an increase in age being associated with an increase in advisory fee ratio, but the relationship is not statistically significant.

b. Valuation frequency.

The valuation frequency can be considered as a measure of the information processing activity associated with the account. Thus accounts with more frequent valuations would involve a higher level of expenses.

The results of the analysis are consistent with this hypothesis for all classes of accounts. For the total number of accounts, a 1 percent increase in valuation frequency is associated with a 0.11 percent increase in fee ratio.

c. Total account assets

The economies of scale associated with the administration of larger amounts of assets should be reflected in terms of lower advisory fee ratios. It would also be expected that the economies of scale would

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[45] In the following discussion, where the impact of changes in the explanatory factors are discussed, the following convention will be used:

Changes in the following will be percentage changes from a starting amount—for example, a 100% increase in account asset size would result from an asset increase from $1 million to $2 million—Fee Ratio, Valuation Frequency, Total Account Assets, Advisory Complex.

Changes in the remaining factors will be discussed in terms of absolute differences. For example, a 10 percentage point increase in turnover rate would result from an increase from a 30 percent to 40 percent turnover rate.

[46] As noted in sec. A of this chapter, Section 15 of the Investment Company Act requires investment advisory contracts that are to be continued beyond two years to be approved annually.

differ by account type. For example, there are differences in expenses between taking on an increment of $100 million of corporate account assets and the same amount of new mutual fund assets.

For all types of accounts, an increase in asset size was associated with a statistically significant decrease in the average fee ratio. For the total number of accounts, a 1 percent increase in account assets was associated with a 0.25 percent reduction in fee ratio.

The fee ratio reduction percentage differed substantially among account types, however. For registered investment companies, a 1 percent increase in assets was associated with a 0.05 percent reduction in fee ratio. For institutional and corporate accounts the percentage reduction ranged from 0.26 percent for the accounts of non-profit organizations to 0.36 percent for corporation accounts. The reduction in fee ratio for individual and personal trust accounts associated with a 1 percent increase in account assets was 0.25 percent.

d. Account investment objective

This factor is included to represent the additional advisory attention needed to advise accounts with aggressive (maximal capital gain oriented) investment objectives. These accounts may require the adviser to follow more stocks more intensively than would be required for less aggressively managed accounts.[47]

For all classes of accounts (except "other"), more aggressive investment objectives were associated with higher advisory fee ratios. For the total number of accounts, a 35 percent increase in fee ratio was associated with a change from an income to capital gain oriented account.

e. Investment discretionary authority

The experience of the advisory industry is that non-discretionary relationships require more time and paper work than discretionary accounts. For example, in completing an account transaction, the client must be reached by telephone or letter and the basis for the recommendation and its applicability to that client explained to him. The client sends back his approval, the transaction is arranged, the client is advised. In a discretionary account, on the other hand, the program is developed, the transactions are arranged and the client may or may not be informed at the time. Thus, the theory goes, there is a substantial saving of time otherwise involved in trying to reach the client in advance and presenting a full explanation to him for his approval.

The regression results, however, are at odds with the cost based hypotheses developed above. The results indicate that, on the average, non-discretionary accounts have lower advisory fee ratios. For the total number of accounts, the fee rate for a non-discretionary account is approximately 38 percent lower than that of a fully discretionary account. The result is statistically significant for individual accounts

[47] An aggressively managed income account, however, can require following a large number of real estate opportunities (mortgages, sale-lease backs), corporate, state and municipal credits and economic trends. Also, certain firms with aggressively managed stock portfolios have advertised themselves as concentrating on a very limited number of securities. (For a discussion of concentration in institutional portfolio holdings, see ch. X. C.) Thus, it would be expected that the hypotheses stated above would be true in general but various exceptions will exist.

and for all types of institutional and corporate accounts. It is not statistically significant for investment company and "other" accounts.

One explanation for this effect may be that firms with high concentrations of discretionary accounts may charge higher advisory fees. This is consistent with the fact that many newer advisory firms which will only take discretionary accounts charge higher fees than older firms. Another explanation might be that an adviser with a non-discretionary account may have less responsibility in selecting investments and less risk of client dissatisfaction with the account's performance, and thus is willing to charge a lower fee.

f. Federal income tax bracket of the client

In the case of individual and personal trust accounts, the fee for identical professional advisory services rendered might be related to the ability of the client to pay, as in the case of other professions (doctors, lawyers, etc.). If this practice is prevalent in the advisory industry, there would be a positive relationship between the marginal tax bracket and the fee ratio charged, other things being equal.

The client tax bracket was found to have a significant statistical relationship to the advisory fee charged to the individual and personal trust account. On the average, a one percentage point increase in federal income tax bracket was associated with a 0.3 percent increase in advisory fee ratio.

g. Broker-Dealer affiliation of the adviser

When an account is advised in a complex which is affiliated with a broker-dealer, the possibility exists that some fraction of the brokerage commission generated by the account will be returned in terms of lower advisory fees.[48] It would be expected that the effect would be particularly significant for registered investment companies, where opportunities to offset brokerage from affiliated mutual funds against advisory fees may well exist.

The regression results support the above contentions. For the total number of accounts, the broker-dealer affiliation factor is associated with approximately a 12 percent reduction in fee rate. The result of the brokerage offset is particularly striking for registered investment company accounts. The reduction in fee ratio for these accounts is approximately 40 percent, other things being the same. For individual and personal trust accounts, the reduction is approximately 15 percent. The direction of relationship varies among the institutional and corporate accounts and is statistically significant only for this category of account.

Table IV–50 presents the average fee ratios for the various classes of accounts segmented by broker-dealer affiliation. The results conform to the above discussion of differences in fee ratios associated with the affiliations. Where differences in magnitude exist, however, they are due to the fact that other factors may differ between broker-dealer and non broker-dealer accounts which have not been controlled for in the table.

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[48] The only broker-dealer affiliations considered in this analysis are relationships with firms acting as agents or principals in the execution of client portfolio transactions. This definition excludes any broker-dealer affiliations limited to mutual fund underwriting activities.

h. Trading status of the account

Placing orders for the client is an additional service for which the adviser may be compensated through higher advisory fees. Thus, for accounts where the adviser places orders most or all of the time (without receiving brokerage commissions), the average advisory fee would be expected to be higher.

The result is as predicted for the total number of accounts, where the increase in average fee ratio between accounts for which the adviser does no trading to accounts where he trades most or all of the time is approximately 6 percent. The result is statistically significant, however, only for accounts of non-profit organizations and individual and personal trusts. In these cases the increase is approximately 2 percent for the former and 6 percent for the latter type of accounts.

i. Brokerage allocation

The extent to which the client designates the broker-dealers to be used for his portfolio transactions can affect the advisory fee level in a number of ways.

If the client designates the brokerage, the adviser loses the use of these commissions to purchase additional services from the brokerage community. To compensate for this loss, accounts with high degrees of designated brokerage may be charged higher fees.

On the other hand, designation of brokerage may make things easier for the adviser. There is no need, for example, to have a trading desk to check alternative prices that may be available for the same securities. On this basis, it would be expected that accounts which designate brokerage pay lower fees, other things being the same.

For the total number of accounts, the effect is consistent with the latter hypotheses. Accounts which do not designate brokerage tend to pay slightly higher fees. The fee rate increases approximately 0.05 percent between accounts where all brokerage is designated and accounts where the client designates no brokerage. The magnitude of the effect is similarly small for the various types of accounts and is statistically significant for only three account types.

j. Size of the advisory complex

As the advisory complex grows in terms of assets under advisement, economies of scale will result which can be passed on to clients in several ways. One would be by reduction of advisory fees; this would be reflected in terms of a negative relationship between fee ratio and size of the advisory complex. Another way would be through the provision of extra services to clients (for example, tax planning) without increase in advisory fee. If done that way, the economies associated with larger advisory complexes would not be reflected in terms of lower fee ratios.

The regression results indicate that any economies of scale that do exist are not reflected in terms of statistically significant reductions in advisory fee ratios. For the total number of accounts, a 100 percent increase in the size of the advisory complex assets is associated with a 0.36 percent reduction in advisory fee ratio. The effect is similarly small, of mixed direction and not statistically significant among the various types of accounts.

k. Mutual fund complex factor

This factor is included to measure the effect on advisory fees charged to accounts which are advised within mutual fund complexes.

The regression results show that accounts managed in fund complexes tend to pay higher advisory fees than accounts in non-fund complexes. This result is true for the total number of accounts and is statistically significant for each of the various account types.

For a typical account advised in a fund complex, the fee ratio is approximately 18 percent higher, other things being the same. For a registered investment company, the increase is 62 percent. For institutional and corporate accounts, the increases range from 21 percent for corporate accounts to 35 percent for accounts of insurance companies. For individual and personal trust accounts the difference is approximately 7 percent.

The difference in average fee ratios between fund complex and non-fund complex advisory accounts are presented in Table IV–51. The figures give the same general picture as discussed above. Where differences in magnitude exist between percentage differences in Table IV–51 and the regression results, they are due to differences in other factors between fund and non-fund complexes which are not controlled for in the tabular presentation.

l. Turnover of common stock portion of portfolio

Portfolio turnover may be a measure of the degree to which the portfolio is aggressively managed. High turnover implies frequent review and evaluation of the account. If this were the only consideration, accounts with high turnover rates would have higher advisory fee ratios, other things being the same.

This is not typically the whole story. The brokerage commissions that result from higher turnover rate may be useful to obtain additional services from the brokerage community, such as security research or promotional considerations. This is particularly true for advisers of mutual funds, where brokerage commissions have typically been used to reward broker-dealers who sell shares of affiliated funds. Thus some advisers may actually prefer accounts with high turnover rates and may seek them out via lower advisory fees.

The regression results show that turnover rates are positively correlated with advisory fee ratios for all classes of accounts except investment companies. For the total number of accounts, a 10 percentage point increase in turnover rate is associated with a 6 percent increase in fee ratio. For registered investment companies the opposite effect is observed. A 10 percentage point increase in turnover rate is associated with a 2.0 percent reduction in fee ratio. The results from a 10 percentage point increase in turnover rate for individual and institutional and corporate accounts range from a 2.5 percent increase for employee benefit accounts to a 5.6 percent increase for individual and personal trust accounts.

The pattern of results show that the adviser must be compensated to provide higher turnover rates for non-investment company accounts, but are willing to accept lower levels of advisory fees for investment companies with higher turnover rates.

TABLE IV-43

AVERAGE ADVISORY FEES

ACCOUNT TYPE	Number of Advisory Firms	Number of Accounts	Average Advisory Fee Ratio (%)	Average Fee Paid (Total Fees) / (Total Assets) (%)
1. Registered Investment Companies	86	320	0.45	0.39
2. Nonregistered Investment Companies	109	245	0.60	0.66
3. Employee Benefit Plans	133	3,019	0.40	0.10
4. Insurance Companies	133	347	0.20	0.07
5. Nonprofit Organizations	137	2,062	0.28	0.09
6. Corporate Accounts	140	1,053	0.40	0.11
7. Individuals and Personal Trust	152	34,460	0.48	0.29
8. Other Accounts	157	514	0.39	0.13
9. Total Accounts	157	42,020	0.46	0.28

TABLE IV-44

DISTRIBUTION OF AVERAGE ADVISORY FEE RATIOS

	PERCENTAGE OF ACCOUNTS BY AVERAGE ADVISORY FEE RATIO						
TYPE OF ACCOUNT	0 %	Greater than 0% 0.2%	Greater than .2% 0.4%	Greater than 0.4% 0.6%	Greater than 0.6% 0.8%	Greater than 0.8% 1.0%	Greater than than 1%
1. Registered Investment Companies	5.0	7.8	21.6	54.1	8.1	2.2	1.2
2. Nonregistered Investment Companies	11.7	8.9	16.2	32.4	14.6	3.6	12.6
3. Employee Benefit Plans	6.8	20.1	29.8	29.5	6.5	2.9	4.3
4. Insurance Companies	5.7	55.9	22.6	11.2	3.4	0.6	0.6
5. Nonprofit Organizations	14.1	31.4	34.3	14.9	2.5	1.4	1.5
6. Corporate Accounts	2.8	30.8	20.8	31.8	5.8	2.8	5.2
7. Individual and Personal Trust	5.6	11.4	23.5	43.0	8.1	3.1	5.4
8. Other Accounts	29.9	14.3	15.2	29.5	3.2	1.9	5.9
9. Total Accounts	6.4	13.8	24.3	39.9	7.6	2.9	5.1

TABLE IV-45

DISTRIBUTION OF ADVISORY FEE BASES

ACCOUNT TYPE	Flat Fee	Percentage of Assets	Combination of First Two	Incentive Fee	No Fee Paid	Other
	PERCENTAGE OF ACCOUNTS BY FEE BASIS					
1. Registered Investment Companies	2.2	72.8	0.3	16.8	1.2	6.6
2. Nonregistered Investment Companies	3.2	70.9	9.3	6.5	2.4	6.1
3. Employee Benefit Plans	5.4	81.5	7.0	0.0	1.3	4.8
4. Insurance Companies	16.0	60.7	18.6	0.0	1.4	3.2
5. Nonprofit Organizations	12.4	69.8	9.2	0.0	3.1	5.4
6. Corporate Accounts	14.2	65.4	16.9	0.0	0.3	3.0
7. Individual and Personal Trust	8.7	79.0	8.0	0.1	1.2	2.9
8. Other Accounts	7.6	52.0	6.5	0.0	8.6	24.6
9. Total Accounts	8.8	77.8	8.3	0.2	1.3	3.5

TABLE IV-46

DISTRIBUTION OF ADVISORY FEE RATIOS AND SIZE OF ACCOUNT AND SIZE OF ADVISORY COMPLEX

REGISTERED INVESTMENT COMPANY ACCOUNTS

Total Advisory Assets of Complex ($000)	Size Range of Accounts ($000)	Number of Accounts	Average Size of Account ($000)	Average Fee Ratio (%)
0 - 100	0 - 0.25	0	0.00	0
	0.25 - 1.0	3	0.54	0.47
	1.0 - 10.0	9	3.22	0.61
	10.0 - 100.0	2	17.11	0.52
	100 +	Ø0	0.0	0.0
100 - 750	0 - 0.25	1	0.06	1.56
	0.25 - 1.0	7	0.50	0.45
	1.0 - 10.0	15	5.04	0.44
	10.0 - 100.0	60	42,87	0.47
	100.0+	18	275.44	0.44
750 +	0 - 0.25	3	0.14	0.61
	0.25 - 1.0	5	0.62	1.42
	1.0 - 10.0	25	5.38	0.38
	10.0 - 100.0	69	47.33	0.47
	100.0 +	76	524.57	0.44
TOTAL	0 - 0.25	4	.12	0.85
	0.25 - 1.0	15	.55	0.78
	1.0 - 10.0	49	4.88	0.40
	10.0 - 100.0	131	44.83	0.47
	100.0 +	94	476.86	0.44

TABLE IV-47

DISTRIBUTION OF ADVISORY FEE RATIOS BY SIZE OF ACCOUNT AND SIZE OF ADVISORY COMPLEX

INSTITUTIONAL AND CORPORATE ACCOUNTS

Total Advisory Assets of Complex ($000)	Size Range of Accounts ($000)	Number of Accounts	Average Size of Account ($000)	Average Fee Ratio (%)
0 - 100	0 - 0.25	205	0.10	0.83
	0.25 - 1.0	81	0.50	0.53
	1.0 - 10.0	42	2.80	0.35
	10.0 - 100.0	5	19.17	0.26
	100.0 +	0	0.0	0.0
100 - 750	0 - 0.25	508	0.13	0.70
	0.25 - 1.0	449	0.54	0.45
	1.0 - 10.0	387	3.09	0.36
	10.0 - 100.0	68	22.74	0.23
	100.0 +	3	234.72	0.02
750 +	0 - 0.25	964	0.14	0.57
	0.25 - 1.0	1,477	0.55	0.40
	1.0 - 10.0	1,574	3.31	0.24
	10.0 - 100.0	435	26.28	0.10
	100.0 +	38	267.08	0.03
TOTAL	0 - 0.25	1,677	.13	0.64
	0.25 - 1.0	2,007	.55	0.42
	1.0 - 10.0	2,003	3.26	0.26
	10.0 - 100.0	508	25.74	0.12
	100.0 +	41	264.71	0.03

TABLE IV-48

DISTRIBUTION OF ADVISORY FEE RATIOS BY SIZE OF ACCOUNT AND SIZE OF ADVISORY COMPLEX

INDIVIDUAL AND PERSONAL TRUST ACCOUNTS

Total Advisory Assets of Complex ($000)	Size Range of Accounts ($000)	Number of Accounts	Average Size of Account ($000)	Average Fee Ratio (%)
0 - 100	0 - 0.25	1,632	0.09	0.93
	0.25 - 1.0	544	0.45	0.39
	1.0 - 10.0	85	1.80	0.17
	10.0 - 100.0	0	0.0	0.0
	100.0 +	0	0.0	0.0
100 - 750	0 - 0.25	5,371	0.12	0.59
	0.25 - 1.0	3,356	0.48	0.26
	1.0 - 10.0	994	2.20	0.20
	10.0 - 100.0	26	18.38	0.07
	100.0 +	1	117.08	0.0
750 +	0 - 0.25	8,461	0.14	0.45
	0.25 - 1.0	8,144	0.49	0.22
	1.0 - 10.0	2,287	2.19	0.18
	10.0 - 100.0	70	20.33	0.06
	100.0 +	4	157.28	0.02
TOTAL	0 - 0.25	15,464	.13	0.55
	0.25 - 1.0	12,044	.49	0.38
	1.0 - 10.0	3,366	2.18	0.19
	10.0 - 100.0	96	19.80	0.06
	100.0 +	5	149.24	0.02

TABLE IV-49

ANALYSIS OF ADVISORY FEE RATIOS

Category of Account	No. of Obs.	INDEP. VAR	YEAR	V FR	ASST	OBJT	AUTH	TAX	BR.D	TRAD	BROK	SIZE	FUND	TURN	CONS	R^2
Reg. Inv. Co.	293	REG. COEF.	0.0793	-0.0795	-0.0585	-0.0919	-0.0556	0.0095	-0.5216	-0.2079	0.0052	-0.0387	0.4832	-0.0021	0.51	0.24
		T STAT.	1.54	-0.71	-1.97	-1.54	-1.14	1.57	-3.73	-1.87	3.97	-0.99	3.73	-2.06		
Non Reg. Inv. Co.	187	REG. COEF.	0.0333	-0.1863	-0.1947	-0.2223	-0.0739	-0.0002	-0.1023	0.0883	-0.0002	-0.0403	0.2010	0.0002	-0.03	0.36
		T STAT.	0.54	-2.29	-5.14	-2.99	-1.43	-0.06	-0.76	0.98	-0.17	-1.33	1.50	0.11		
Emp. Benefit Plans	2716	REG COEF.	-0.0911	-0.1548	-0.3021	-0.2075	-0.0622	0.0025	0.0172	0.0266	0.000	-0.0210	0.2687	0.0025	0.65	0.49
		T STAT.	-5.04	-8.90	-34.59	-8.71	-5.23	0.95	0.53	1.41	0.07	-1.94	6 37	4.13		
Insurance Companies	320	REG COEF.	-0.2703	-0.1680	-0.4222	-0.2095	-0.1363	-0.0005	0.0456	-0.0117	0.0056	0.0237	0.3003	0.0049	0.65	0.68
		T STAT.	-5.32	-2.93	-13.33	-2.85	-2.66	-0.19	0.40	-0.19	3.63	0.62	1.97	2.43		
Non Profit Org.	1662	REG COEF.	-0.1853	-0.0191	-0.2663	-0.0722	-0.0621	-0.0000	-0.0590	0.1171	-0.0005	-0.0090	0.1875	0.0032	0.35	0.40
		T STAT.	-9.07	-0.71	-21.89	-2.21	-3.30	-0.01	-1.20	4.11	-0.94	-0.57	3.18	3.21		
Corporate Accounts	991	REG COEF.	-0.1240	-0.1969	-0.3611	-0.3893	-0.1047	-0.0014	0.2805	-0.0202	0.0014	-0.0338	0.2187	0.0013	1.22	0.69
		T STAT.	-4.88	-6.17	-23.05	-10.67	-4.10	-0.96	4.53	-0.58	1.86	-1.79	3.34	1.08		
Ind. & Pers. Trusts	30957	REG COEF.	-0.0704	-0.0663	-0.2432	-0.0561	-0.0819	0.0027	-0.1641	0.0313	0.0006	0.0068	0.0731	0.0056	0.37	0.33
		T STAT.	-18.22	-12.94	-70.74	-9.74	-23.52	10.02	-17.09	5.74	5.40	2.62	6.67	27.34		
Other Accounts	359	REG COEF.	-0.1765	-0.1225	-0.2844	0.0941	0.0101	0.0037	-0.0716	-0.0511	-0.0026	0.0277	0.5965	0.0073	0.20	0.56
		T STAT.	-3.07	-1.06	-7.78	1.24	0.19	1.37	-0.59	-0.63	-1.87	0.89	3.26	3.41		
Total All Accounts	37480	REG COEF.	-0.0728	-0.1052	-0.2541	-0.0752	-0.0814	0.0026	-0.1220	0.0295	0.0005	-0.0036	0.1664	0.0055	0.42	0.37
		T STAT.	-19.30	-21.58	-97.42	-13.47	-24.07	13 68	-13.28	5.61	5.19	-1.44	15.92	29.56		

(Column group header: Regression Coefficients and T Values)

REGRESSION EQUATION

$$LOG(FEE) = LOG(CONST) + b_1\ LOG(YEAR) + b_2\ LOG(V\ FR) + b_3\ LOG(ASSET) + b_{10}\ LOG(SIZE) + b_4\ (OBJT) + b_5\ (AUTH) + b_6\ (TAX) + b_7 (BR.D) + b_8 (TRAD) + b_9\ (BROK) + b_{11}\ (FUND) + b_{12}\ (TURN)$$

TABLE IV-50

IMPACT OF BROKER-DEALER AFFILIATION ON FEE RATIOS

	No Broker-Dealer Affiliation			Broker-Dealer Affiliation		
	Number of Advisers	Number of Accounts	Average Fee Ratio Percent	Number of Advisers	Number of Accounts	Average Fee Ratio Percent
1. Registered Investment Companies	62	262	0.49	19	42	0.37
2. Nonregistered Investment Companies	36	166	0.70	18	52	0.60
3. Employee Benefit Plans	64	2,007	0.47	27	812	0.50
4. Insurance Companies	41	256	0.21	13	73	0.21
5. Nonprofit Organizations	58	1,341	0.34	25	432	0.31
6. Corporate Accounts	54	794	0.40	20	234	0.43
7. Individuals and Personal Trust	84	25,052	0.58	29	7,536	0.46
8. Other Accounts	34	259	0.54	12	109	0.55
9. Total Accounts	118	30,137	0.55	39	9,290	0.45

TABLE IV-51

ADVISORY FEE RATIOS FOR ACCOUNTS ADVISED IN MUTUAL FUND COMPLEXES

	Non-Fund Complex Accounts			Fund Complex Accounts		
Account Type	No. of Advisers	No. of Accounts	Average Fee Ratio (%)	No. of Advisers	No. of Accounts	Average Fee Ratio (%)
1. Registered Investment Companies	28	69	0.39	53	235	0.50
2. Nonregistered Investment Companies	36	170	0.58	18	48	1.00
3. Employee Benefit Plans	70	2,468	0.47	21	351	0.58
4. Insurance Companies	42	301	0.20	12	28	0.30
5. Nonprofit Organizations	66	1,580	0.32	17	193	0.38
6. Corporate Accounts	56	864	0.36	18	164	0.66
7. Individuals and Personal Trust	90	28,787	0.50	23	3,801	0.90
8. Other Accounts	36	332	0.44	10	36	1.52
9. Total Accounts	105	34,571	0.47	53	4,856	0.83

E. ECONOMIC STRUCTURE OF THE ADVISORY INDUSTRY

1. Introduction

The purpose of this section is to present an analysis of the economic structure of the advisory industry. The topics for analysis include operating revenues, operating expenses, advisory personnel and the profitability of firms in the advisory industry. Where the data permitted, an attempt was made to separate registered investment company operations from other activities of the advisory firms.

The respondent group includes 129 advisory firms which were selected on the basis of information obtained from the I-5 screening questionnaire. This number includes a random sample of 64 large advisory firms and a random sample of 65 small firms.

The data for this section were obtained from the I-65 questionnaire, in particular from tables 3 (Statement of Gross Operating Revenue) and 5 (Personnel in Various Categories).

For a group of the firms with mutual fund principal underwriting operations, summary statistics are presented for net distribution revenue as a percentage of fund sales and total advisory profit. Also, for advisory firms which acted as broker-dealers for client transactions, a summary table is included which contains the amounts of brokerage commissions obtained as a percentage of total operating revenue.

2. Analysis of Operating Revenues (see Tables IV-52 to 55)

Operating revenue is composed of the following items: management fees from advisory accounts, subscriptions and other revenue from publications, commissions and give-ups on advisory client securities transactions, *net* distribution revenue from principal underwriting functions of the adviser and affiliates and other revenue.[49]

Tables IV-52 and IV-53 show the composition of revenues for typical large and small advisory firms. Management fees have been separately reported for registered investment companies, non-registered investment companies, institutional and corporate accounts, and individual and personal trust accounts. Distribution revenues are included with the "other revenue" category in the tables.

The average large advisory firm had $2.4 million of revenue in 1964 and $3.2 million in 1968.[50] In both years approximately 60 percent of total revenues were obtained from advisory fees, of which two thirds resulted from registered investment companies. A relatively small percentage (8 percent) of revenues resulted from publications. Brokerage commissions on advisory client transactions amounted to 4.6 percent of total revenue in 1964 and 12.3 percent in 1968. Other operating revenue (including mutual fund net distribution revenue) amounted to 27.4 percent of total revenue in 1964 and 16.4 percent in 1968.[51]

For small advisory firms, the average revenues amounted to $129,000 in fiscal 1964 and $279,000 in 1968. Whereas 72 percent of revenue

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[49] The net distribution revenue is the fraction of mutual fund sales loads retained by the adviser and any affiliated principal underwriters.

[50] The data were reported for the fiscal years of the advisory firms and thus do not represent results for identical calendar periods. However, approximately 80 percent of the firms had December 31 year-endings.

[51] Since the number of firms in the sample differ for 1964 and 1968, part of the change in the distribution of revenues over the four-year period may reflect structural changes with the remainder due to change in the composition of the sample.

resulted from advisory fees in 1964, only 48 percent came from this source in 1968. Publication revenues were typically insignificant. Revenues from brokerage commissions increased substantially, from 14.3 percent of revenue in 1964 to 36.6 percent in 1968. Other operating revenues amount to approximately 12 percent of revenues in both years.

A substantial difference existed in both years between the composition of advisory fees for small and large firms. Whereas two-thirds of the advisory fees of large firms resulted from registered investment companies, a very small fraction of advisory fees resulted from this source for small firms. For small advisory firms approximately 85 percent of advisory fees resulted from individual and personal trust accounts.

Table IV–54 presents a diagram of total advisory revenue versus total advisory assets for the 1968 year. Revenues ranged from a high of $24 million to a low of less than $1,000. Advisory assets range from a high in excess of $5 billion to a low of $6,000.[52] When a regression line was fitted to the data points, a 1 percent increase in advisory assets was found on the average to correspond to a 0.73 percent increase in advisory revenue. Simultaneously, as the proportion of registered investment companies in the total advisory assets increased, revenues increased. A 1 percent increase in the proportion of registered investment companies was on average associated with a 0.0082 percent increase in operating revenue.[53]

Twenty-four advisory firms reported receiving mutual fund underwriting revenues during 1968. Expressed as a percentage of mutual fund sales for these 24 firms during the year, net underwriting revenues averaged 1.09 percent of fund sales for the 24 firms.[54] The values ranged from approximately 0 percent to a high of 5.0 percent of sales. Expressed as a percentage of total revenue, the average (unweighted) percentage was 26.9 percent. Individual values ranged from 0.4 percent of 80.2 percent, with the higher values occurring in small advisory firms.

Table IV–55 presents a distribution of brokerage commissions on client transactions as a percentage of total 1968 revenue. For the 32 broker-dealer affiliated advisers reporting, the average (unweighted) percentage was 51 percent.[55] Individual values ranged from 0.05 percent to 100 percent. Again, the higher percentages tend to be associated with small advisory complexes.

3. Analysis of Operating Expenses (See Tables IV–56 to IV–60)

Tables IV–56 through IV–59 present operating expense data for the advisory firms in the I–65 survey. The data were reported for the advisory firms' 1964 and 1968 fiscal years. The first two tables

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[52] Table IV–54 shows the natural logarithm of revenue versus the natural logarithm of advisory assets. To maintain confidentiality of the data, three firms with advisory assets in excess of $4 billion have been removed from the table.

[53] The regression equation is given by:

$$\text{Log}_e\ (\text{REV}) + -2.58 \times 0.7348\ \text{Log}_e\ (\text{ASSETS}) \times 0.0082\ (\text{Percent—REG. IC})$$
$$(t=17.34) \qquad (t=3.52)$$

$R^2=0.77$. Number Observations=112 (Number of Firms with Completed Data).

[54] Unweighted average of individual advisory firm percentages.

[55] The weighted average for 1968 (see table IV–52) was 12.6 percent of total revenue.

provide total expense data for large and small advisory firms. The second two tables provide expense breakdowns for the registered investment company advisory and distribution functions for the sub-group of firms which reported separate investment company expense data.[56]

The total expense data for large advisory firms indicate that an average firm in the sample had $1.7 million of expenses (before taxes) in 1964 and $2.4 million in 1968. The largest single expense category was employee compensation, which amounted to 68 percent of total expenses in 1964 and 61 percent in 1968. Advertising and other solicitation of new business amounted to approximately 5 percent of expenses. Administrative expenses for clients amounted to a similar proportion of expenses.

The total expense data for small advisory firms presents a similar picture. Employee compensation was the major expense, amounting to 69 percent of expenses in 1964 and 63 percent in 1968. The total expenses for an average small advisory firm were $98,000 in 1964 and $222,000 in 1968.

For the sub-group of large firms providing an expense breakdown for registered investment companies (Table IV–58), these expenses were $1.8 million in 1964 and $2.1 million in 1968. Of these totals, personnel expenses amounted to 69 percent in 1964 and 60 percent in 1968. Advertising expenses rose from 3.6 percent of expenses to 5.2 percent between 1964 and 1968. Administrative services for registered investment companies averaged approximately 6.5 percent of total expenses for the two years.

Table IV–60 shows a diagram of total advisory expenses versus total assets for 1968. Total expenses ranged from a high of $11.0 million to a low of $2,000.[57]

The reason for distinguishing between corporations and other organizational forms in the scattergrams and the regression analyses results from the fact that small partnerships and sole proprietorships may have inflated expense values resulting from the practice of partners and proprietors taking what amounts to dividend payments from the firms in the form of salaries. This is not usually the case for larger corporations where officers are paid a salary and the excess of revenues over expenses after corporate taxes is either retained or paid out in the form of dividends. Respondents who were sole proprietorships or partnerships were asked to report an "equivalent" salary for principals rather than reporting as compensation the composite of salary as well as return on capital. In determining such equivalence, the partnership or sole proprietorship was asked to give due consideration to the rates of salaries or other compensation paid to officers or other policy-making employees by investment advisers similarly situated but doing business as a corporation. However, to give explicit recognition to the data quality problems, the scattergrams differentiated between the two types of organizational forms.

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[56] If an advisory firm had more than 10 percent of its 1964 or 1968 total operating revenue from registered investment companies a separate statement of advisory and distribution expenses for these advisory accounts was requested.

[57] The scattergram shows the natural logarithm of revenue versus the natural logarithm of assets. To maintain confidentiality of the data, three firms with total advisory assets in excess of $4.0 billion have been eliminated from the diagram.

Regression analysis was used to examine the statistical relationship between total expenses and total advisory assets. A factor was included in the regression to allow for differences in organizational form and hence, potential upward bias in expense data from sole proprietorships and partnerships.[58] The regression results indicated that, on average, a 1 percent increase in advisory assets during 1968 was associated with a 0.69 percent increase in expenses. Simultaneously, as the proportion of registered investment companies in the total advisory assets increased, expenses increased. A 1 percent increase in the proportion of registered investment companies was associated with a 0.0079 percent increase in total expenses.[59]

4. Analysis of Advisory Personnel (Tables IV–61 and IV–62)

Tables IV–61 and IV–62 show the average numbers of advisory personnel in typical large and small advisory firms as of December 31, 1969. Within the eight employee categories used, the numbers of full-time equivalent personnel are broken down between officers (that is, proprietors, partners or officers) and employees. The tables indicate that typically one-half of the employee category represent clerical employees. When the two categories are considered together, it is found that an average large firm had 76.9 full-time equivalent personnel in 1964 and 103.3 full-time equivalents in 1969 while an average small firm had 10.5 full-time equivalents in 1964 and 12.0 in 1969.

Regression analysis was used to examine the relationship between advisory personnel and total advisory assets. The results indicated that, on average, a 1 percent increase in total advisory assets was associated with a 0.56 percent increase in the number of full-time equivalent personnel. The results also indicated the advisory firms with registered investment company accounts tended to be some what more labor intensive. A 1 percent increase in the proportion of registered investment companies in the mix of total advisory assets was associated with a 0.0084 percent increase in the number of full-time equivalent personnel.[60]

5. Analysis of Profitability Data (Tables IV–63 through IV–69)

The purpose of this section is to combine the revenue, expense and advisory asset data to develop measures of the profitability of advisory firms. The primary profit measure used is the rate of before tax profits to advisory assets. Where the advisory firms had provided separate expense data for registered investment company and other advisory

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[58] The structural variable, designated "FORM" had a value of 1.0 for sole proprietorships and partnerships and 0.0 for corporations.

[59] The regression equation is given by:
$Log_e(EXP) = 2.35 - 0.1481$ (FORM) $+ 0.6878$ Log_e (ASSET) $+ 0.0079$ (Percent REGISTERED IC.) $(t = -0.174)$ $(t = 16.24)$
$(t = 3.34)$
$R^2 = 0.75$
Number of Observations = 112

[60] The regression equation is given by:
Log_e (Personnel) -0.58 0.5575 Log_e (ASSETS) 0.0084 (Percent REGISTERED I.C.)
$(t = 13.90)$ $(t = 3.84)$
$R^2 = 0.70$
Number of Observations = 112.

accounts, profit ratios were computed for these activities as well as for the total firm.[61]

Tables IV–63 through IV–65 present profit summaries for the corporate form advisory firms in the I–65 sample. Partnerships and sole proprietorships were eliminated to avoid potential downward bias in the profit ratios due to potentially inflated expense figures.

Table IV–63 presents profit data for the total advisory firm for fiscal years 1964 and 1968. The 60 respondent advisers for 1964 had total advisory assets of $15.4 billion, total revenues of $97.2 million and total expenses of $59.7 million. The profit before federal taxes for these firms was $37.5 million which was 0.23 percent of total 1964 advisory assets. Expressed as a percentage of total advisory revenues, the profit amounted to 39 percent of 1964 revenues. When the advisory firms were grouped according to total 1964 advisory assets, the profit ratio was seen to increase with the size of the advisory firm. Advisers with less than $100 million of assets earned a total of 0.148 percent of the assets, advisers with more than $750 million of assets earned a total of 0.281 percent of advisory assets.

In 1968 there were 90 advisers with corporate organizational forms in the sample. These firms accounted for $40.7 billion of the estimated $130 billion of advisory assets. The sample estimate for revenues, expenses and before tax profits were $170.3 million, $114.6 million and $55.6 million respectively. The profit figure represented 0.137 percent of advisory assets, about one-half the size of the 1964 profit ratio. The relationship between size of advisory firm and profit ratio was not uniform in 1968. Middle range ($100 million to $750 million) advisory firms had the highest profit ratio (0.192 percent of assets) with large firms next (0.118 percent) followed by smaller firms (0.091 percent). The total profit for the 90 corporations in 1968 amounted to 33 percent of total advisory revenues.

Tables IV–64 and IV–65 are the results of the attempt to separate registered investment companies from other advisory clients to obtain separate profit measures. The first Table shows profit calculations for the advisory firms which furnished separate expense schedules for registered investment companies. These calculations were possible for 27 adviser corporations in 1964 and 38 adviser corporations in 1968. Profit ratios for the other assets advised by these firms are included in Table IV–64 for comparison purposes. Table IV–65 shows the aggregate profit calculations for the corporate form advisers who either advised no registered investment companies or for which no separate expense breakdowns were provided.[62]

For the 27 advisers in 1964 and 38 in 1968 the profit ratios were 0.36 percent of investment company assets in 1964 and 0.21 percent in 1968. These figures are based on $9.3 billion of assets in 1964 and $17.6

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[61] In order to compute separate profit ratios for registered investment companies and other clients when the required expense data were available, allocation of certain revenue items was required. Publication revenue was deleted from consideration. Commissions and give-ups on advisory client securities transactions were allocated on the basis of the relative magnitude of registered investment company and other client assets. The net distribution revenue component of "other revenue" was allocated entirely to investment company revenues. The remaining "other revenue" was allocated on a basis of assets.

[62] The latter group of firms advised relatively small amounts of registered investment company assets. For example, $764 million versus $17.6 billion for the companies represented in Table IV–64.

billion in 1968. These advisers also advised $4.3 billion of other accounts in 1964 and $10.7 billion in 1968. The profit ratios for those advisory assets were 0.04 percent in 1964 and 0.11 percent in 1968. During each of the years the results for investment companies indicated a trend toward higher profit ratios for larger advisory complexes. This did not exist for other accounts advised in these complexes.

The profit data for the remaining firms indicate profit ratios substantially lower than shown for all corporate form advisers in table IV–63. For 1964, the 33 advisers with no investment company expense data advised $2.7 billion of assets with a profit ratio of 0.08 percent. In 1968, the 52 advisory firms in this category advised $12.5 billion with a profit ratio of 0.06 percent.[63] No relationship between profit ratios and size of advisory complex appeared to exist for these firms.

Tables IV–66 and IV–67 present the actual profit ratios for the corporate form advisers included in the above analysis. The firms are grouped by size of total advisory assets. Additionally, if the advisory firm was a fund complex this fact has been designated. The profit ratio for the total advisory complex is presented as well as the ratios for registered investment company and other types of advisory clients where expense breakdowns were available.[64] Where separate calculations were possible, the average profit ratios were found to be higher for investment companies than other advisory clients for advisory complexes in excess of $100 million in assets. The reverse is true for smaller advisory complexes where other advisory activities were found to be more profitable in both 1964 and 1968.

Table IV–68 presents a diagram of the 1968 total profit ratios versus total advisory assets for the complete sample of advisory firms in the I–65 survey (including partnerships and sole proprietorships). This diagram supports the proposition that advisory profit ratios were not highly related to the size of total advisory assets during 1968. Table IV–69 presents a similar diagram for the sub-group of advisory firms which reported separate investment company expenses.[65]

Regression analysis was used to examine the relationship between profit ratios and the size and composition of advisory assets (see Table IV–70). The regression results indicate a statistically significant relationship between total profit ratios and assets in 1964

[63] The $12.4 billion of other assets covered in this sample plus the $10.7 billion in table IV–54 represent about 28 percent of the estimated $80 billion of investment advisory accounts which are not registered investment companies.

[64] The procedures followed in constructing profit ratios for tables IV–66 and IV–67 were as follows:

(1) If separate operating expense breakdowns were available for both registered investment companies and other advisory clients, profit ratios were computed for both account types.

(2) If expense allocations were *not* available *and* more than 90 percent of total revenue originated from registered investment company sources, the profit ratio for investment company operations was set equal to the profit ratio for the entire firm.

(3) If expense allocations were *not* available *and* more than 90 percent of total revenue originated from advisory clients other than registered investment companies, the profit ratio for other accounts was set equal to the profit ratio for the entire firm.

(4) If none of the above conditions existed, profit calculations were not attempted for either class of account.

[65] Assets are shown in these scattergrams in the natural logarithm form. As in previous scattergrams, the three largest firms in the sample have been deleted from the diagram.

but the relationship does not continue to the 1968 period. There is also some indication that the investment company profit ratios tend to be higher with increased proportions of registered investment company assets but the result is not statistically significant.[66]

6. Summary

The weighted average profit ratios for corporate form advisers were 0.23 percent and 0.14 percent in 1964 and 1968 respectively. While average profit ratios declined approximately 40 percent, total advisory assets grew from $15.3 billion to $40.7 billion and profits went from $37.5 million (39 percent of revenues) to $55.6 million (33 percent of revenues).

For advisory firms with separate expense breakdowns for registered investment companies, the profit ratios on these operations were seen to be substantially higher than for other advisory accounts. The weighted average profit ratios were 0.36 percent and 0.21 percent of investment company assets in 1964 and 1968 respectively. This is contrasted with profit ratios of 0.04 percent and 0.11 percent for other advisory clients of the same firms.

For advisory firms with little or no mutual fund accounts, the average profit ratios were 0.08 percent and 0.06 percent of total advisory assets in 1964 and 1968 respectively.

While large mutual fund complexes appeared to be typically more profitable than non-fund complexes, the reverse was true for fund complexes with less than $100 million. In 1968, the weighted average profitability ratio for ten small fund complexes was approximately —0.50 percent.

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[66] The lack of significance is due at least in part to the mixing of profit ratios from large and small advisory complexes. As seen from tables IV–66 and IV–67, the relative profitability for the two account types changes between large and small advisory forms.

TABLE IV-52

GROSS OPERATING REVENUE OF LARGE ADVISERS ($100 MILLION OR MORE OF ADVISORY ASSETS)

(a) Management Fees from Investment Advisory Services	1964 FISCAL YEAR*		1968 FISCAL YEAR**	
	Averages ($000)	%	Averages ($000)	%
(1) Registered Investment Companies	848.4	36.0	1258.9	38.9
(2) Offshore Funds	0.5	0.0	6.5	0.2
(3) Other non-registered investment companies (including investment partnerships [hedge funds], clubs, venture capital funds, and other entities)	2.7	0.1	18.0	0.6
(4) All Other Client Accounts				
(a) Institutional and Corporate	168.3	7.1	262.2	8.1
(b) Individuals or Personal Trusts	389.8	16.5	497.2	15.4
TOTAL MANAGEMENT FEES	1,409.7	59.7	2,042.8	63.2
(b) Subscriptions and Other Revenue From Publications	195.4	8.3	256.2	7.9
(c) Commissions and Give-Ups on Advisory Client Securities Transactions	109.3	4.6	396.2	12.3
(d) Other Operating Revenue	645.9	27.4	531.1	16.4
TOTAL OPERATING REVENUE	2,360.3	100.0	3,226.3	100.0

*Number of Respondents 55
Average Firm Size (Dec. 1964) $516 Millions

**Number of Respondents 64
Average Firm Size (Dec. 1968) $859 Millions

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TABLE IV-53

GROSS OPERATING REVENUE OF SMALL ADVISERS (LESS THAN $100 MILLION OF ADVISORY ASSETS)

(a) Management Fees from Investment Advisory Services	1964 FISCAL YEAR* Averages ($000)	1964 FISCAL YEAR* %	1968 FISCAL YEAR** Averages ($000)	1968 FISCAL YEAR** %
(1) Registered Investment Companies	5.1	3.9	16.6	6.0
(2) Offshore Funds	0.0	0.0	11.2	4.0
(3) Other non-registered investment companies (including investment partnerships [hedge funds], clubs, venture capital funds, and other entities)	0.0	0.0	0.6	0.2
(4) All Other Client Accounts				
(a) Institutional and Corporate	4.6	3.6	6.3	2.3
(b) Individuals or Personal Trusts	83.8	64.8	98.4	35.3
TOTAL MANAGEMENT FEES	93.5	72.3	131.1	47.8
(b) Subscriptions and Other Revenue From Publications	3.6	2.8	2.1	0.8
(c) Commissions and Give-Ups on Advisory Client Securities Transactions	18.6	14.3	102.1	36.6
(d) Other Operating Revenue	13.7	10.6	41.6	14.9
TOTAL OPERATING REVENUE	129.4	100.0	279.0	100.0

*Number of Respondents - 34
Average Firm Size (Dec. 1964) $25.5 Million

**Number of Respondents - 61
Average Firm Size (Dec. 1968) $34.5 Million

TABLE IV-54

Log$_e$ of 1968 Total Advisory Revenue
Vs. Log$_e$ of Advisory Assets

TABLE IV-55

BROKERAGE COMMISSIONS ON ADVISORY CLIENT TRANSACTIONS AS
A PERCENTAGE OF TOTAL REVENUE

1968 FISCAL YEAR - 32 BROKER-DEALER AFFILIATED ADVISORY FIRMS

Percentage Range	Number of Firms
0-5	3
5-10	1
10-15	0
15-20	0
20-25	1
25-30	2
30-35	3
35-40	1
40-45	2
45-50	1
50-55	3
55-60	3
60-65	1
65-70	2
70-75	2
75-80	2
80-85	2
85-90	1
90-95	1
95-100	1
	32

TABLE IV-56

TOTAL OPERATING EXPENSES FOR LARGE ADVISORY FIRMS
($100 OR MORE OF ADVISORY ASSETS)

EXPENSE ITEM	1964		1968	
	TOTAL EXPENSES		TOTAL EXPENSES	
	AV. ($000)	%	AV. ($000)	%
a. Subscriptions to Other Publications and Statistical Services	9.5	0.6	18.8	0.8
b. Advertising and Other Solicitation of Customers	84.4	5.0	130.1	5.5
c. Employee Compensation (including partners, officers, directors, consultants, etc.)				
(1) Account Supervisors, Counselors, and Portfolio Managers	301.4	17.8	430.5	18.2
(2) Research Staff	158.2	9.4	215.1	9.1
(3) Sales Personnel	346.0	20.5	251.9	10.6
(4) Professional Traders	11.3	0.7	22.8	1.0
(5) Clerical, Secretarial	168.3	10.0	266.3	11.2
(6) Executives (not included above)	92.9	5.5	147.1	6.2
(7) Other Personnel (specify)	64.8	3.8	110.0	4.6
d. Cost of Publications Sold	44.1	2.6	53.1	2.2
e. Occupancy Expense	57.0	3.4	84.9	3.6
f. Communications Expense	47.1	2.8	89.4	3.8
g. Equipment Expense	21.8	1.3	58.4	2.5
h. Travel and Entertainment Expense	31.3	1.9	60.7	2.6
i. Administrative Services for Clients	78.5	4.6	135.1	5.7
j. Depreciation	18.7	1.1	34.0	1.4
k. Other Operating Expenses	154.2	9.1	255.7	10.8
l. TOTAL Operating Expense	1689.5	100.0	2363.9	100.0

Number of Respondents: 55 (1964); 64 (1968).

TABLE IV-57

TOTAL OPERATING EXPENSES FOR SMALL ADVISORY FIRMS
(LESS THAN $100 MILLION OF ADVISORY ASSETS)

EXPENSE ITEM	1964		1965	
	TOTAL EXPENSE		TOTAL EXPENSE	
	AV. ($000)	%	AV. ($000)	%
a. Subscriptions to Other Publications and Statistical Services	2.0	2.0	4.3	1.9
b. Advertising and Other Solicitation of Customers	3.9	4.0	6.5	2.9
c. Employee Compensation (including partners, officers, directors, consultants, etc.)				
(1) Account Supervisors, Counselors, and Portfolio Managers	33.2	33.9	44.3	20.0
(2) Research Staff	5.0	5.1	13.2	5.9
(3) Sales Personnel	6.6	6.7	47.4	21.4
(4) Professional Traders	0.0	0.0	1.2	0.6
(5) Clerical, Secretarial	13.9	14.3	19 0	8 6
(6) Executives (not included above)	4.6	4.7	11.5	5.2
(7) Other Personnel (specify	2.8	2.9	3.5	1.6
d. Cost of Publications Sold	0.4	0.4	0.9	0.4
e. Occupancy Expense	6.4	6.5	8.6	3.9
f. Communications Expense	4.3	4.4	11.2	5.0
g. Equipment Expense	1.5	1.5	4.9	2.2
h. Travel and Entertainment Expense	2.8	2.8	4.8	2.2
i. Administrative Services for Clients	0.3	0.3	1.9	0.8
j. Depreciation	0.6	0.6	1.4	0.6
k. Other Operating Expenses	9.7	9.9	37.2	16.8
l. TOTAL Operating Expense	98.0	100.0	221.8	100.0

Number of Respondents: 35 (1964); 61 (1968).

TABLE IV-58

OPERATING EXPENSES OF REGISTERED INVESTMENT COMPANY ADVISORY AND DISTRIBUTION FUNCTIONS--
LARGE ADVISORY FIRMS ($100 MILLION OR MORE OF ADVISORY ASSETS)

EXPENSE ITEM	1964 REG. INV. CO. AV. ($000)	1964 REG. INV. CO. %	1965 REG. INV. CO. AV. ($000)	1965 REG. INV. CO. %
a. Subscriptions to Other Publications and Statistical Services	6.7	0.4	12 1	0.6
b. Advertising and Other Solicitation of Customers	63.6	3.6	111.5	5.2
c. Employee Compensation (including partners, officers, directors, consultants, etc.)				
(1) Account Supervisors, Counselors, and Portfolio Managers	212.9	12.0	262.5	12.3
(2) Research Staff	102.4	5.8	140 3	6.6
(3) Sales Personnel	607 2	34 4	376 8	17.6
(4) Professional Traders	14.8	0.8	24.7	1.2
(5) Clerical, Secretarial	131.7	7.5	205.3	9.6
(6) Executives (not included above)	107.7	6.1	169.8	8.0
(7) Other Personnel (specify)	49.8	2.8	100.0	4.7
d. Cost of Publications Sold	0.0	0.0	0.0	0.0
e. Occupancy Expense	39.2	2.2	65.0	3.0
f. Communications Expense	55.2	3.1	94.6	4.4
g. Equipment Expense	26.8	1.5	65.6	3.1
h. Travel and Entertainment Expense	29.4	1.7	61.4	2.9
i. Administrative Services for Clients	110.3	6.2	144.1	6.7
j. Depreciation	19.4	1.1	28.4	1.3
k. Other Operating Expenses	190.0	10.8	273.7	12.8
l. TOTAL Operating Expense	1767.1	100.0	2135.8	100.0

Number of Respondents: 29 (1964); 36 (1968)

TABLE IV-59

OPERATING EXPENSES OF REGISTERED INVESTMENT COMPANY ADVISORY AND DISTRIBUTION FUNCTIONS
SMALL ADVISORY FIRMS (LESS THAN $100 MILLION OF ADVISORY ASSETS)

EXPENSE ITEM	1964 REG. INV. CO. AV. ($000)	1964 REG. INV. CO. %	1968 REG. INV. CO. AV. ($000)	1968 REG. INV. CO. %
a. Subscriptions to Other Publications and Statistical Services	6.6	6.1	11.5	4.2
b. Advertising and Other Solicitation of Customers	0.2	0.2	10 4	3.7
c. Employee Compensation (including partners, officers, directors, consultants, etc.)				
(1) Account Supervisors, Counselors, and Portfolio Managers	50.0	46.0	30.8	11.1
(2) Research Staff	0 2 0	1.8	1.5	0.6
(3) Sales Personnel	1.2	1.1	87.6	31.6
(4) Professional Traders	0.0	0.0	1.0	0.4
(5) Clerical, Secretarial	16 2	14.9	19.9	7.2
(6) Executives (not included above)	1.0	0.9	8.9	3.2
(7) Other Personnel (specify	5.8	5.3	2.2	0.8
d. Cost of Publications Sold	0.0	0.0	1.6	0.6
e. Occupancy Expense	4.4	4.1	5.3	1.9
f. Communications Expense	5.0	4.6	10.8	3.9
g. Equipment Expense	0.2	0.2	1.5	0.6
h. Travel and Entertainment Expense	3.6	3.3	7 5	2.7
i. Administrative Services for Clients	0.0	0.0	4.5	1.6
j. Depreciation	0.4	0.4	0 7	0.2
k. Other Operating Expenses	12.0	11.0	71.2	25.7
l. TOTAL Operating Expense	108.6	100.0	277	100.0

Number of Respondents: 5(1964); 13(1968)

TABLE IV-60

Log$_e$ of 1968 Total Operating Expenses vs. Log$_e$ of Advisory Assets

Log$_e$ Expenses

9.54
8.58
7.62
6.65
5.69
4.72
3.76
2.80
1.83
0.87

-0.9395 0.1563 1.2522 2.3480 3.4438 4.5396 5.6354 6.7312 7.8271 8.9229

Log$_e$ Assets

Symbols:

1. Sole Proprietorships or Partnerships
2. Corporations
3. Multiple Observations

TABLE IV-61

ADVISORY PERSONNEL - LARGE ADVISERS
($100 MILLION OR MORE OF ADVISORY ASSETS)

EMPLOYMENT CATEGORY	NUMBER OF FULL-TIME EQUIVALENTS							
	Proprietors, Partners or Officers				Employees			
	Dec. 31, 1964		Dec. 31, 1969		Dec. 31, 1964		Dec. 31, 1969	
	Average	%	Average	%	Average	%	Average	%
1. Account Supervisors, Counselors and Portfolio Managers	3.5	42.8	4.8	40.3	4.5	6.5	6.3	6.9
2. Economic Research Staff	0.4	4.3	0.6	4.8	0.6	0.9	0.9	1.0
3. Investment Research Staff	1.0	12.5	1.3	11.2	7.4	10.8	9.0	9.9
4. Sales Personnel	0.9	11.1	1.3	11.3	18.2	26.6	13.9	15.2
5. Professional Traders	0.1	1.6	0.3	2.1	0.7	1.0	1.5	1.6
6. Clerical, Secretarial	0.1	0.7	0.1	0.9	28.0	40.8	43.8	47.8
7. Executives (not included above)	2.0	24.6	3.1	26.2	1.2	1.7	1.5	1.6
8. Other	0.2	2.6	0.4	3.2	8.0	11.7	14.6	15.6
TOTAL PERSONNEL OF INVESTMENT ADVISER	8.2	100.0	11.9	100.0	68.6	100.	91.5	100.0

Number of Respondents: 1964, 55; 1969, 64

TABLE IV-62

ADVISORY PERSONNEL - SMALL ADVISERS
(LESS THAN $100 MILLION OF ADVISORY ASSETS)

EMPLOYMENT CATEGORY	NUMBER OF FULL-TIME EQUIVALENTS							
	Proprietors, Partners or Officers				Employees			
	Dec. 31, 1964		Dec. 31, 1969		Dec. 31, 1964		Dec. 31, 1969	
	Average	%	Average	%	Average	%	Average	%
1. Account Supervisors, Counselors and Portfolio Managers	1.2	61.4	1.2	48.7	0.9	10.8	0.8	8.0
2. Economic Research Staff	0.1	5.0	0.1	3.8	0.0	0.3	0.1	0.8
3. Investment Research Staff	0.2	10.0	0.3	11.2	0.3	3.6	0.5	5.3
4. Sales Personnel	0.1	6.7	0.3	13.8	2.2	25.3	2.6	26.8
5. Professional Traders	0.0	0.0	0.0	1.4	0.1	0.6	0.2	1.5
6. Clerical, Secretarial	0.0	0.0	0.0	1.7	4.8	55.2	4.8	50.0
7. Executives (not included above)	0.2	10.5	0.4	14.4	0.2	2.3	0.4	4.2
8. Other	0.1	6.2	0.1	5.1	0.2	1.9	0.3	3.5
TOTAL PERSONNEL OF INVESTMENT ADVISER	1.9	100.0	2.4	100.0	8.7	100.0	9.7	100.0

Number of Respondents: 1964, 33; 1969, 61

TABLE IV-63

PROFIT SUMMARY

ALL ADVISERS WHO WERE CORPORATIONS -- 1964

FIRM SIZE ($ MILLION)	NUMBER OF ADVISERS	ASSETS ($ MILLION)	REVENUE ($ MILLION)	EXPENSES ($ MILLION)	PROFIT ($ MILLION)	PROFIT TO ASSETS PERCENT
750+	7	9,436.7	61.67	35.16	26.50	.281
100-750	22	5,874.6	30.26	20.56	9.70	.165
Less Than 100	31	876.8	5.30	4.00	1.30	.148
Total	60	15,388.1	97.23	59.72	37.5	.232

ALL ADVISERS WHO WERE CORPORATIONS -- 1968

FIRM SIZE ($ MILLION)	NUMBER OF ADVISERS	ASSETS ($ MILLION)	REVENUE ($ MILLION)	EXPENSES ($ MILLION)	PROFIT ($ MILLION)	PROFIT TO ASSETS PERCENT
750+	14	28,736.4	99.25	65.29	33.96	.118
100-750	33	10,710.6	62.00	41.48	20.51	.192
Less Than 100	43	1,272.2	9.01	7.85	1.16	.091
Total	90	40,719.2	170.26	114.62	55.63	.137

TABLE IV-64

PROFIT ANALYSIS -- INVESTMENT COMPANY ADVISERS
(CORPORATIONS ONLY)

1964

FIRM SIZE ($ MILLION)	NUMBER OF	ASSETS ($ MILLION)		REVENUE ($ MIL.)		EXPENSES ($ MIL.)		PROFIT ($ MILLION)		PROFIT ASSETS %	
		INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER
750+	7	6,219.9	3,216.8	55.61	6.15	29.76	5.41	25.76	.75	.414	0.0233
100-750	13	2,930.6	963.3	16.62	2.25	8.99	1.30	7.63	.95	.260	0.0986
Less Than 100	7	176.9	90.3	1.24	0.24	0.79	0.41	0.46	-.17	.260	-0.1883
Total	27	9,327.4	4,270.4	73.47	8.64	39.51	7.12	33.66	1.53	.361	0.0358

1968

FIRM SIZE ($ MILLION)	NUMBER OF ADVISERS	ASSETS ($ MILLION)		REVENUE ($ MIL.)		EXPENSES ($ MIL.)		PROFIT ($ MILLION)		PROFIT ASSETS %	
		INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER	INVESTMENT COMPANY	OTHER
750+	11	12,599.4	8,701.6	75.88	13.55	46.28	9.96	29.60	3.59	.235	0.0413
100-750	17	4,770.7	1,870.0	23.95	15.60	15.15	7.75	8.81	7.85	.185	0.4198
Less Than 100	10	192.0	114.4	1.28	0.44	2.20	0.47	-.92	-0.19	-.479	-0.1661
Total	38	17,562.1	10,686.0	101.11	29.59	63.63	18.18	37.49	11.25	.2135	0.1053

TABLE IV-65

PROFIT ANALYSIS

ADVISERS WITH NO
INVESTMENT COMPANY
EXPENSE DATA
(CORPORATIONS ONLY)

1964

Firm Size ($mil)	Number of Advisers	Assets ($mil)	Revenue ($mil)	Expenses ($mil)	Profit ($mil)	Profit Assets (%)
750+	0	0	0	0	0	-
100-750	9	1,980.7	11.39	10.27	1.12	0.0565
Less Than 100	24	697.3	3.82	2.81	1.01	0.1448
Total	33	2,678.0	15.21	13.08	2.13	0.0795

1968

Firm Size ($mil)	Number of Advisers	Assets ($mil)	Revenue ($mil)	Expenses ($mil)	Profit ($mil)	Profit Assets (%)
750+	3	7,435.5	9.83	9.05	0.77	0.0104
100-750	16	4,069.9	22.44	18.58	3.86	0.0948
Less Than 100	33	965.7	7.45	5.58	2.27	0.2351
Total	52	12,471.1	39.72	33.21	6.90	0.0553

TABLE IV-66

PROFIT RATIOS FOR ADVISORY COMPLEXES WITH CORPORATE ORGANIZATIONAL FORMS - 1964

Size of Advisory Complex ($ Million)	Mutual Fund Complex	Profit Ratios - Percent		
		Other Advisory Clients	Registered Investment Companies	Total Complex
750 and over	Excluded to preserve confidentiality	-0.004	.161	.092
		-	.295	.295
		-	.991	.991
		-	.323	.323
		-	.227	.227
		-.001	.220	.017
		.050	-.158	.047
	Averages	.015 (3)	.294 (7)	.285 (7)
100-750	yes	-	.102	.102
	yes	-	-	.202
	yes	-	.200	.206
	no	-.002	.301	.074
	yes	-	.187	.187
	yes	-	.276	.276
	yes	-	.636	.636
	yes	-	.181	.181
	no	.054	-.061	.023
	yes	-.253	.010	-.027
	yes	.620	.664	.644
	yes	1.249	.194	.196
	no	-.002	-	-.002
	no	-	-	.004
	no	.025	-	.025
	no	-.048	-	-.048
	no	.031	-	.031
	no	-.031	.428	.007
	yes	-	0.369	.369
	no	.016	-	.016
	no	.001	-	.001
	no	.720	-	.720
	Averages	.182 (13)	.269 (13)	.174 (22)
Less Than 100	yes	-	.156	.156
	yes	-	.685	.685
	yes	-	-	.172
	no	.620	-	.620
	no	-	-	.235
	no	.018	-	.018

TABLE IV-66
(continued)

Size of Advisory Complex ($ Million)	Mutual Fund Complex	Profit Ratios - Percent: Other Advisory Clients	Registered Investment Companies	Total Complex
Less than 100 (continued)	no	-	-	.055
	no	.015	-	.015
	no	.733	-	.733
	no	.600	-	.600
	no	-.142	-	-.142
	yes	-	-3.397	-3.397
	no	-1.333	-	-1.333
	no	.095	-	.095
	no	-	-	1.297
	no	.165	-	.105
	no	.265	-	.265
	no	-2.857	-	-2.857
	no	.305	-	.305
	no	-	-	.024
	no	-.478	-	-.478
	no	.045	-	.045
	no	.031	-	.031
	no	.259	-	.259
	no	-0.031	-	-0.031
	no	.259	-	.259
	Averages	-.080 (18)	-.852 (3)	-.085 (26)*
	Averages	.029 (34)	.130 (23)	.066 (55)

* Five advisors with less than $1,000 or assess were deleted from the sample

TABLE IV-67

PROFIT RATIOS FOR ADVISORY COMPLEXES WITH CORPORATE ORGANIZATIONAL FORMS - 1968

Size of Advisory Complex ($ Million)	Mutual Fund Complex	Profit Ratios - Percent		
		Other Advisory Clients	Registered Investment Companies	Total Complex
750 or more	yes	.013	.355	.141
	yes	.015	.042	.017
	yes	-	.270	.270
	yes	-	.312	.312
	yes	-	.305	.305
	yes	-	.176	.176
	yes	.143	.188	.181
	no	-.015	-.146	-.032
	no	.021	.212	.075
	no	.018	.009	0.018
	no	.006	-	.006
	no	.080	-.494	.064
	no	.015	-	.015
	no	.036	-	.036
		.030	.112	.113
		(10)	(11)	(14)
100-750	yes	-	.148	.148
	yes	-	-	.150
	yes	-	.219	.219
	yes	-	.124	.124
	yes	-.169	.279	.270
	yes	-	-.074	-.074
	yes	-	.136	.136
	yes	.070	.015	.051
	yes	-	.099	.099
	yes	.048	.037	.020
	yes	.398	.636	.524
	yes	.448	.127	.172
	yes	-	-	.226
	no	.983	1.137	.995
	no	0.008	-	.008
	no	.003	-	.003
	no	1.010	-	-.010
	no	.158	-	.158
	no	.037	-	.037
	no	-0.017	.317	.010
	no	-.009	-	-.009
	no	.001	-	.001
	yes	-	.344	.344
	no	-.031	-	-.031
	no	-	-	.704

TABLE IV-67
(continued)

Size of Advisory Complex ($ Million)	Mutual Fund Complex	Profit Ratios - Percent: Other Advisory Clients	Registered Investment Companies	Total Complex
100-750 (continued)	yes	-0.054	.114	.027
	no	.026	-	.026
	no	.033	-	.033
	no	.302	-	.302
	no	.098	.550	.108
	no	-0.002	-	-0.002
	no	.1481	-	.1481
	no	.7641	-	.7641
	Averages	.136 (23)	.263 (16)	.172 (33)
Less Than 100	no	.071	-	.071
	yes	-	-.816	-.816
	no	.004	-	.004
	no	.080	-	.080
	no	0.0	-	0.0
	no	.042	-	.042
	yes	.667	0.138	.037
	no	-.430	-	-.430
	yes	-	-	.301
	no	.016	-	.016
	no	.380	-	.380
	no	-0.525	-1.756	-1.421
	no	.672	-	.672
	yes	-	-.618	-.618
	no	.045	-	.045
	no	.300	-	.300
	no	.344	-	-.344
	no	.136	-	-.136
	yes	-	1.449	1.449
	yes	-	-2.609	-2.609
	no	.235	-	.235
	no	3.098	-	3.098
	no	-4.359	-	-4.359
	no	1.526	-	1.526
	no	1.064	-	-1.004
	no	.055	-	.055
	no	.103	-	.103
	yes	-	-0.088	-.088
	no	-	-	.710

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TABLE IV-67
(continued)

Size of Advisory Complex ($ Million)	Mutual Fund Complex	Profit Ratios - Percent: Other Advisor Clients	Registered Investment Companies	Total Complex
Less than 100 (continued)	no	.250	.-	.250
	no	.750	-	.750
	no	1.015	-	1.015
	no	.302	-	.302
	no	.478	-	.478
	no	0.098	.550	.108
	no	1.580	-	-1.500
	no	-.093	-	-.093
	no	.984	-	.984
	no	-.002	-	-.002
	no	.148	-	.148
	no	-.300	-	-.300
	no	-1.114	-	-1.114
	no	.353	-	.353
	Averages	.050 (36)	-.503 (8)	-.031 (43)
TOTAL		.076 (69)	.041 (35)	-.066 (90)

Parenthesis indicate number of firms

TABLE IV-68

1968 Total as a Percentage

of Advisory Assets vs. Log_e of Advisory Assets

profit

3.02
2.28
1.53
0.79
0.04
-0.70
-1.45
-2.20
-2.94
-3.69

-0.9395 0.1563 1.2522 2.3480 3.4438 4.5396 5.6354 6.7312 7.8271 8.9229

Log_e Assets

Symbols: 1. Sole Proprietorship or Partnership
2. Corporation
X. Multiple Observation

TABLE IV-69

1968 REG. INVESTMENT COMPANY PROFITS AS A PERCENTAGE OF REG. INVESTMENT COMPANY ASSETS VS. LOG_E OF INVESTMENT COMPANY ASSETS

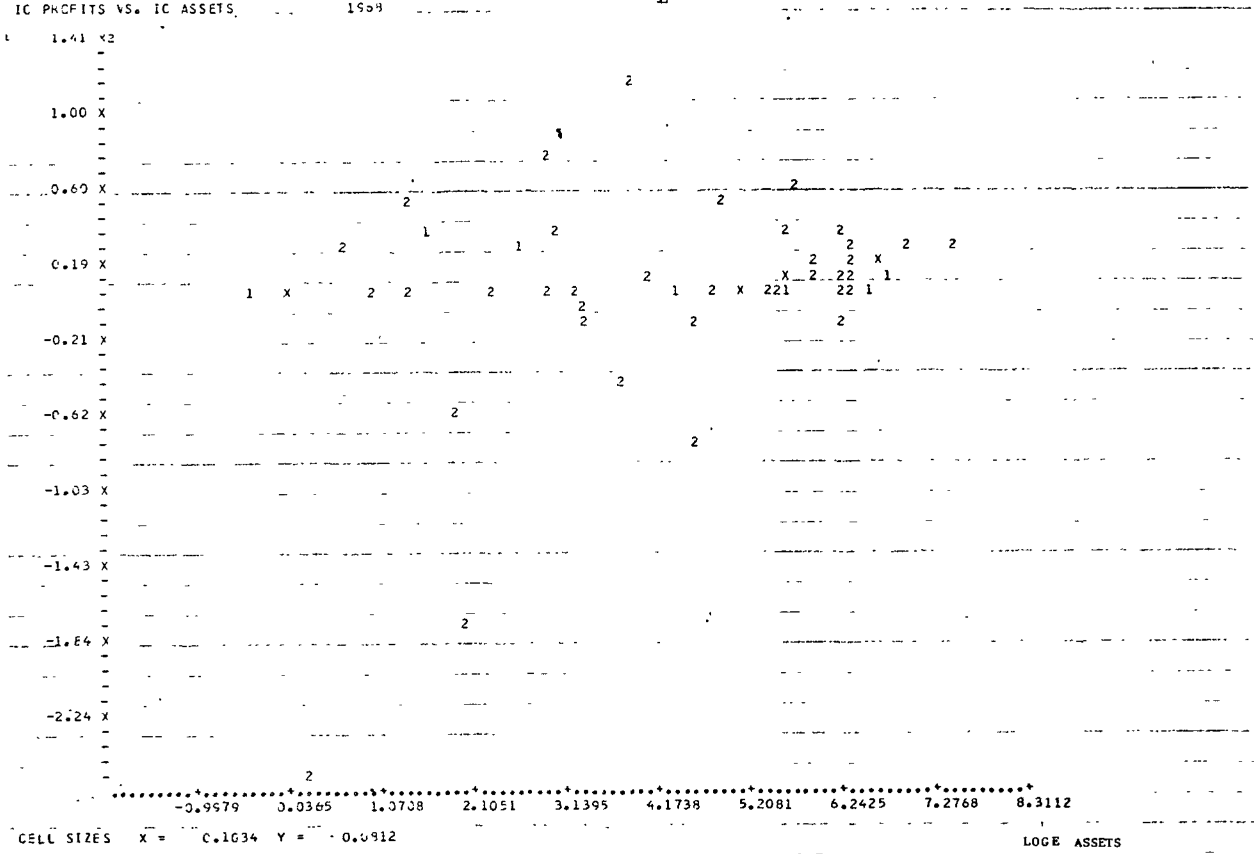

TABLE IV-70

SUMMARY OF PROFITABILITY REGRESSION RESULTS

YEAR	DEPENDENT VARIABLE PROFIT RATIO	NO. OBS.	INTER-CEPT	FORM	R.IA*	R.BD**	LOG_E ASSET	% REG I.C	LOG_E ASSET REG IC	LOG_E ASSET OTHER	R^2
1964	TOTAL	77	-0.63	-0.1531	-0.0035	0.0003	0.0782	0.0018			
				(-1.05)	(-2.07)	(0.36)	(2.26)	(0.98)			0.19
	REG. IC	29	0.50	-0.2852	-0.0000	0.0005			-0.0139		0.08
				(-1.34)	(-0.01)	(0.13)			(-0.24)		
	OTHER	55	-2.14	0.0577	-0.0031	0.0005				0.2003	
				(0.22)	(-0.99)	(0.35)				(3.21)	0.19
1968	TOTAL	112	0.55	-0.0606	-0.0026	0.0004	-0.0267	0.0018			
				(0.34)	(-1.21)	(0.35)	(-0.70)	(0.83)			0.04
	REG. IC	43	-0.15	-0.2450	0.0000	0.0014			0.0129		
				(-0.58)	(-0.00)	(1.87)			(0.13)		0.13
	OTHER	83	0.05	-0.0046	-0.0021	0.0004				0.0141	
				(-0.04)	(-1.74)	(0.54)				(0.58)	0.07

* Percentage of 1969 gross income of advisory complex and affiliated companies from investment advisory services.

** Percentage of 1969 gross income of advisory complex and affiliated companies from broker dealer functions (t statistic)

F. PERFORMANCE FEES

1. Introduction

The use of performance fees to reward investment company advisers is now commonplace. A significant proportion of all investment companies, particularly those with growth oriented investment objectives, have incentive fee advisory contracts. This is a relatively recent development. In mid-1966 there were only four mutual funds with performance fees, but one year later, there were 16. By mid-1968 there were 54; 120 by mid-1969 and on June 30, 1970, 128 were in effect with 52 additional performance fee contracts proposed for funds whose registration statements were pending at the Commission. Reflecting the dramatic trend to incentive fee arrangements, approximately 40 percent of the registered investment companies which commenced operations during 1968 and 1969 proposed to use incentive fee arrangements.

The Investment Company Amendments Act of 1970 substantially restricts the type of performance fee arrangement permissible and proscribes the classes of advisory accounts for which incentive fees may be charged.[67] Notwithstanding these legislative protections, which will be discussed in detail in section 3 below, other questions remain. Issues must be resolved such as how performance is to be evaluated, the characteristics of an appropriate index against which performance may be measured, the payment of fees and credits, and protecting shareholders against the adviser's possible default in satisfying liabilities resulting from poor performance.

This section discusses (a) the current situation relating to performance fee usage, (b) the legislative history of statutory provisions relating to performance fee arrangements, (c) the question of measurement of the adviser's performance, and (d) certain other issues raised by incentive fee arrangements.

Performance fees have been criticized on the grounds that they are a one-way street to higher fees, that they encourage speculation and that they create severe conflict of interest problems within an advisory complex. The following excerpts from a letter by Mr. George S. Johnston, Chief Executive Officer of Scudder, Stevens and Clark, the largest investment counsel firm, established in 1919, clearly present this point of view:[68]

> We . . . urge the concept that the identity of interest between client and adviser should be maximized whenever possible and conflict between the two should be reduced to the minimum. We believe that leveraged advisory fees have the opposite tendency . . .
>
> It seems to us that other than the desire for more management fees, the adviser's justification of leveraged fees is based upon two premises, both of which we consider untrue. The first false premise is that an investment advisory fee based upon a specific percentage of capital and terminable at will, lacks incentive to provide the best service for a client. This is simply inaccurate. There is built into such a fee structure a reward for appreciation. Of greater importance, however, is the fact that a fee structure without a long term contract provides a tremendous incentive from the opposite point of view. If the adviser fails to

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[67] Investment Company Amendments Act of 1970. Section 25, amending Section 205 of the Investment Advisers Act of 1940, effective December 14, 1971.

[68] Letter to the Members of the House Committee on Interstate and Foreign Commerce, August 27, 1970, commenting on H.R. 17333.

deliver a competitive performance, he is going to lose the account. As a practical matter, it is difficult to think of a greater or more properly oriented incentive than this factor alone. Indeed, the classic form of fee schedule probably identifies the objectives of the client and the adviser as closely as can be done.

The second major premise behind the arguments for the leveraged fee is that the investment adviser has it within his power to vary the investment performance of his client's account in proportion to the fee to be paid by the client. If this were true it must follow that the advice he gave for an unleveraged fee is not his best. Our experience is that this is also untrue. We believe that unsuccessful decisions of a professional nature involve the best effort at the time and the introduction of a possible bonus at that point would not have changed it one bit. Furthermore, professional standards of conduct and compensation to do a good job make it indefensible that an adviser will withhold a decision that has been very enthusiastically arrived at because the fee is inadequate.

If the adviser's current investment advice is the best he can produce, the leveraged fee inevitably tempts him to get "superior" results either by taking increasing risks or taking extreme positions. That is the nub of our objection to a Congressional endorsement of leveraged fee schedules. Such a schedule spawns a conflict of interest in which an adviser can be encouraged to take inappropriate risks with other people's money. If an adviser takes the risk and is wrong, he loses a client. But, as you can imagine and as your mail may have shown, the application of the error can be disastrous to the capital of the client. By dint of salesmanship, the adviser can replace the client far more easily than the investor can replace his capital.

We believe that leveraged fees will inexorably lead in this direction because the adviser has a disproportionate amount to gain and little to lose. While this conflict could theoretically be mitigated by a fee schedule which provided for a sharing of losses, there are, as a practical matter no investment advisers who could be either bonded or provide the capital for this.

Finally, in addition to the principles involved, a variety of technical problems exist if the fee is not to be unfair. These include the difficulty of establishing a really fair formula, the need for a prohibition against an adviser receiving leveraged fees in boom markets and then shifting to flat fees when markets are difficult, and a proper definition of the base to be used (should the base not be an average of funds which take similar risks rather than a conservative composite?). What of the arithmetic importance of "Valuation Day" and related possible abuses to affect the fee such as security valuations in markets of limited liquidity, the need for accruals (down and up) including a segregation by the adviser of adequate funds in contemplation of a possible reduction in fee and the prejudice to shareholders who purchase or redeem just before or after Valuation Day? These are extremely difficult problems which have received limited study and attention.

On the other hand, performance fees have been defended on the grounds that they allow sophisticated clients additional degrees of freedom in negotiating fee arrangements with advisers, permit superior advisers to obtain additional compensation and permit profitable operations of smaller economic units which do not have access to large efficient sales organizations. The following excerpts from a letter by Mr. J. M. Hartwell, President of J. M. Hartwell and Company, a prominent medium sized investment advisory firm established in 1965, presents this point of view: [69]

We believe very strongly that fees paid for money management should be based upon performance. To the extent that fees create a reward for good performance and penalize poor performance, they constitute an effective incentive to the money manager. It is this type of compensation formula which has attracted bright new competitive talent into the industry. Such arrangements also appeal to numerous investors who are loathe to pay sizeable management fees during bad periods, but who are quite content to pay substantial amounts where their investments have shown above average appreciation. Although it might be said

[69] Letter to Senator John J. Sparkman, Chairman, Senate Banking and Currency Committee, April 28, 1969, printed in Hearings before the Senate Banking and Currency Committee on S. 34 and S. 296, 91st Cong., 1st Sess., 421–424 (1969).

that the traditional fee based upon a percentage of the total value of a fund rewards good performance since the fee increases with an increase in the value of the fund, for the most part the increase or decrease in the size of a fund and thus in the amount of such type fee is a function not of investment performance, but of the efficiency and capability of the sales organization utilized by the fund managers. In other words, if a mutual fund organization with a traditional fee arrangement has a good sales force it is guaranteed to have sizeable income from mutual fund management fees, irrespective of whether the investment performance of the funds under management is good or bad.

The more effective of the younger money managers today are imaginative and extremely competitive. A performance type incentive fee appeals to them not only because of its moneymaking potential, but because its many possible variations stimulate their competitive instincts. It is in the best interest of all mutual fund shareholders that these managers be encouraged to enter into the mutual fund industry rather than into other forms of money management. They will not, however, be very encouraged by legislation which restricts performance type fees and tends to intrench the traditional established methods of compensation and benefit the older fund organizations with large, well-developed sales organizations at the expense of younger and smaller competitors trying to break into the field.

2. Types of Performance Fees

Performance fee arrangements typically fall into two general categories: (1) fee bases related to the performance of a market index or (2) a fee based solely on the performance of the fund itself without reference to the performance of any index. In the latter case the advisory fee is typically based on a percentage of the net unrealized capital gains, or net realized capital gains, or dividend and interest income.

The following is a description of a representative market index related performance fee:

For its services as Investment Adviser and Manager, the Fund pays [Adviser] an annual fee that is divided into two parts: a basic fee based on net asset value plus a fee based on performance. The latter fee gives management a bonus when the Fund performs well and penalizes management in any year in which its performance is below that of the Standard & Poor's Composite Stock Price Index of 500 Stocks. This dual management fee is designed to give the Fund's manager [Adviser] an incentive to achieve maximum capital appreciation consistent with the purposes and investment policy of the Fund. The agreement with this fee arrangement became effective October 1, 1968.

The basic fee is payable monthly and is computed on the net asset value of the Fund as of the close of business each day. The fee is based on the following annual rates: .75% on the first $5 million and .50% on the excess over $5 million.

The performance fee, which is in addition to the basic fee, is computed at the end of each year by comparing the Fund's performance for the year with the Standard & Poor's Composite Stock Price Index of 500 Stocks (the "Index") for the same year. Each percentage point (fractions to be prorated) that the Fund's performance exceeds the "Index" performance is multiplied by .10% of the Fund's average net assets. The maximum performance fee is .50% of the average net assets.

On the other hand, if the performance of the Fund does not equal the "Index" performance for the year [Adviser] must give the Fund a refund. The amount of this refund is equal to .10% of the average annual net assets for each percentage point (fractions to be prorated) that the Fund's performance drops below the "Index" performance. The maximum refund can be no more than .50% of the average net assets.

In computing the performance fee or refund, the Fund's performance is measured by the change in the net asset value per share during the fiscal year. This change is adjusted to compensate for any distribution of capital gains. In making this adjustment it is assumed that all distributions of capital gains have been reinvested in shares of the Fund as of the payment date at net asset value per share.

Net asset value at the end of each year reflects net investment income received and dividends paid by the Fund during the year. No adjustment is made for dividends in measuring the Fund's performance. The performance of the "Index" is measured by the difference between the "Index" at the beginning and the end of the year. Any increase does not include dividends paid on the stocks listed in the "Index," except insofar as the "Index" automatically adjusts for dividends.

It is important to remember that the performance fee is based on the Fund's performance for each year. A performance fee may be paid for a year when the Fund outperforms the "Index," although the Fund's performance over a longer period of time may be below the "Index" average. Conversely, a performance fee will not be paid in a year in which the Fund performs below the "Index" average, although the Fund's performance over a longer period of time exceeds the "Index" average. It is possible for a performance fee to be earned even if the Fund's assets decline in value during the year, provided the "Index" performance shows a greater percentage decline. Thus for fiscal year ended May 31, 1970 the net asset value per share of the Fund, adjusted for capital gains distributions, declined 24.82% but during the same period the "Index" declined 26.01% so that the Fund paid a performance fee of $3,182 based on the 1.19% difference in the rate of decline. For fiscal 1969, the net asset value per share increased by 11.59% and the "Index" increased 4.84% so that the Fund paid a performance fee of $15,109 based on the 6.75% difference.

Mutual funds usually pay management fees as a percentage of average net assets. Generally investment fees based on net asset value approximate one-half of 1 percent of such net asset value annually, although some of the smaller mutual funds pay management fees on a higher percentage of up to 1% of such net asset value. Based upon one-half of 1% of net assets, the investment advisory fees would have been $14,879, $15,109 and $13,305 respectively for the fiscal years ended May 31, 1968, 1969 and 1970.

The following schedule compares the performance of the . . . Fund with that of Standard & Poor's Composite Price Index of 500 Stocks for the years ended May 31, 1963 through 1970. It sets forth the estimated fees [Adviser] would have received had the present agreement been in effect during such periods reflecting separately the basic fee only and the basic fee as adjusted by the performance fee.

FEE SCHEDULE AGREEMENT

Fiscal year ended May 31	Percent change in asset value of share of fund [1]	Percent change in Standard & Poor's composite stock price index of 500 stocks	Difference between fund and index	Basic fee only	Basic fee plus or minus performance fee
1963	+20.70	+18.73	+1.97	$11,375	$14,362
1964	+18.26	+13.52	+4.74	13,399	21,868
1965	+6.39	+10.02	−3.63	14,501	7,483
1966	+18.55	−2.59	+21.14	16,164	26,940
1967	+12.64	+3.43	+9.21	17,823	29,705
1968	+8.97	+10.78	−1.81	22,319	16,933
1969	+11.59	+4.84	+6.75	22,664	37,773
1970	−24.82	−26.01	+1.19	20,060	23,242

[1] This column indicates the percentage change in asset value of a share of the fund (capital gain distributions reinvested) and the index, respectively, over the years ended May 31st. [70]

An example of a fee based solely on the performance of the fund itself without reference to the performance of any index as follows:

Management Fee Formula

No management fee is paid for any year in which no investment profit is made. In any other year, the Fund will pay the Investment Adviser for its services an annual fee equal to 10% of the aggregate of the dividend income, interest income, and investment profit of the Fund for the year with regard to which the fee is to be paid. Expenses and taxes payable by the Fund are not taken into account in computing such investment profit and dividend and interest income. The invest-

[70] Commission Public File No. 2-9748, prospectus dated Oct. 1, 1970, at 5; 6.

ment profit for any year is defined to mean capital gains, both realized and unrealized allocable to such year.

The management contract prescribes certain rules for the computation of gains and losses for management fee purposes to insure that unrealized gains allocable to a particular year will not be used as the basis for the payment of additional management fees in subsequent year. Accordingly, in the case of a security or commitment held at the end of a particular year, the value used in computing gains and losses at the end of such year is taken as the base for the computation of gains and losses in that security or commitment for management fee purposes in the following year. If the Fund should sustain an investment loss for any year, such loss will be offset against dividend and interest income in computing the management fee for that year, but will not be carried over to offset gains or income in computing the management fee for any subsequent year.

Although most mutual funds pay management fees based on a percentage of their net asset value, the Investment Adviser's compensation under the foregoing arrangement will depend solely upon its success in producing investment profit and dividend and interest income for the Fund. Management fees based on net asset value generally approximate one-half of one percent of such net asset value annually, so that there may be wide variations in the management fee paid by the Fund in relation to its net asset value as compared to other funds. The management fee will be large in relation to net asset value and income in a year in which there is a substantial investment profit; on the other hand, if losses are sustained, the fee will to such extent be smaller and under certain circumstances no fee may be payable.[71]

The Commission during the 1969 Congressional Hearings on its legislative program listed 137 investment companies which had performance fee arrangements in effect or proposed as of June 30, 1969.[72] Six were closed-end companies. Of the remaining 131 funds, the fees of 120 were related to the performance of market indexes. The Standard & Poor's 500 Stock Composite Index was the most popular comparison standard used by 60 funds. The Dow Jones Industrial Average (30 stocks) was used by 28; the NYSE Composite Index (all stocks on the Exchange) was used by 21 funds; and the best performance of the foregoing three indexes was used by nine. The Dow Jones Composite Index (75 stocks) and the National Quotation Bureau Over-the-Counter Industrial Exchange (35 stocks) were used by one fund each. No fund determined fees by relating its performance to an index of funds. However, 11 based fees solely on the performance of the fund itself.

Funds are continuing to use performance-based incentive fee arrangements and the same indexes as performance standards. Of 508 funds listed in a commercial survey, 110 had incentive fee arrangements as of December 3, 1970.[73] The total assets of these 110 funds amounted to $3.14 billion or 6.9 percent of the total assets of the funds included in the survey. All but one of these funds had growth as their primary investment objective and thus were more volatile than non-performance funds.

An earlier survey published by the same organization found 101 funds with incentive fee arrangements as of March 12, 1970.[74] The per-

[71] Commission Public File No. 2-16341, prospectus dated October 31, 1969, at 6.

[72] This table appears in *Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., pt. 2, 882–884, 888 (1969) ["1969 House Hearings"].

[73] Arthur Lipper Corp. *Mutual Fund Performance Analysis*, December 3, 1970.

[74] Arthur Lipper Corp., *Note on Incentive Management Fees*, March, 1970. The increasing popularity of incentive fee arrangements in 1968 and 1969 was indicated by the fact that of 152 new funds incorporated into the Lipper Service between January 1, 1968 and March 12, 1970, 67, or 44 percent, used incentive fee compensation arrangements. The 67 funds represented $1.3 billion or 48.5 percent of the $2.8 billion of new fund assets reported as of December 31, 1969.

formance comparison standards used by these 101 funds as of March 12, 1970 and their total assets as of December 31, 1969 are set forth in Table IV-71 below.

TABLE IV-71.—*Mutual Fund Incentive Fee Arrangements Bases for Performance Comparison* [75]

Basis for Performance Comparison	Number of Funds	Total Assets Dec. 31 1969 (millions)	Percentage of Assets
Dow Jones Industrial Average	20	$1,593.2	41.7
Standard & Poor's 500	48	1,479.3	38.7
Standard & Poor's 425	3	29.1	.8
New York Stock Exchange Composite	17	270.0	7.1
Dow Jones 65 Stock Composite	1	41.3	1.1
Over-the-counter industrial average	1	7.8	.2
Combination (DJIA-NYSE-S. & P. 500)	4	278.9	7.3
Other	7	119.0	3.1
Total	101	3,818.6	100.0

Of the 120 index related performance fee arrangements listed by the Commission during the 1969 House Hearings, 76 funds had no reductions in basic fee rates for inferior performance, or had reductions which were not proportionate to fee rates for superior performance. The fee provisions of 115 of the 120 funds which were related to index performance contained annual basic fee rates stated as a percent of net assets, and 94 of those rates were 0.5 percent of average net assets or higher. Total fees authorized by the various provisions ranged as high as 6 percent annually of net assets. Only 20 of the 115 basic fee provisions were subject to any reduction in the fee by reason of increases in the amount of net assets managed. While all 115 afforded additional compensation for outperforming the market index used, only 87 of them provided for any reduction in the basic fee for performance below that of the index, and only 44 of these 87 imposed as large a total reduction for performing below the index as the additional compensation provided for outperforming the index.

It can be seen from the foregoing that, aside from the question of a proper index to measure performance, the fee formulae generally provided a one-sided basis of compensating the adviser. In most cases, the basic fee rates guaranteed the adviser are no lower than the rates received under contracts which have no performance fee provisions and, in a vast majority of the cases, there are no provisions for reductions in the basic fee rates in recognition of the economies of size. In addition, in the majority of cases, the advisers are afforded the opportunity to receive even higher fees for performance, without the risk of commensurate reductions in fees, or any reductions at all, the poor performance.

3. Legislative Background of Existing Regulatory Framework

Until the Investment Company Amendments Act of 1970, investment advisers registered under the Investment Advisers Act of 1940 were prohibited from charging clients an advisory fee "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." [76] However, the Investment Ad-

[75] Arthur Lipper Corp., *Note on Incentive Management Fees*, March 1970.
[76] Investment Advisers Act § 205, 15 U.S.C. 80b-5 (1964).

visers Act excepted from that prohibition without any limitation, fee arrangements with investment companies.[77] Also, an "investment adviser whose only clients are investment companies and insurance companies" was exempt from registration under the Investment Advisers Act [78] and therefore such advisers were not restricted from charging performance-based advisory fees.

In the legislation as originally proposed in March of 1940, all performance fee arrangements of investment companies would have been prohibited by both Title I, the Investment Company Act of 1940 and Title II, the Investment Advisers Act. The Investment Advisers Act would have prohibited registered advisers, including advisers to investment companies, from charging fees based upon a share of capital gains upon or capital appreciation of the client's funds.[79] It also contained a declaration that:

the national public interest and the interest of investors are adversely affected

* * * * * * *

(3) when the compensation of investment advisers is based upon profit sharing contracts and other contingent arrangements conducive to excessive speculation and trading.[80]

The proposed Investment Company Act would have prohibited compensation based upon capital gains or capital appreciation by excluding such contingent compensation arrangements from enumerated permissible fee arrangements.[81]

Application of these limitations to advisers of investment companies was criticized by industry representatives on the grounds that performance fees were not characteristic of the advisory profession [82] and that proof of any specific abuses in the investment advisory field was lacking.[83] The investment adviser of a fund complex whose fee was based on fund investment profits objected to the bill's limitation on contingent fees on the grounds that one of the important objectives of the complex was to "closely link the interests of investors and management throughout the life of the investment" and that this was best achieved by compensating management in proportion to and at the time when the investor himself profits from his investment.[84]

At the close of the Senate Hearings, Arthur H. Bunker, Executive Vice President of Lehman Corporation, outlined proposals embodying "the considered and agreed views of a large and, . . . representative portion" of the industry.[85] With respect to compensation of management he stated that the provision "should contain substantially the same requirements for approval by stockholders . . . [as in the original bill]. It should not, however, dictate the basis of management compensation, provided that the method of payment is clearly and adequately set forth to shareholders . . .".[86] The memorandum setting

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[77] Investment Advisers Act § 205, 15 U.S.C. 80b–5 (1964). *See also,* 1969 House Hearings 204–205.
[78] Investment Advisers Act § 203(b)(2), 15 U.S.C. 80b–3(b)(2) (1964).
[79] S. 3580 and H.R. 8935, 76th Cong., 3rd Sess. § 205 (1940).
[80] S. 3580 and H.R. 8935, 76th Cong., 3rd Sess. § 202 (1940).
[81] Section 15(a) of S. 3580 would have permitted compensation paid by an investment company to be based upon one or more of the following bases, and no other: a definite sum of money for a definite period; a definite percentage of the company's income from interest and dividends; or a definite percentage of the value of the company's net assets as of a definite date or averaged over a definite period.
[82] *Hearings on S. 3580 before the Subcommittee on Securities and Exchange of the Senate Committee on Banking and Currency,* 76th Cong., 3d Sess. 713 (1940) [hereinafter cited as *1940 Senate Hearings*].
[83] *1940 Senate Hearings* 711–712, 761.
[84] *1940 Senate Hearings* 664.
[85] *1940 Senate Hearings* 1052.
[86] *1940 Senate Hearings* 1055.

forth the "agreement in principle" between the Commission and the industry referring to compensation of management, stated ". . . The Commission recommends, but does not insist, that certain types of profit-sharing contracts be outlawed. . . ." [87]

In the compromise bill which emerged from discussions between representatives of the industry and the Commission after the close of the 1940 Senate Committee Hearings, the Title I limitations upon the type of compensation an investment company could pay were deleted and investment advisers whose only clients were investment companies and insurance companies were exempted from registration under Title II, the Investment Advisers Act, and from the prohibition against charging performance fees. The Investment Advisers Act declaration referring to profit sharing and other contingent arrangements as "conducive to excessive speculation and trading" was also deleted.

Commission Counsel David Schenker explained that the revisions in the Investment Advisers Act were based upon a draft submitted by a representative of Scudder, Stevens & Clark. Summarizing the changes in the Act, Mr. Schenker stated:

> There are just one or two slight changes in title 2; and I personally feel that there will not be any vigorous objection to it. I think we have tried to meet all the objections that were asserted at the committee hearing.[88]

Congressional attention did not return to investment company performance fees until 1967, after completion of the Study of Mutual Funds prepared for the Commission by the Wharton School of Finance and Commerce,[89] the Report of the Special Study of the Securities Markets of the Securities and Exchange Commission[90] and Public Policy Implications of Investment Company Growth.[91] Neither the Wharton Report nor the Special Study treated performance fees as significant, since, as pointed out above, when these reports were published very few investment companies had performance-based fee arrangements.

The Public Policy Report, published in December, 1966, focused primarily upon the level of fees rather than the method of their computation. However, in it the Commission recommended that the Investment Advisers Act be amended to require that investment advisers to investment companies be subject to the registration provisions of the Act and also to require that contracts between registered investment companies and their advisers not provide for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the funds of the investment company.[92] In so doing, the Commission at the same time made clear that it believed that "the *sustained* investment performance of a company would be an appropriate consideration in evaluating the reasonableness of its advisers' compensation." [93] [Emphasis added.]

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[87] Memorandum of May 13, 1940, entitled "Framework of Proposed Investment Company Bill (Title I), Embodying Suggestions Resulting from Conferences between Securities and Exchange Commission and Representatives of Investment Companies." *Hearings on H.R. 10065 before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 98 (1940).

[88] *1940 Senate Hearings* 1124.

[89] Wharton School of Commerce and Finance, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 580 (1962) [hereinafter referred to as the "Wharton Report"].

[90] SEC, *Report of the Special Study of the Securities Markets*, H.R. Doc. No. 95 88th Cong., 1st Sess. (1963–1964) [hereinafter referred to as the "Special Study"].

[91] H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter referred to as the "Public Policy Report"].

[92] Public Policy Report 32, 346.

[93] Public Policy Report 145.

The Commission's recommendations were embodied in a bill to amend the Investment Company Act submitted by the Commission to Congress in May of 1967.[94] However, since the Commission's then limited experience with performance fees charged to investment companies indicated that the main concern with such fees was that they increased for good performance but did not correspondingly decrease for poor performance, the Commission, after discussions with the industry, modified its recommendation. As modified, the Commission proposed that investment company performance fees be permitted provided that they increase and decrease proportionately on the basis of the fund's performance measured against an appropriate index of securities prices or such other measure of investment performance as the Commission may specify. During Congressional hearings in 1969 on the Commission's legislative proposals, the Commission argued that performance-based fees are unfair for the following reasons:[95]

1. Bonuses are paid when a fund outperforms an index, but no penalties (or disproportionately small penalties) are imposed when the index outperforms a fund—truly a one-way street.[96]
2. Fees for favorable performance are paid in cash by investment companies to advisers, but refunds of fees owed by advisers to funds (because of underperformance) often result only in credits against future fees.
3. Investment companies have no assurance that advisers will be financially able to meet obligations to pay any performance fee owed to them.
4. Carry-forward fee credits for inferior performance tend to discourage the termination of advisory contracts despite a poor record of management if advisers cannot pay unsatisfied credits.
5. Asset value of fund shares cannot be accurately computed when outstanding "credits" are owed by advisers.
6. Many such fee arrangements are so complex that it is virtually impossible to understand them.

The Investment Company Amendments Act of 1970 reflects the Commission's recommendations. It amends the Investment Advisers Act to require registration of advisers even though their only clients are investment companies and it prohibits registered advisers from charging performance fees to investment companies unless such fees increase and decrease proportionately in relation to an appropriate index of securities prices or other measure of investment performance as the Commission may specify.[97] It also permits a registered adviser to charge any other person a performance fee, but only if the contract relates to the investment of assets in excess of $1 million and the client is not a trust, collective trust fund or separate account which is part of an employee benefit plan qualified under Section 401 of the Internal Revenue Code. These provisions will become effective on December 14, 1971, one year from the date of passage of the Amendments Act.

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[94] S. 1659, H.R. 9510 and H.R. 9511, 90th Cong., 1st Sess. (1967).

[95] *1969 House Hearings* 870–872.

[96] Commission exhibits demonstrated that rate schedules of performance fee contracts were not subject to decreases for inferior performance proportionate to increases in fee rates for superior performance.

[97] Sections 24(a) and 25 of the Investment Company Amendments Act of 1970, respectively, amending sections 203 and 205 of the Investment Advisers Act of 1940.

4. Performance Standards and Incentive Fee Arrangements

This section provides a discussion of some of the concepts and methodology used in measuring the investment performance of institutional investors. Additionally, the implications of using various performance standards as part of incentive fee arrangements are examined.[98]

a. Definition of the problem

The basic premise of an incentive fee arrangement is that superior performance by an adviser will be rewarded by additional compensation. The converse, of course, is that inferior performance will be penalized via a reduction in compensation. The result of this type of arrangement should be to align the objectives of the adviser and his client as closely as possible toward producing superior investment results.

While the concept of rewarding those who perform well and penalizing those who perform poorly is not controversial, its practical application in the area of investment management is not straightforward.[99] The crux of the difficulty lies in the measurement of investment performance. If the way in which a manager's investment performance is measured is poorly devised, it may no longer be true that the objectives of client and adviser are the same. Indeed, differences betweeen the interests of the two may well be created or accentuated.

Virtually all performance fee arrangements in effect at the present time fall short of the goal expressed above. As discussed below, existing incentive fee arrangements provide an incentive to the adviser to invest his clients' funds in securities having high volatility, even though such action may not be consistent with the investment objectives of the account. The thrust of this subsection and the next is to suggest one possible mehod for measuring investment performance which would reduce incentives on the part of an adviser to expose his client's funds to excessive risk.

b. Some basic concepts

There are a number of basic propositions and empirical findings relating to rates of return on financial assets[100] that are useful in attempts to measure the performance of institutional investors:

1. Average rates of return achieved by "riskier" or more volatile securities (and hence more volatile portfolios) tend, in the long run, to be greater than those on less volatile securities (or portfolios). During any particular period of time, of course, riskier portfolios expose their owners to greater potential losses than less risky portfolios.

2. Although work remains to be done on risk measurement, there is evidence that the volatility of rates of return on institutional portfolios provides a useful measure of the risk borne by portfolio shareholders.[101] The higher the relative volatility of a security or portfolio relative to a broadly based market index, the greater will be the response of the portfolio's net asset value to movements in the market as

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[98] A more detailed discussion of the performance measurement techniques can be found in the appendix to this section.

[99] See testimony of Chairman Hamer H. Budge, *Hearings before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce on H.R. 11999 and S. 224*, 91st Cong., 2d Sess. 868–872 (1969).

[100] Return includes dividends and capital distributions plus unrealized capital appreciation, before taxes.

[101] See the appendix to this section for more detailed references and a discussion of volatility measures.

a whole. Thus, mutual funds or other diversified portfolios having high volatility will tend to have substantially higher rates of return than the index during market upswings and substantially lower rates of return during downturns.

3. Investment returns on well diversified portfolios are, on average, highly correlated with returns on the market as a whole.

c. Implications for performance measurement

Empirical evidence indicates that returns on diversified portfolios (such as mutual funds) are highly predictable once market returns over the period are known. Thus, such predicted values may be used as a standard against which actual returns can be compared. The standard in this case would be chosen to have the same degree of volatility as that displayed on the average by the institutional portfolio (for example, mutual funds) during the evaluation period.

The rate of return generated by a standard portfolio of given volatility is defined as: the yield on treasury bills (treated for analytical purposes as a risk free asset) plus the volatility coefficient (the volatility of returns on the fund relative to similiarly calculated returns on a broadly based market index, such as the Standard and Poor 500 Stock Index) times the difference between returns on the market and on treasury bills. The standard, in effect, represents a combination of two portfolios, the market portfolio and a riskless portfolio, where the relative amounts of each are such that a specified volatility factor is obtained. For comparison with a specific managed portfolio, the riskless and market portfolios would be combined to obtain a volatility equal to that displayed on the average by the fund being evaluated. The fund manager would be entitled to a performance fee only if the average total return produced under his management, net of all expenses, exceeds the rate of return displayed by an unmanaged, standard portfolio having the same average volatility.

d. Incentive fees

The procedure discussed above permits the decomposition of returns on managed portfolios into two components, one attributable to the manager's skill in selecting individual securities or anticipating broad movements in the market itself, and the second attributable to the average degree of investment risk (or market volatility) borne by the portfolio's shareholders during the period in question. In devising an incentive fee arrangement it is the first component which is relevant for the compensation of investment managers.[102]

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[102] There are essentially two ways by which a fund manager can outperform a standard portfolio having the same average volatility. The first is by being able to select stocks which performed in a superior way during the evaluation period. These would be securities which had higher rates of return than would be implied by the market related risk displayed by the stock. The second would be by predicting movements in the market itself, and shifting the volatility of the portfolio before the movement takes place. Thus, if a manager were able to predict the market, he could (and presumably would) move into less volatile securities, including short-term debt if permitted by the advisory contract, before a downswing, and into more volatile securities prior to a market upswing.

If the adviser could operate successfully in either of these modes, the result would be a positive excess return for the fund during the evaluation period. However, if his insight into either individual stocks or market movements were no better than average, his portfolio rebalancing actions may well not generate enough additional return to cover the incremental brokerage and administrative expenses involved in such changes, in which case the fund's performance would be inferior to that of the unmanaged standard against which it is compared (for which, of course, no portfolio transactions other than the reinvestment of dividends and no investment advisory expenses of any sort are required).

When an adviser is compensated on the basis of total fund return, or on the basis of fund return relative to an index having lower volatility than the fund itself (the usual case with current incentive fees), an incentive exists on the part of the manager to cause the portfolio to asume greater risk since additional portfolio volatility is, on the average, associated with higher rates of return and, hence, higher levels of managerial compensation. Thus, when a non-risk-adjusted performance fee standard is chosen, the adviser is rewarded for additional risk borne by the fund's shareholders. Volatility adjusted performance standards are designed to remove this bias and, thereby, reduce incentive for an adviser to fashion excessively volatile portfolios. Combined with adequate disclosure in a fund's prospectus or elsewhere of the degree of volatility (relative to a market index) assumed by the portfolio, risk-adjusted performance fee arrangements such as those sketched above would appear to more closely align the interests of portfolio managers and their clients than most existing types of fee arrangements.

5. Considerations for the Administration of Incentive Fee Arrangements

The foregoing discussion leads to considerations of what safeguards would accompany the type of volatility adjusted performance measure discussed above. Of course, rates of return on fund shares and the comparison portfolio would be computed in identical fashion and include all distributions made on both portfolios. Further, the comparison standard portfolio would have to display the same degree of volatility during the evaluation period as the managed portfolio.

A further consideration concerns the symmetrical handling of superior and inferior performance. To the extent that an incentive fee is paid for superior performance by the adviser, a penalty would be charged to the adviser for relatively poor performance. Thus, the incentive fee would increase and decrease proportionately for superior or inferior performance relative to the standard portfolio.[103] Moreover, relatively small or random changes in portfolio return should not trigger large changes in the arrangement of incentive compensation paid.

The interval of time over which performance is measured also must be considered. This interval should be sufficiently long to insure that accurate measures of fund volatility and adviser performance can be obtained. As discussed in the appendix, one to three year intervals have been suggested as the minimum time period over which such evaluations should be conducted.

The preceding discussion focuses on incentive fee arrangements between advisers and their clients. Similar considerations apply to the

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[103] Where the possibility of negative fees exist, considerations concerning the refunding of these amounts on the same basis as that for which positive payments are made come into play.

Also, where adviser liabilities for negative fees are possible, provisions for the protection of fund shareholders against the possibility that the adviser would not be able to return the amounts due become a consideration. One possibility would be capital or bonding requirements for advisers using incentive fee structures.

procedures used by advisers to compensate portfolio managers. To prevent possible conflict of objectives between portfolio managers and either the shareholders or the advisory organization, if portfolio managers also are compensated on an incentive basis, the considerations discussed above would be equally applicable to these arrangements.

Appendix to Section F

The appendix to Section F appears at the end of Chapter IV.

G. ORGANIZATION OF ADVISORY FIRMS FOR INVESTMENT DECISION MAKING

1. Introduction

The purpose of this section is to provide information regarding the manner in which advisory firms are organized for investment decision making and associated management functions. The data were obtained from the I–65 Investment Advisor Intrinsics Questionnaire. As before, advisory firms have been designated as either "fund" or "non-fund" complexes, and the sample has been stratified into "large" and "small" firms.

The following pages summarize the data collected. Section G.2 deals with the basic question of the degree of centralization of decision making authority within advisory firms; section G.3 presents data on the number of portfolio managers and analysts employed by different types and sizes of advisory firms; section G.4 deals with aspects of the duties of portfolio managers and security analysts; section G.5 presents data on the security evaluation principles employed in advisory firms and the external sources of information relied upon; and section G.6 summarizes the proportion of advisory firms which use computers for various research and administrative functions.

2. Concentration of Decision Making Authority

Virtually all types of centralized and de-centralized organizations existed within the I–65 sample. The most centralized forms of organization (where the top management effectively made the investment decisions) provide a list of securities which are rigidly rated or a set of decision making rules for subordinate account managers to implement. In the least centralized organizations the top management of the firm appeared to lay-down a very broad and general policy for investment decision making. The account managers, or portfolio managers, would then in a virtually autonomous fashion make investment decisions for their accounts. It was difficult to put together a pattern that could be stratified by type and size of advisory firm. To the extent it could be done it is shown in figure IVg–1.

Differences exist between fund and non-fund complexes and between large and small advisory firms. For small fund complexes the management of the advisory firm in effect was the portfolio manager. For a large fund complex the decision making tended to be more non-centralized. An investment committee of the senior management of

the firm typically generated either an approved list of securities or very general policy with respect to investment decision making. The portfolio managers then, with authority ranging from complete to limited, implemented policies for their mutual funds and other clients.

For non-fund complexes similar differences existed between large and small firms. For small firms the pattern was typically that of the various principals of the firm advising their own group of accounts on a semi-autonomous basis. For large non-fund complexes the principals of the firm tended to form an investment committee which, as in the case of fund complexes, made investment policy. In the case of large firms decision making authority tended to be more centralized for non-fund complexes than for fund complexes. That is to say, the investment committee tended to lay down a very rigid approved list of securities or, in some cases, actually made decision rules which specified the securities to be bought and sold for individual accounts.

Figure IVg-1

TYPICAL INVESTMENT DECISION AUTHORITY PATTERNS

Fund Complexes

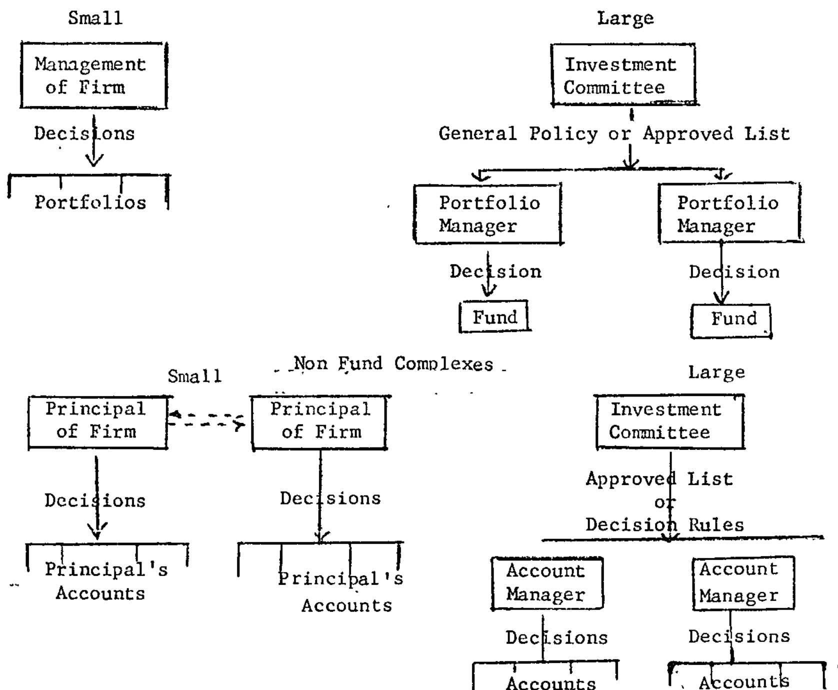

Table IV–72 indicates the proportion of advisory firms with investment committees and account managers. As could be expected large firms are more likely to have investment committees than small firms. For the sample as a whole 80 percent of large firms had investment committees while only 40 percent of small firms had investment committees. Similarly, large firms are more likely to have portfolio or account managers than small firms. This is less true in the case of fund complexes where approximately 79 percent of small fund complexes have portfolio managers compared to 89 percent for large fund complexes. In the case of non-fund complexes almost 94 percent of the large firms reporting said they used portfolio managers while only 60 percent of the small firms stated that they used a portfolio manager system.

Table IV–73 summarizes the data that were collected on the investment authority of account managers to make investment decisions for accounts where the advisory firm had discretionary authority. The advisers were asked to indicate whether their portfolio managers had (a) complete authority (b) limited authority or (c) no authority. The responses tend to be very similar for all types of advisory complexes and sizes of advisory complexes. Typically about 70 percent of the firms responded that portfolio managers had limited authority while approximately 25 percent indicated complete authority.

3. Numbers of Advisory Personnel

Table IV–74 summarizes statistics on the average numbers of account managers, economic research analysts, and investment research analysts that were maintained by average firms of different types and sizes. The table shows that fund complexes tend, on the average, to have more than twice the number of securities analysts than non-fund complexes, but only about one-half the number of people involved in economic research. On the average, non-fund complexes tended to have 7.4 portfolio managers per firm while fund complexes, with substantially fewer accounts, tended to have 5.8 portfolio managers per firm. Table IV–74 also provides a comparison between the average personnel breakdowns in 1964 and 1969. The most substantial rates of personnel growth are among large fund complexes.

4. Duties and Educational Backgrounds of Investment Personnel

Table IV–75 summarizes information about the percent of an account manager's time which is devoted to decision making and related supervision of accounts. The data are tabulated for those firms that indicated on I–65 that they used the account manager or portfolio manager system. The results show that, in large fund and large non-fund complexes, portfolio managers tend to spend about 75 percent of their time in investment decision making and related supervision of portfolios. The percentages are lower for small fund and non-fund complexes where, as might be expected, portfolio managers have a broader range of other duties.

Table IV–76 presents data on the percentage of an investment research analyst's time that is spent in personal contact—that is to say visits, telephone calls, etc.—with issuers of securities. The responses indicate that the typical analyst spends about 24 percent of his time in contact with portfolio companies. This percentage is somewhat

higher for fund complexes than for non-fund complexes, 34 percent as against 20 percent.

Table IV–77 presents data collected on the educational backgrounds of account managers and security analysts. The adviser was asked to indicate the proportion of his account managers and security analysts with either law degrees or advanced degrees in business administration. The data indicate that, in the case of account managers, fund complexes tend to have a higher proportion of analysts with law or advanced business degrees (51 percent) than non-fund complexes (39 percent). The same differences appear to exist for investment research analysts where 74 percent of fund complex analysts had law or advanced degrees in business as compared to 47 percent for non-fund complex analysts. Differences also exist between large firms and small firms, with more investment research analysts and account managers in large firms holding law or advanced business degrees than those in small firms.

5. Security Evaluation Procedures

Table IV–78 summarizes the response with respect to the importance of various types of approaches to security evaluation. The advisory firms were asked to rate the importance of the following approaches, using the importance categories utilized throughout this chapter (that is, 1=most important, 5=least important):

a. Fundamental approaches.
b. Technical approaches.
c. Economic outlook approaches.
d. Other approaches.

The following definitions were given to supplement these descriptions. For the fundamental approach, the emphasis is on analysis and projections of corporate earnings. The technical approach relies particularly on market action as the central factor. The economic outlook approach relies primarily on the interpretation of various aggregate economic series and indicators such as money supply, GNP, etc. for key signals about market movements. In the "other approaches" category the firms were asked to explain the particular approach(es) indicated.

The results indicate that the fundamental approach is typically the most important, with 77 percent of the total sample indicating that this approach is "very important, always used." The importance appears somewhat greater to large firms who had an average response of 1.16, than small firms whose average response was 1.50. Technical approaches appear only of moderate interest with 63 percent of the total sample responding that this approach was either somewhat important but not used frequently, or not important and used only rarely. This approach had seemingly greater importance to small firms whose average response was 2.92 than to large firms whose average response was 3.86. Economic projection approach appears to be more important to large firms relative to small firms. There is very little difference between fund complexes and non-fund complexes with respect to the importance attached to these three evaluation techniques. Thus, the picture emerges of large firms making more use of fundamental approaches to security evaluation which rely on fundamental economic analysis whereas small firms appear to be putting somewhat more emphasis on technical approaches to security evaluation.

Table IV–79 presents the data collected on the importance of specific external information sources to the securities research process. The purpose of this question was to obtain information about the extent to which advisory firms currently utilize various external sources for securities research and information. For each of the external sources the adviser was asked to assign a code number which best described utilization of that source in making decisions about which security to purchase or to sell for advisory accounts. The importance codes were as previously used. The external information sources were:

a. Information and recommendations from broker-dealers purchased via commission dollars;

b. Information and recommendations purchased from other investment advisers on a continuing or contractual basis;

c. Information and recommendations received from other research organizations not included above (with or without compensation);

d. Direct contact with security issuers;

e. Financial statements of issuers, and

f. Others (in which case the adviser was asked to explain the source being indicated).

The results indicate that the most important source of investment information appears to be the financial statements of issuers which, for all sizes and types of firms, receive the highest importance ranking.[104] Direct contact with security issuers ranked next, followed by information received from other research organizations and then information purchased from broker-dealers via commission dollars. Information purchased from other investment advisers on a contractual basis appeared to be relatively unimportant for most firms.

6. Use of Computers for Administration and Decision Making Purposes

Table IV–80 summarizes data collected on I–65 about the use of computers in investment advisory organizations. The table indicates that 78 percent of fund complexes and 62 percent of non-fund complexes own or rent an electronic computer either on an in-house or service bureau basis. Larger firms tend to be more likely to use computers than smaller firms, 88 percent as against 47 percent.

The most common function for which the computer was utilized was account administration, with 50 percent of the responding firms indicating this use. This was followed by general administration duties, with 39 percent. A substantial number of firms also indicated that a computer was being used for trading administration (30 percent) as well as investment research (27 percent). As expected, these percentages tended to be substantially higher for large firms as opposed to smaller firms which tend to be less automated.

[104] In a report published in March 1969, a Commission study group reported that financial analysts make only meager use of periodic reports (8Ks, 9Ks, etc.) filed with the Commission pursuant to the Securities Exchange Act of 1934. "Disclosure to Investors, A Reappraisal of Administrative Policies Under the '33 and '34 Securities Acts" (The Wheat Report), at 318–319. Reasons advanced for this were that these reports are filed spasmodically rather than on a fixed basis and that analysts did not have ready access to these reports. Assuming the Wheat Report findings to be valid and the responses to the current Study to be accurate it would appear that the financial statements utilized by the respondents to the Study were those found in prospectuses filed with the Commission pursuant to the Securities Act of 1933, or found in annual reports to shareholders required by the Commission's proxy rules or by applicable stock exchange rules.

TABLE IV-72

PROPORTION OF ADVISORY FIRMS WITH

INVESTMENT COMMITTEES AND ACCOUNT MANAGERS

Type of Firm	Size of Firm	Number of Respondent Firms	Proportion with Investment Committees (%)	Proportion with Account Managers (%)
Fund Complex	Large	27	70.3	89.0
	Small	14	50.0	78.6
	Total	41	63.4	85.4
Non Fund Complex	Large	37	86.5	93.5
	Small	52	36.5	59.6
	Total	89	57.3	74.3
Total Sample	Large	64	79.7	92.2
	Small	65	39.4	64.6
	Total	129	59.2	78.2

TABLE IV-73

AUTHORITY OF ACCOUNT MANAGERS TO MAKE INVESTMENT DECISIONS FOR ACCOUNTS WHERE FIRM HAS DISCRETIONARY AUTHORITY

Type of Firm	Size of Firm	Number of Firms with Account Managers	Distribution of Responses by Category (%)			Average Response
			Complete Authority 1	Limited Authority 2	No Authority 3	
Fund Complex	Large	24	20.83	75.00	4.17	1.83
	Small	11	27.27	72.73	0.0	1.73
	Total	35	22.86	74.29	2.86	1.80
Non Fund Complex	Large	35	20.00	77.14	2.86	1.83
	Small	31	32.26	58.06	9.68	1.77
	Total	66	25.76	68.18	6.06	1.80
Total Sample	Large	59	20.34	76.27	3.39	1.83
	Small	42	30.95	61.90	7.14	1.76
	Total	101	24.75	70.30	4.95	1.80

TABLE IV-74

INVESTMENT RESEARCH AND MANAGEMENT PERSONNEL

Type of Firm (1969)	Size of Firm (1969)	Number of Firms		AVERAGE NUMBER OF FULL TIME EQUIVALENTS					
				Account Managers		Economic Research Analysts		Investment Research Analysts	
		1964	1969	1964	1969	1964	1969	1964	1969
Fund Complex	Large	24	26	4.5	8.0	0.5	0.6	10.2	13.9
	Small	4	13	1.3	1.3	0.0	0.2	0.7	1.1
	Total	28	39	4.1	5.8	0.4	0.5	8.9	9.6
Non Fund Complex	Large	30	38	11.0	13.6	1.3	2.0	7.3	8.2
	Small	28	42	2.2	2.1	0.1	0.2	0.5	0.7
	Total	58	80	6.7	7.4	0.7	1.0	4.0	4.2
Total Sample	Large	54	64	8.1	11.3	0.9	1.5	8.6	10.5
	Small	32	55	2.1	1.9	0.1	0.2	0.6	0.8
	Total	86	119	5.9	6.8	0.6	0.8	5.6	6.0

TABLE IV-75

PERCENTAGE OF ACCOUNT MANAGER'S TIME DEVOTED TO INVESTMENT DECISION MAKING AND RELATED SUPERVISION OF ACCOUNTS

Type of Firm	Size of Firm	Number of Firms with Account Managers	Distribution of Responses by Category (%)					Average (%)
			0-20%	21-40%	41-60%	61-80%	81-100%	
Fund Complex	Large	24	11.11	3.70	11.11	22.22	51.85	74.37
	Small	11	21.43	0.0	42.86	0.0	35.71	56.43
	Total	35	14.63	2.44	21.95	14.63	46.34	68.24
Non Fund Complex	Large	35	7.89	0.0	13.16	26.32	52.63	76.97
	Small	31	40.38	0.0	19.23	19.23	21.15	45.58
	Total	66	26.67	0.0	16.67	22.22	34.44	58.83
Total Sample	Large	59	9.23	1.54	12.31	24.62	52.31	75.89
	Small	42	36.36	0.0	24.24	15.15	24.24	47.88
	Total	101	22.90	0.76	18.32	19.85	38.17	61.78

TABLE IV-76

PERCENTAGE OF INVESTMENT RESEARCH ANALYST'S TIME SPENT IN PERSONAL CONTACT (VISITS, TELEPHONE CALLS, ETC.) WITH ISSUERS OF SECURITIES

Type of Firm	Size of Firm	Number of Firms With Security Analysts	Distribution of Responses by Category (percent)					Average (percent)
			0-20%	21-40%	41-60%	61-80%	81-100%	
Fund Complex	Large	23	21.74	43.48	21.74	8.70	4.35	36.0
	Small	14	28.57	42.86	28.57	0.0	0.0	30.0
	Total	37	24.32	43.24	24.32	5.41	2.70	34.0
Non-Fund Complex	Large	35	54.29	37.14	5.71	2.86	0.0	21.0
	Small	41	70.73	19.51	9.76	0.0	0.0	18.0
	Total	76	63.16	27.63	7.89	1.32	0.0	20.0
Total Sample	Large	58	41.38	39.66	12.07	5.17	1.72	27.0
	Small	55	60.00	25.45	14.55	0.0	0.0	21.0
	Total	113	50.44	32.74	13.27	2.65	0.88	24.0

TABLE IV-77

PROPORTION OF FULL-TIME EQUIVALENT ACCOUNT MANAGERS AND SECURITY ANALYSTS WITH LAW DEGREES OR ADVANCED DEGREES IN BUSINESS ADMINISTRATION

Category of Employee	Type of Firm	Size of Firm	Number of Respondent Firms	Distribution of Responses by Category (percent)					Average Response (percent)
				0-20%	21-40%	41-60%	61-80%	81-100%	
Account Manager	Fund Complex	Large	23	30.43	8.70	26.09	13.04	21.74	49.86
		Small	11	27.27	9.09	18.18	18.18	27.27	54.52
		Total	34	29.41	8.82	23.53	14.71	23.53	51.37
	Non-Fund Complex	Large	35	25.71	25.71	22.86	17.14	8.57	41.09
		Small	31	45.16	16.13	12.90	6.45	19.35	36.10
		Total	66	34.85	21.21	18.18	12.12	13.64	38.75
	Total Sample	Large	58	27.59	18.97	24.14	15.52	13.79	44.57
		Small	42	40.48	14.29	14.29	9.52	21.43	40.93
		Total	100	33.00	17.00	20.00	13.00	17.00	43.04
Investment Research Analysts (Security Analyst)	Fund Complex	Large	22	9.09	9.09	27.27	27.27	27.27	83.47
		Small	11	27.27	9.09	18.18	9.09	36.36	55.45
		Total	33	15.15	9.09	24.24	21.21	30.30	74.13
	Non-Fund Complex	Large	33	12.12	18.18	27.27	30.30	12.12	54.09
		Small	31	41.94	12.90	19.35	6.45	19.35	38.48
		Total	64	26.56	15.62	23.44	18.75	15.62	46.53
	Total Sample	Large	55	10.91	14.55	27.27	29.09	18.18	65.84
		Small	42	38.10	11.90	19.05	7.14	23.81	42.93
		Total	97	22.68	13.40	23.71	19.59	20.62	55.92

CATAGORIES OF AVAILABLE RESPONSES:

CATAGORY 1. VERY IMPORTANT, ALWAYS USED

CATEGORY 2. IMPORTANT, USED OFTEN BUT NOT ALWAYS

CATEGORY 3. SOMEWHAT IMPORTANT, USED SOMETIMES BUT NOT FREQUENTLY

CATEGORY 4. NOT IMPORTANT, USED ONLY INFREQUENTLY OR RARELY

CATEGORY 5. UNIMPORTANT, NEVER USED

TABLE IV-78

APPROACHES TO SECURITY EVALUATION - IMPORTANCE OF SPECIFIC ALTERNATIVES

Alternative	Type of Firm	Size of Firm	Number of Resp.	Distribution of Responses by Importance Category (%)					Average Response
				1	2	3	4	5	
Fundamental Approach	Fund Complex	Large	26	92.31	3.85	3.85	0.0	0.0	1.12
		Small	14	71.43	21.43	7.14	0.0	0.0	1.36
		Total	40	85.00	10.00	5.00	0.0	0.0	1.20
	Non-Fund Complex	Large	38	84.21	13.16	2.63	0.0	0.0	1.18
		Small	52	65.38	25.00	3.85	1.92	3.85	1.54
		Total	90	73.33	20.00	3.33	1.11	2.22	1.39
	Total Sample	Large	64	87.50	9.37	3.12	0.0	0.0	1.16
		Small	66	66.67	24.24	4.55	1.52	3.03	1.50
		Total	130	76.92	16.92	3.85	0.77	1.54	1.33
Technical Approach	Fund Complex	Large	26	7.69	11.54	38.46	42.31	0.0	3.15
		Small	14	14.29	35.71	28.57	21.43	0.0	2.57
		Total	40	10.00	20.00	35.00	35.00	0.0	2.95
	Non-Fund Complex	Large	38	0.0	15.79	26.32	47.37	10.53	3.53
		Small	52	21.15	11.54	30.77	17.31	19.23	3.02
		Total	90	12.22	13.33	28.89	30.00	15.56	3.23
	Total Sample	Large	64	3.12	14.06	31.25	45.31	6.25	3.37
		Small	66	19.70	16.67	30.30	18.18	15.15	2.92
		Total	130	11.54	15.38	30.77	31.54	10.77	3.15

TABLE IV-78
(continued)

APPROACHES TO SECURITY EVALUATION - IMPORTANCE OF SPECIFIC ALTERNATIVES

Alternative	Type of Firm	Size of Firm	Number of Resp.	Distribution of Responses by Importance Category (%)					Average Response
				1	2	3	4	5	
Economic Projection	Fund Complex	Large	25	24.00	64.00	12.00	0.0	0.0	1.88
		Small	14	28.57	28.57	28.57	14.29	0.0	2.29
		Total	39	25.64	51.28	17.95	5.13	0.0	2.03
	Non-Fund Complex	Large	38	26.32	55.26	15.79	2.63	0.0	1.95
		Small	51	27.45	33.33	23.53	7.84	7.84	2.35
		Total	89	26.97	42.70	20.22	5.62	4.49	2.18
	Total Sample	Large	63	25.40	58.73	14.29	1.59	0.0	1.92
		Small	65	27.69	32.31	24.62	9.23	6.15	2.34
		Total	128	26.56	45.31	19.53	5.47	3.12	2.13
Other Approaches	Fund Complex	Large	10	30.00	10.00	0.0	0.0	60.00	3.50
		Small	5	40.00	0.0	0.0	0.0	60.00	3.40
		Total	15	33.33	6.67	0.0	0.0	60.00	3.47
	Non-Fund Complex	Large	11	18.18	0.0	0.0	9.09	72.73	4.18
		Small	21	0.0	14.29	0.0	0.0	85.71	4.57
		Total	32	6.25	9.37	0.0	3.12	81.25	4.44
	Total Sample	Large	21	23.81	4.76	0.0	4.76	66.67	3.86
		Small	26	7.69	11.54	0.0	0.0	80.77	4.3[illegible]
		Total	47	14.89	8.51	0.0	2.13	74.47	4.13

CATEGORIES OF AVAILABLE RESPONSES:

CATEGORY 1. VERY IMPORTANT, ALWAYS USED

CATEGORY 2. IMPORTANT, USED OFTEN BUT NOT ALWAYS

CATEGORY 3. SOMEWHAT IMPORTANT, USED SOMETIMES BUT NOT FREQUENTLY

CATEGORY 4. NOT IMPORTANT, USED ONLY INFREQUENTLY OR RARELY

CATEGORY 5. UNIMPORTANT, NEVER USED

TABLE IV-79

IMPORTANCE OF SPECIFIC EXTERNAL INFORMATION SOURCES TO THE SECURITIES RESEARCH PROCESS

External Information Source	Type of Firm	Size of Firm	Number of Resp.	Distribution of Responses by Importance Category (%)					Average Response
				1	2	3	4	5	
Broker Dealers - Purchased Via Commission Dollars	Fund Complex	Large	26	7.69	53.85	23.08	3.85	11.54	2.58
		Small	14	7.14	35.71	7.14	7.14	42.86	3.43
		Total	40	7.50	47.50	17.50	5.00	22.50	2.87
	Non-Fund Complex	Large	38	10.53	34.21	15.79	10.53	28.95	3.13
		Small	50	2.00	18.00	16.00	10.00	54.00	3.96
		Total	88	5.68	25.00	15.91	10.23	43.18	3.60
	Total Sample	Large	64	9.37	42.19	18.75	7.81	21.88	2.91
		Small	64	3.12	21.88	14.06	9.37	51.56	3.84
		Total	128	6.25	32.03	16.41	8.59	36.72	3.37
Other Investment Advisers on a Continuing or Contractual Basis	Fund Complex	Large	26	3.85	7.69	15.38	19.23	53.85	4.12
		Small	14	7.14	7.14	28.57	7.14	50.00	3.86
		Total	40	5.00	7.50	20.00	15.00	52.50	4.02
	Non-Fund Complex	Large	38	2.63	5.26	23.68	21.05	47.37	4.05
		Small	51	9.80	1.96	15.69	17.65	54.90	4.06
		Total	89	6.74	3.37	19.10	19.10	51.69	4.06
	Total Sample	Large	64	3.12	6.25	20.31	20.31	50.00	4.08
		Small	65	9.23	3.08	18.46	15.38	53.85	4.02
		Total	129	6.20	4.65	19.38	17.83	51.94	4.05

TABLE IV-79
(Continued)

IMPORTANCE OF SPECIFIC EXTERNAL INFORMATION SOURCES TO THE SECURITIES RESEARCH PROCESS

External Information Source	Type of Firm	Size of Firm	Number of Resp.	Distribution of Responses by Importance Category (%)					Average Response
				1	2	3	4	5	
Research Organizations Not Included Above (With or Without Compensation)	Fund Complex	Large	26	0.0	7.69	38.46	34.62	19.23	3.65
		Small	14	14.29	35.71	28.57	7.14	14.29	2.71
		Total	40	5.00	17.50	35.00	25.00	17.50	3.32
	Non-Fund Complex	Large	38	0.0	26.32	23.68	36.84	13.16	3.37
		Small	50	14.00	34.00	22.00	12.00	18.00	2.86
		Total	88	7.95	30.68	22.73	22.73	15.91	3.08
	Total Sample	Large	64	0.0	18.75	29.69	35.94	15.62	3.48
		Small	64	14.06	34.38	23.44	10.94	17.19	2.83
		Total	128	7.03	26.56	26.56	23.44	16.41	3.16
Direct Contact With Security Issuers	Fund Complex	Large	26	46.15	34.62	11.54	3.85	3.85	1.85
		Small	14	0.0	57.14	7.14	21.43	14.29	2.93
		Total	40	30.00	42.50	10.00	10.00	7.50	2.22
	Non-Fund Complex	Large	38	26.32	31.58	21.05	15.79	5.26	2.42
		Small	51	9.80	21.57	21.57	21.57	25.49	3.31
		Total	89	16.85	25.84	21.35	19.10	16.85	2.93
	Total Sample	Large	64	34.38	32.81	17.19	10.94	4.69	2.19
		Small	65	7.69	29.23	18.46	21.54	23.08	3.23
		Total	129	20.93	31.01	17.83	16.28	13.95	2.71

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TABLE IV-79
(continued)

IMPORTANCE OF SPECIFIC EXTERNAL INFORMATION SOURCES TO THE SECURITIES RESEARCH PROCESS

External Information Source	Type of Firm	Size of Firm	Number of Resp.	Distribution of Responses by Importance Category (%)					Average Response
				1	2	3	4	5	
Financial Statements of Issuers	Fund Complex	Large	26	80.77	11.54	3.85	0.0	3.85	1.35
		Small	14	50.00	28.57	14.29	0.0	7.14	1.86
		Total	40	70.00	17.50	7.50	0.0	5.00	1.52
	Non-Fund Complex	Large	38	68.42	13.16	10.53	5.26	2.63	1.61
		Small	51	41.18	33.33	11.76	3.92	9.80	2.08
		Total	89	52.81	24.72	11.24	4.49	6.74	1.88
	Total Sample	Large	64	73.44	12.50	7.81	3.12	3.12	1.50
		Small	65	43.08	32.31	12.31	3.08	9.23	2.03
		Total	129	58.14	22.48	10.08	3.10	6.20	1.77
Other	Fund Complex	Large	8	12.50	25.00	0.0	0.0	62.50	3.75
		Small	4	0.0	0.0	0.0	0.0	100.00	5.00
		Total	12	8.33	16.67	0.0	0.0	75.00	4.17
	Non-Fund Complex	Large	15	13.33	20.00	6.67	6.67	53.33	3.67
		Small	27	18.52	11.11	11.11	3.70	55.56	3.67
		Total	42	16.67	14.29	9.52	4.76	54.76	3.67
	Total Sample	Large	23	13.04	21.74	4.35	4.35	56.52	3.70
		Small	31	16.13	9.68	9.68	3.23	61.29	3.84
		Total	54	14.81	14.81	7.41	3.70	59.26	3.78

TABLE IV-80

Functions for Which Computers are used in Advisory Firms

Type of Firm	Size of Firm	Number of Firms In I-65 Sample	Proportion of Firms Using a Computer %	Proportion of Users who Employ Computer for Tasks Specified (%)						
				Investment Research	Economic Research	Account Admin	Trading Admin	Sales Admin	General Admin	Other
Fund Complex	Large	27	89	41	33	63	52	52	59	15
	Small	14	57	14	7	43	29	36	43	0
	Total	41	78	32	24	56	44	46	54	10
Non Fund Complex	Large	38	87	39	21	74	34	21	42	13
	Small	52	44	13	6	27	15	13	25	10
	Total	90	62	24	12	47	23	17	32	11
Total Sample	Large	65	88	40	26	69	42	34	49	14
	Small	66	47	14	6	30	18	18	29	8
	Total	131	67	27	16	50	30	26	39	11

H. MANAGEMENT OF SPECULATIVE FUNDS

1. Introduction

The purpose of this section is to provide a description of the ways in which aggressive capital gain oriented funds are managed and to examine differences in the portfolio behavior of two groups of such funds: (1) registered open-end funds which indicated they would engage in certain speculative investment techniques ("registered speculative funds"), and (2) unregistered private investment partnerships ("hedge funds"). This section reviews the growth of the hedge funds and the registered speculative funds and compares the numbers of shareholders and limited partners, the average sizes of their holdings and the net capital inflows of both types of funds. It analyzes the aggregate assets and liabilities of each type of fund including their cash positions, borrowings and short sales. The aggregate common stock and convertible security holdings of each type of fund are classified by exchange listing, and the turnover and activity rates of their common stock portfolios are contrasted.

The extent to which the respective types of funds dealt in new issues during 1968 is reviewed and advisory fees and expenses of the two types of funds are examined. An attempt is made to determine what differences in the characteristics and operations of the two types of speculative funds can be attributed to differences in regulation, characteristics of investors and the size of the funds.

2. The Funds Sampled

The information contained in this section is derived from surveys of registered investment companies and unregistered investment partnerships conducted in 1969 by the Commission's Divisions of Corporate Regulation and Trading and Markets. The data obtained from the registered open-end investment companies cover calendar year 1968 and are based upon the responses of 43 such funds which, as of December 31, 1968, indicated that their policies included the use of one or more of the following investment techniques: (1) buying restricted securities; (2) selling securities short; (3) borrowing to purchase or carry securities; (4) purchasing or selling put and call options and (5) arbitraging.[105] The data obtained from the survey of unregistered private investment partnerships are based upon the statements provided by 140 such entities.[106]

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[105] Responses were requested from 44 funds, selected on the basis of a staff survey indicating that these were the only funds which indicated in their statements of policy that they could engage in one or more of the investment techniques. One fund was excused from responding. In addition, responses were obtained from six closed-end investment companies which indicated they would engage in one or more of the speculative investment techniques. However, this section omits the data submitted by these closed-end companies.

[106] The survey, conducted by the Division of Trading and Markets, was intended to assemble information about investment entities which depended to a significant extent upon the use of margin accounts, bank loans, short selling and the writing and buying of options. The survey was not confined to entities which engaged in this type of activity since information was not available to identify such investment partnerships. Originally 215 investment partnerships and similar entities were included in the survey. Of these, 75 were eliminated because they were inactive during 1968 or were entities such as private investment clubs, family partnerships and others.

Unless otherwise indicated the data contained in this section are as of December 31, 1968. On that date, the 43 registered speculative funds had total assets of almost $1.7 billion or approximately 3 percent of the estimated $58 billion invested in mutal funds, and were 7 percent of the 603 active open-end funds registered. The 140 hedge funds surveyed had total assets of $1.3 billion.

3. An Overview

The registered speculative funds were smaller and more recently registered than average mutual funds. The average size registered speculative fund was $39 million and the median size was $13.6 million, while the average size mutual fund was $96 million at December 31, 1968.[107] The average hedge fund was $9 million and the median size hedge fund was $2.7 million at December 31, 1968. The average age of the mutual fund which reported to the Study was 14 years as of September 30, 1969.[108] More than half of the registered speculative funds surveyed, 24, were registered in the years 1966–1968. More than half of the hedge funds, 78, were formed in 1968 alone.

The hedge funds had fewer participants (none had as many as 100), but they were generally persons of greater means than the shareholders of the registered speculative funds. The median number of shareholder accounts for the registered speculative funds was 3,250 and the average account size was $3,787. The average account size for members of the Investment Company Institute ("ICI") was $5,800 as of December. 31, 1968.[109] On that date the 28 largest hedge funds accounted for over 82 percent of the assets of all hedge funds. At the time of formation of those 28 hedge funds, the median capital contribution of their general partners was $100,000; for their limited partners, it was $149,000.

The median minimum purchase requirement for the 26 registered speculative funds which had such requirements was $500. For 14 of the 28 largest hedge funds, those which had a minimum requirement for new limited partners, the median was $250,000.

The 35 registered speculative funds in operation throughout 1968 enjoyed a huge net capital inflow during the year, 105 percent of their beginning of the year net assets. For all members of the ICI net capital inflow was just over five percent of beginning of the year net assets.[110] The net capital inflow of the 43 registered speculative funds accounted for 34 percent of the net capital inflow for all members of the ICI.[111] For the hedge funds during 1968 net capital inflow was 8.7

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[107] In the sample of 320 registered investment company accounts advised by 158 advisory firms reported in sec. B of this chapter, the average account size was $174 million at September 30, 1969.

[108] Sec. B. above.

[109] ICI, 1969 Mutual Fund Fact Book. At yearend 1968, the ICI represented 240 open-end investment companies, with total assets of almost $52.7 billion, or about 90 percent of the total assets of all open-end investment companies on that date. Throughout this section, data published by the ICI for all 240 members in the 1969 Mutual Fund Fact Book will be referred to.

[110] ICI, 1969 Mutual Fund Fact Book.

[111] ICI, 1969 Mutual Fund Fact Book.

percent of the beginning year assets of those hedge funds which were in operation throughout the year. Total hedge fund assets grew rapidly from $333 million at yearend 1966 for the 35 hedge funds organized in 1966 or earlier to $1.3 billion for 140 hedge funds at year end 1968.

The largest portion of the assets of members of the ICI, of the registered speculative funds and of the hedge funds was invested in common stocks as of December 31, 1968. However, the hedge funds and registered speculative funds had smaller portions of their portfolios invested in common stocks (61 percent of the hedge funds' and 74 percent of the registered speculative funds' portfolios) than did members of the ICI, who had 84 percent. Cash and cash items accounted for 6.1 percent of the total assets of ICI members, 8.8 percent of the registered speculative funds' and 9.5 percent of the hedge funds' total assets.

The relative total liabilities of the hedge funds (equal to 31.7 percent of total hedge funds assets) were about three times greater than the relative total liabilities of the registered speculative funds (10.8 percent of registered speculative funds total assets). Hedge fund borrowings were equal to 14.6 percent of their total assets, while borrowings were only 2.4 percent of the total assets of the registered speculative funds. Short selling played a significant role in the hedge funds' market strategy for 1968, but was of relatively minor importance for the registered speculative funds. Short positions accounted for 11.6 percent of the yearend total assets of hedge funds, but less than one percent of the registered speculative funds' total assets. The ratios of short sales to total sales of the hedge funds were 10 times as high a those of the registered speculative funds during the first two quarters of 1968.

Although New York Stock Exchange listed common stocks were the largest stockholdings of the hedge funds and the registered speculative funds, they accounted for less than half of the stock portfolios of each, 49.4 percent of the registered speculative funds' portfolios and 46.7 percent of the largest hedge funds'.[112] In contrast, NYSE listed stocks accounted for 92 percent of the common stock holdings of registered investment companies represented in Table IX–14, as of September 30, 1969.[113]

Over-the-counter ("OTC") stocks were the second largest of the common stock holdings of the registered speculative funds and of the hedge funds. Almost 29 percent of the registered speculative funds' common stock portfolios and 26.4 percent of the common stock portfolios of the largest hedge funds were OTC stocks. The registered speculative funds had 20 percent of their portfolios in American Stock Exchange ("Amex") listed stocks and the hedge funds had 25 percent as of December 31, 1968. In contrast, OTC common stocks accounted

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[112] Throughout this section the 28 largest hedge funds, with assets accounting for 82 percent of the assets of the hedge funds surveyed, will be referred to. However information on market listing was available for only 27 of the largest hedge funds.

[113] Table IX–14 also indicates that 96 percent of the common stock portfolios of all institutions were invested in NYSE listed stocks.

for 6.2 percent of the common stock portfolios of a sampling of 37 ICI members for the latter portion of 1970, and Amex listed stocks accounted for 5.7 percent of the portfolios of registered investment companies as of September 30, 1969, as indicated in Table IX–14.

The registered speculative funds engaged in a much greater proportion of trading in relation to their assets than did all members of the ICI and the hedge funds engaged in a greater proportion than did the registered speculative funds.

The 30 registered speculative funds which purchased new issues during 1968 participated in about 30 percent of the number of all 1968 new issues. These purchases of new issues were valued at almost $8 million at their initial offering price, or slightly less than 0.5 percent of the value of all new issues. The 82 hedge funds which purchased new issues participated in 64 percent of the number of 1968 new issues. The value of the hedge funds' new issue purchases amounted to $23 million or 1.2 percent of the value of all new issues. The registered speculative funds and the hedge funds combined received about 9.7 percent of the shares offered in the 15 new issues in which they were most highly concentrated in 1968. On the average the hedge funds received three shares for every two shares the registered speculative funds received of these 15 new issues.

For fiscal years ended during 1968 the registered speculative funds had significantly higher expense ratios and advisory fees than did all members of the ICI. The expense ratios of 34 of the registered speculative funds for 1968 were 1.16 percent of their 1968 average net assets on a weighted basis. Their 1968 advisory fees were 0.70 percent of their average net assets on a weighted basis. In contrast, the ICI claimed expense ratios of 0.46 percent of average net assets and advisory fees of 0.35 percent on a weighted basis in 1968 for a sample group representing 90 percent of the assets of its members.[114] The higher expense and advisory fee ratios of the registered speculative funds may be explained to a great degree by the higher percentage of performance fees among the registered speculative funds. Of the 35 registered speculative funds which comprised the sample, 51 percent had performance fee arrangements for 1969 while only 17 percent of the industry sample described in section D of this chapter had performance fee arrangements as of September 30, 1969. Of the 28 largest hedge funds, 23 compensated their general partners on the basis of a percentage of the fund's realized capital gains. Of these funds, 19 paid their managers 20 percent of net realized capital gains, operating profit or income.

By September 30, 1970, the total assets of the 28 hedge funds which were largest at December 31, 1968 were almost 70 percent less than at yearend 1968 and at least 5 of the 28, including the one which was

[114] But see, *1969 House Hearings* 874–877 for the Commission's criticism of these averages.

previously the largest, had either been dissolved or were in the process of liquidating. The net assets of the registered speculative funds were 40 percent less at June 30, 1970 than they were as of yearend 1968.

4. Size

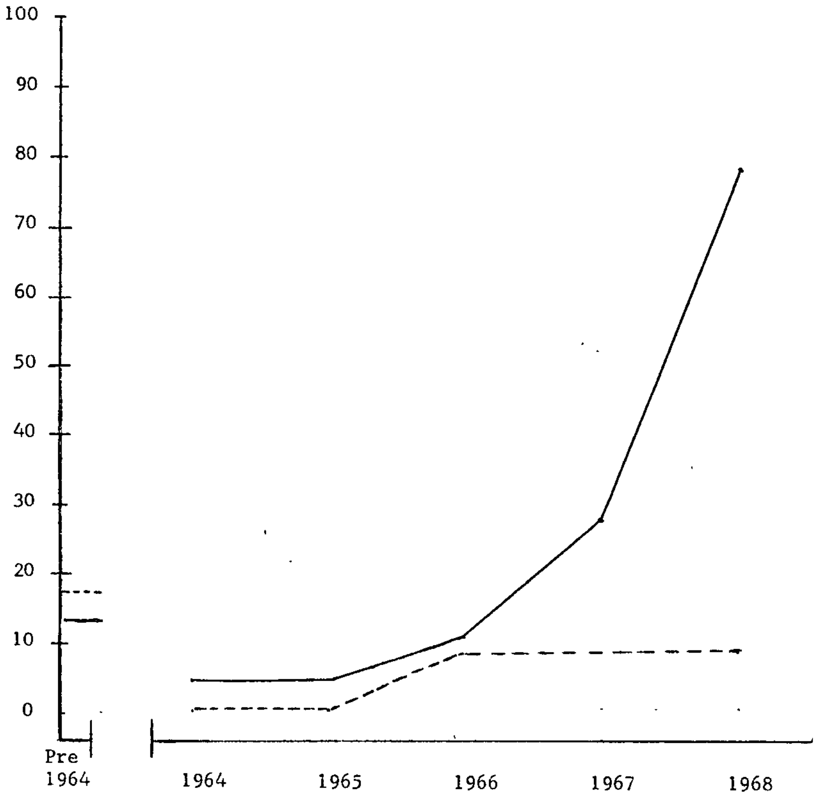
In general, the hedge funds were smaller than the registered speculative funds. Table IV-81 classifies the 43 registered speculative funds and 140 hedge funds into six sets by asset size and indicates the percentage which each set represents of the total number of hedge funds and of the total number of registered speculative funds and of the aggregate total assets of each type of fund as of December 31, 1968. Of the registered speculative funds surveyed, 15, or 35 percent, had assets of less than $5 million. In contrast 99, or 71 percent, of the hedge funds had assets of less than $5 million. The registered speculative funds ranged in size from $355,000 to $356 million in assets as of December 31, 1968. The median size of the registered speculative funds was $13.6 million, while the average size was $39 million. The hedge funds ranged in size from less than $50,000 in assets to $118 million. The median hedge fund size was $2.7 million and the average size was $9 million. The 28 largest hedge funds, those with assets in excess of $10 million at December 31, 1968, held 82 percent of the total assets of the 140 hedge funds included in the survey.

5. Year of Registration or Formation

Most of the funds studied were relatively new. Only 10 percent, 14 of the 140 investment partnerships active in 1968, had existed five years earlier. Of the registered speculative funds, 17, or 30 percent, were registered five years earlier. More than half of the hedge funds, 78, were formed during 1968, while more than half of the registered speculative funds, 24, were formed in the period 1966 through 1968.

Table IV-82 classifies the registered speculative and hedge funds surveyed by asset size and year of registration or formation. Although the oldest hedge fund surveyed was formed in January, 1949, it was not until the latter part of the 1960's that hedge funds began to proliferate. Table IV-82 indicates that 116 of the 140 hedge funds were formed in the years 1966-1968. The sharp contrast in the time pattern in the founding of the hedge funds and registered funds is demonstrated by Chart IV H-a. This contrast may be explained in part by the absence of any registration or minimum size requirements for the hedge funds. Differences in the rewards to the managers, normally the general partners, may also explain the increase in hedge funds.[115]

[115] See sec. H. 16 below.



6. Growth of Funds Assets

The growth in the numbers of registered speculative funds and hedge funds was accompanied by an increase in their asset size. The 35 hedge funds organized in 1966 or earlier had aggregate assets of $333 million at yearend 1966, $588 million at yearend 1967 and $830 million at yearend 1968.[116] Those hedge funds that had been in ex-

[116] Includes fiscal year rather than calendar year data for three funds and net assets rather than total asset values for two funds.

istence for several years grew through admission of new partners, additional investments by existing partners and market appreciation of their portfolios.

The registered speculative funds had net assets of $162 million or less than 0.5 percent of the $38.1 billion invested in mutual funds at the end of 1965. During the next three years, total assets of all mutual funds increased 53 percent, but total net assets of the funds which indicated that they would engage in speculative techniques grew more than 825 percent to almost $1.5 billion. During the three year period, three registered speculative funds accounted for a large portion of the growth, expanding from approximately $83 million at the beginning of the period to approximately $737 million at yearend 1968. A fourth fund jumped from just over $1 million in assets to over $100 million in the year 1968 alone.

The asset growth of the registered speculative funds reflected not only new cash inflows but also capital appreciation. Of the 22 registered funds with speculative investment policies which had made a public offering before 1967, 13 had per share appreciation of 50 percent or more. At yearend 1968, the 31 speculative funds in operation throughout the year showed an average appreciation for the year of more than 21 percent.

7. Registered Speculative Fund Shareholder Accounts and Minimum Purchase Requirements

At least 389,000 shareholder accounts, or almost 4.2 percent of the shareholder accounts of all ICI member funds were represented at December 31, 1968, by the 40 registered speculative funds for which such information was provided. The number of shareholder accounts per registered speculative fund ranged from as few as 100 in a $359,000 fund to almost 89,000 in a $278.3 million fund. The median number of shareholder accounts for the registered speculative funds was 3,250, while the average number of shareholder accounts per registered speculative fund was 9,722. In contrast, half of 308 registered investment companies surveyed had 10,000 or more shareholder accounts.[117]

Table IV–83 ranks the funds by size and indicates the number of shareholder accounts by fund size among the 40 registered speculative funds for which information was provided. It indicates that more than half of the registered speculative funds, 24 of 40, had less than 5,000 shareholder accounts and that 15 of these 24 had between 1,000 and 5,000 shareholder accounts. As might be expected, the largest funds tended to have the largest numbers of shareholder accounts, 13 funds with assets of $25 million or more each had 5,000 or more shareholder accounts. In the aggregate, the four largest registered funds had almost 220,000 shareholder accounts and together accounted for almost 57 percent of the 389,000 shareholder accounts of the registered funds which supplied information.

The average shareholder account size for the 40 registered speculative funds was $3,787. This compares with an average account size of $5,800 for all ICI members as of December 31, 1968. The median size

[117] See Table IV–26.

of shareholder accounts for each of the registered speculative funds at December 31, 1968, ranged from $692 per account to $27,200.

Of the 43 registered speculative funds surveyed, seven had no minimum dollar initial investment requirement. For the 26 which required minimum dollar investments, the average minimum dollar purchase requirement was $1,105 and the median was $500. A minimum share purchase requirement of from five to 100 shares was required by nine funds. For these funds the minimum investment requirement at December 31, 1968, ranged from $50 to $915. At the other end of the spectrum, the remaining fund, a so-called "swap fund", which issued its securities only in exchange for other securities, required an exchange of securities with a value of not less than $10,000. The highest minimum purchase requirement was $15,000.

8. Hedge Fund Partners and Their Capital Contributions

The typical hedge fund is organized as a limited partnership with one or more general partners who manage the fund and a much larger number of limited partners who do not participate in investment decisions. Of the 140 investment partnerships surveyed 127 were so constituted (93 with only one or two general partners).[118] In all, the 140 hedge funds had 482 general partners and 3,240 limited partners at December 31, 1968.

Table IV–84 indicates the distribution of limited partners among the 127 hedge funds set up as limited partnerships. It indicates that 73 of the 127 partnerships had 15 or more limited partners.[119] Although the number of limited partners varies greatly, all of the hedge funds had less than 100 participants since they would be required to register under the Investment Company Act if they were to exceed this number.[120] Generally there is a positive correlation between the assets of the partnership and the number of limited partners. Of the 27 largest typical private investment partnerships (those with assets of $10 million and over) only one had less than 15 limited partners, six had between 15 and 29 limited partners, 9 had between 30 and 49 limited partners, 9 had between 50 and 74 limited partners and two had between 75 and 99 limited partners.

Capital contributions to a hedge fund do not end with its formation. In all, 71 hedge funds reported a minimum initial investment

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[118] In 10 of the remaining 13, all participants were general partners. None of these had assets in excess of $1.5 million. The other three had only one limited partner and seven or eight general partners.

[119] Section 203(b)(3) of the Investment Advisers Act, 15 U.S.C. 80b–3(b)(3) (1964), excepts from the registration requirement of that Act any investment adviser who during the course of the preceding 12 months has had fewer than 15 clients and who does not hold himself out generally to the public as an investment adviser. The Investment Company Amendments Act of 1970 (P.L. 91–547) adds the requirement effective December 14, 1971 that to qualify for the exception from registration the investment adviser may not be an investment adviser to any investment company registered under the Investment Company Act.

[120] Section 3(c)(1) of the Investment Company Act excludes from the definition of Investment Company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities. See Securities Act Release No. 4552 (1962). Registration under the Investment Company Act may be required even if a partnership has less than 100 partners if some of the partners are not individuals but are joint accounts or other entities investing in the fund. In such case each participant could be counted separately. Registration could also be required if a public offering were made or more than one partnership is created whose memberships aggregate more than 100 persons and they are operated on a parallel or integrated basis. Only two of the hedge funds approached the 100 person maximum. One had 96 limited partners, three general partners and assets of $250,000, and the other had 95 limited partners, two general partners and assets of almost $5 million at year end 1968.

requirement for new limited partners.[121] Of these, 27 had assets of $5 million or more and all 27 reported a minimum requirement of $100,000 or more. The minimum amount of initial investment required by the 71 hedge funds which reported this information is shown in Table IV–85.

The 28 largest hedge funds (representing 82 percent of the assets of the hedge funds surveyed) received continuing contributions from both their general and limited partners from their formation through December 31, 1968. These contributions took the form of cash, securities, reinvestment of dividends and capital gains distributions or any combination of the three. Table IV–86 indicates the number of partners, the average capital contribution at time of formation and the minimum capital contribution for new limited partners for the 28 largest hedge funds as of December 31, 1968. The capital contribution of the limited partners of the 26 hedge funds which had limited partners at the time of their formation ranged from $1,000 to $800,000 and the median capital contribution at the time of their formation was $149,000. The general partners' average capital contribution at the time of formation ranged from $1 to $1,027,000 and the median of the average capital contributions of the general partners was $100,000.

Half of these 28 hedge funds required a minimum capital contribution for new limited partners. The minimums ranged from one fund with $100,000 to four funds with a $500,000 minimum contribution. The median value of the minimum capital contribution requirements for new limited partners of these 14 hedge funds was $250,000.

9. Capital Inflow

Of the 43 registered speculative funds, 35 were in operation throughout 1968. As indicated in Table IV–87 their total net cash inflow for the year was $538 million or 105 percent of their net assets at the beginning of the year.[122] For all members of the ICI 1968 net capital inflow was almost 5 percent of beginning of the year net assets.[123] The eight registered speculative funds which began operations during the year received $195 million in their initial offerings[124] and an additional $39 million during the year for a total of almost $234 million. The total net inflow of the eight new funds accounted for 30 percent of the total capital inflow of the 43 registered speculative funds and 18 percent of the year-end total net assets of this group. The $772 million total net inflow of the 43 registered speculative funds accounted for 34 percent of the net inflow of all members of the ICI for 1968.[125]

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[121] These hedge funds were requested to state whether any minimum amount was required as an initial investment by any new partners. Many funds were so new at the time they responded that they had not considered this question. Others stated they had no intention of admitting new partners.

[122] The registered speculative funds were not asked to report purchases and sales of their shares. However, estimates of their net cash inflow and initial capitalization were based upon information contained in their monthly balance sheets. Net cash inflow was estimated on the basis of the number of shares outstanding at the end of each month, and the average net asset value per share during each month with adjustments made for distributions. Reinvested income and capital gains distributions were not counted as capital inflow. The amount of capital contributed in a fund's initial public offering was equal to the first reported value of net assets for that fund.

[123] ICI, 1969 Mutual Fund Fact Book 13–19.

[124] Shares sold at initial offering price.

[125] ICI, 1969 Mutual Fund Fact Book 13–19. ICI figures include reinvested income distributions of $632 million as capital inflow.

As is indicated in Table IV-88 the monthly total net cash inflow for the 35 registered speculative funds in operation throughout 1968 ranged from $31 million to $64 million and the average monthly cash inflow for the group was $45 million, or 9 percent of net assets as of the beginning of the year. During the first half of 1968, net cash inflow averaged 7.5 percent of the net assets of the 35 registered speculative funds as of the beginning of each month; however, it declined to 4.8 percent during the second half of the year.

The correlation between net cash inflow and unadjusted performance may be examined in Table IV-89 which classifies the 35 registered speculative funds which operated throughout the year into seven groups of five funds each, according to their relative rates of return for 1968.[126] The funds in the group with the best rates of return over the year accounted for 27 percent of the total net inflow of all 35 registered speculative funds. The net cash inflow of the funds in the other performance groupings ranged from 13 percent to 119 percent of their beginning of the year net assets. However, the group with the best rates of return over the year had a net cash inflow which amounted to more than 46 times (4,606 percent) their beginning of the year net assets. The ratio of the 1968 net inflow to December 31, 1967 net assets for the five funds with the best 1968 performance was 39 times higher than the next highest ratio for the groups of registered speculative funds and affords dramatic evidence of the strong correlation between performance and sales of funds shares among the registered speculative funds.

Hedge funds may derive capital inflow from new partners, existing partners or both. Table IV-90 indicates that the average net additional capital inflow [127] per fund for the 28 largest hedge funds increased over the 3-year period, from $2.5 million in 1966, to $4.4 million in 1967 and $4.7 million in 1968. Their 1968 total net additional capital inflow of $113.4 million represented 10.7 percent of the 28 hedge funds' year-end total assets. The 23 hedge funds in this group which were in existence throughout the year had total net capital inflow of $78.2 million during 1968 [128] which was 8.7 percent of their total assets at the beginning of the year.

10. Assets

A comparison of the assets held by the 43 registered speculative funds, 129 hedge funds and all members of the ICI at yearend 1968 is contained in Table IV-91. It indicates a number of significant differences between the operation of the hedge funds and the registered speculative funds and between the speculative funds and the general fund population represented by ICI members.

The hedge funds used leverage to a much greater extent than the registered speculative funds. Liability items were equal to almost 30 percent of the total assets of the hedge funds as of December 31, 1968,

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[126] The rates of return discussed are not the volatility adjusted performance measures discussed in other parts of the Study, but simply represent the total return to stockholders during the interval.

[127] Partner contributions (cash, securities, and reinvestment of dividends and capital gains) less partner withdrawals.

[128] This figure represents the $113.4 million total net additional capital inflow for 1968, less $35.2 million attributable to the five hedge funds formed during that year.

while they equaled only about 11 percent of the assets of the registered speculative funds.[129] The net asset figure published by the ICI did not distinguish between total and net assets of its members.

Although the largest portion of the total assets of each of the three groups was invested in common stocks, the hedge funds held a significantly smaller portion of their assets, 61 percent, in common stocks than did the registered speculative funds, 74 percent. In contrast, the portfolios of ICI members as a group consisted of 84 percent common stocks.

Convertible preferred stocks accounted for 5.4 percent of the portfolios of the registered speculative funds and 6.7 percent of the hedge funds' portfolios. The data published by the ICI do not distinguish between convertible and non-convertible preferred stocks or between non-convertible and convertible bonds. However, a comparison of all senior securities indicates that ICI members' portfolios contained 9.7 percent senior securities, compared with 7.0 percent of the registered speculative funds' portfolios.

The hedge funds' portfolios contained 4.2 percent warrants while the registered speculative funds held half that percentage of warrants, 2.1 percent. For the industry as a whole warrants were a negligible item and were not separately stated in the aggregate data. The hedge funds held receivables for securities sold of 7.9 percent which was more than double the 2.9 percent receivable for securities sold held by the registered speculative funds. This is probably a reflection of the higher turnover rate of hedge funds, almost double that of the registered speculative funds.[130]

The "other assets", which comprise 4.9 percent of the portfolios of the registered speculative funds and 3.6 percent of the hedge funds portfolios, include dividends and interest receivable, accounts receivable for shares subscribed and proceeds from short sales and accounts receivable for securities sold where that item accounted for less than 10 percent of a respondent's total assets.

11. Cash Position

Both types of speculative funds consistently held relatively greater percentages of cash and cash items than did members of the ICI. At December 31, 1968, ICI members held cash and cash items of 6.1 percent of total assets. The hedge funds were 9.5 percent in cash and cash items and the registered speculative funds held 8.8 percent in cash and cash items.

Cash may be held for several reasons:

(1) as proceeds from fund shares sold but not yet invested;

(2) as proceeds from sales of portfolio securities not yet reinvested;

(3) as proceeds from dividends received on portfolio securities;

(4) for operations, such as maintaining minimum bank balances, payroll and other current liabilities;

(5) for distribution to stockholders;

(6) to meet redemptions; and

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[129] They also used other forms of leverage such as buying and selling puts and calls and investing in warrants. See Tabe IV-94.

[130] For a more complete discussion of turnover rates, see sec. H-14 on Common Stock Turnover and Activity Rates.

(7) as a portfolio strategy, to maintain a defensive position or for portfolio flexibility.

Table IV-92 compares the 1968 quarterly cash positions of the registered speculative funds and the hedge funds, classifying the funds by asset size. The higher percentage of cash held by the registered speculative funds and hedge funds, and all speculative funds as a group compared to the percentage of cash held by all ICI members, probably reflects the smaller size of the speculative funds, the need to meet current liabilities and the portfolio flexibility maintained by both the registered speculative funds and the hedge funds.

12. Liabilities

Table IV-93 reveals a number of significant contrasts between the percentages of liabilities to total assets of the registered speculative funds and the hedge funds as of December 31, 1968. One striking difference has already been indicated in the discussion of assets above, i.e., that the relative total liabilities of the hedge funds (equal to 31.7 percent of total assets) were about three times greater than the relative total liabilities of the registered speculative funds (which were equal to 10.8 percent of total assets).

Hedge funds borrowings were equal to 14.6 percent of total assets and 20 percent of net assets. These borrowings were composed of loans due to broker-dealers on margin of 4.5 percent of total assets,[131] loans payable to banks under Regulation U of 0.3 percent of total assets and other loans payable to banks of 9.8 percent of total assets. On the other hand, although 41 of the 43 registered funds were authorized to borrow from banks their loans outstanding amounted to only 2.4 percent of total assets as of December 31, 1968.

Another significant difference is that short positions were equal to 11.6 percent of the total assets of hedge funds but only 0.8 percent of the registered speculative funds' total assets. Thus short selling was a relatively important part of the portfolio strategy of the hedge funds during 1968, but was not significant for registered speculative funds as a group. The small short position of the registered speculative funds reflects, in part, a self-imposed limitation. Only 17 registered speculative funds indicated in their investment policies contained in their registration statements under the Investment Company Act that they would engage in such activity.[132] It also reflects the Commission staff's interpretation of Section 18 of the Investment Company Act which limits borrowings by investment companies.[133] The hedge funds, on

[131] The registered speculative funds had no loans payable to broker-dealers on margin. This is explained by the Commission staff's interpretation of the prohibition against borrowing by open-end investment companies contained in Section 18 of the Investment Company Act. Unless such borrowing is from a bank, the Commission staff's interpretation is that open-end companies may not establish a margin account with a broker for the purpose of effecting securities transactions on margin. [Investment Company Act Release No. 5633, (1969) p. 6.]

[132] Pursuant to Section 13(a) of the Investment Company Act, having indicated a fundamental policy with respect to short selling, a fund may not alter it without a vote of a majority of its outstanding voting securities.

[133] The staff regards a short sale (other than "against the box") as involving borrowing prohibited by Section 18 of the Act. However, the staff will not recommend any action for violation of Section 18 if the fund deposits and maintains collateral with the broker in the form of cash or government securities equal to the market value of the securities sold short. Both the proceeds and the collateral so deposited must each be equal to the value of the securities sold short so long as the short position is open, and the value of the collateral deposited against short sales, exclusive of proceeds, must not exceed 35 percent of the value of the fund's net assets. [Investment Company Act Release No. 5633, (1969) p. 6]

the other hand, were not under such restrictions. As indicated in Table IV-94, 25 of the largest hedge funds engaged in short-selling activities during 1968. The maximum month-end short positions of these 25 hedge funds were over 100 percent of their long positions in two instances, and ranged between 50 and 100 percent of the long position in 11 other instances.

Short selling, a tool for the sophisticated investor, is characterized by high risks. In an ordinary long position, the investor's risk is limited to 100 percent of his investment; in a short position, the investor's potential loss is unlimited. In general, there are three types of short sales:

(1) *Short sales for profit* are used when the seller expects the price of the security to decline in the future. The difference between the price at the time of the short sale and the price when the short position is covered determines the profitability of the transaction.

(2) *Short sales as a hedge* are used when the seller desires to protect his portfolio against the possibility of large losses due to market fluctuations. Such short sales would not be made for profit *per se*, but would be selected in conjunction with an analysis of all portfolio holdings in order to minimize the risk of market fluctuation.

(3) *Technical short sales* occur principally in two instances: when the seller goes short against the box, i.e., holds a long position at least equal to a short position in the same security or when the seller engages in any of several types of arbitrage transactions, e.g., purchasing convertible bonds and selling the common stock short.

In theory, the hedge fund concept relies upon combining short sales with leverage through borrowing to capitalize upon the ability to discriminate selectively between stocks. Successful hedging requires the selection of short positions in conjunction with long positions to minimize market risk. If price movements of the stocks are unrelated, a short sale in a stock with greater volatility would increase the risk of loss and the use of leverage would make such a portfolio even more speculative.[134]

To the extent that the short position of 11.6 percent of hedge fund total assets represented defensive hedging it would have tended to offset the 14.6 percent loans outstanding of the hedge funds and thereby to have diminished the market exposure of the hedge funds. To the extent that it represented short sales for profit it would have tended to increase the speculative characteristics of the hedge funds.

The various speculative investment techniques which the 43 open-end funds surveyed indicated they could engage in as of yearend 1968 are listed in Table IV-95. By far the most prevalent practice was bank borrowing. As indicated in the table, 41 of the 43 funds were authorized to borrow from banks. Short selling was the next most popular speculative technique, indicated by 17 funds. Buying and selling put

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[134] For example, if a hedge fund has $1,000,000 in assets and borrows $500,000, it may buy $750,000 worth of securities and sell an equal amount of securities short. If *all* or most of the securities decline then the profits on the short sales will offset losses on the long position—a classical "hedge". If, however, the securities purchased decline and those sold short go up the combination of unlimited loss potential on short sales and 150 percent loss on assets due to the leveraging effect of borrowing can be disastrous.

and call options was authorized by 12 funds. Hedging [135] and short term trading [136] were each authorized by 11 funds, while eight were authorized to invest on margin and six to write put and call options.

An indication that a fund could engage in a particular speculative practice did not necessarily indicate that it consistently followed that practice. For example, although 17 of the funds indicated that they could sell short, only six actually held non-technical short positions on October 8, 1968.[137] Similarly, while 12 funds indicated they could trade in options, only six actually purchased put and call options and then only on 55,800 shares. Although six registered speculative funds indicated they could write options, only two actually did so during 1968. The options they wrote covered 8,000 shares for which they received premiums totaling $59,362.

Table IV–93 indicates that the registered speculative funds had 58 percent of their total liabilities, which equalled 6.3 percent of total assets, under the item "Payable for Securities Purchased." Although securities purchased in "general accounts" familiar to investors must be paid for within five business days, investment companies customarily utilize "special cash accounts" to pay for their securities.[138] The payment requirement of a special cash account is ordinarily seven full business days. However, a broker is permitted to extend credit to a customer for up to 35 calendar days (or more, if proper authorities grant specific approval) when a broker executes an order in a special cash account "with the understanding that he is to deliver the security promptly to the customer, and the full cash payment by the customer is to be made promptly against such delivery." [139] During periods of heavy market activity it is not unusual for brokers not to receive and deliver securities, especially those which are heavily traded, to customers within seven business days. The 35 calendar days permitted by Regulation T may enable a fund with a high turnover rate to continually own a relatively large amount of securities for which it has not yet paid.

The net balance payable for securities purchased, for each quarter of 1968, for the registered speculative funds that reported such balances is shown in Table IV–96. It indicates, on an overall basis, the extent to which these funds were using the "float" or balance payable for securities purchased to own securities for which they had not paid. Deducting the amount receivable by funds for securities they had sold, the net balance payable for securities purchased exceeds 5 percent of net assets of all of the funds in the group for the last three quarters of 1968. Although the aggregate figures do not appear startling, in eight instances the balance payable for securities purchased exceeded 25 percent of the net assets of the fund, (and in one of the eight instances, it exceeded 50 percent) thus providing an important source of leverage for these registered speculative funds.

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[135] Hedging is defined for these purposes as the use of investment techniques, most commonly selling short, to protect the value of a portfolio in the event of a general decline in securities prices.

[136] The purchase and sale of a security within a six month period.

[137] This is a representative date for which the New York and American Stock Exchanges reported total short positions.

[138] The provisions governing special cash accounts are set forth in Reg. T, 12 CFR 220.4(c) ("Credit by Brokers and Dealers") issued by the Board of Governors of the Federal Reserve System pursuant to the Securities Exchange Act of 1934.

[139] 12 CFR 220.4(c)(5).

Such use of short term credits, either alone or in conjunction with borrowings, in some cases may have boosted the leverage employed by the registered speculative funds beyond the point envisioned in the Investment Company Act.[140]

13. Exchange Listings of Portfolio Securities

The exchange listings of the portfolio securities of the hedge funds and the registered speculative funds are relatively similar when compared to each other, although some differences exist. Table IV-97 sets forth the composition of the portfolios of the 43 registered speculative funds and 27 of the 28 largest hedge funds by market listing as of December 31, 1968. Their portfolios are divided into common stocks and convertible securities. As indicated by Table IV-97, NYSE listed stocks were the largest common stock holding of both groups, although less than half of the portfolios of both, 49.4 percent of the registered speculative funds' portfolios and 46.7 percent of the hedge funds'. The next largest holding of common stocks of the registered speculative and hedge funds was in OTC stocks, 29 percent of the registered speculative hedge funds' and 26 percent of the hedge funds'. Almost 25 percent of the common stock portfolios of the hedge funds and 20 percent of the common stock portfolios of the registered speculative funds were invested in Amex listed common stocks. These percentages should be viewed in the context of Table VIII-48, which indicates that about 75 percent of the value of all common stocks a year later (yearend 1969) was listed on the NYSE and almost 6 percent on the Amex.

A significant difference between the way the registered speculative funds and hedge funds were managed and the way other types of funds were managed is indicated by comparing the exchange listings of the stocks in the portfolios of the registered speculative funds and hedge funds with those of other investment companies and other accounts of investment company advisers, as shown in the distribution of institutional class portfolios in Table IX-14. That Table, which shows exchange listings for the portfolios of representative industry groups, includes the exchange listings of the portfolios of the registered investment companies and of the other accounts of the 72 investment advisers of the largest investment company complexes at September 30, 1969.[141] Table IX-14 indicates that 96 percent of the portfolios of all institutions, 92 percent of the portfolios of registered investment companies and 96 percent of the other accounts of the investment advisers represented were in NYSE listed stocks, almost double the holdings of NYSE listed common stocks for both the registered speculative funds and the hedge funds.[142]

The OTC holdings of the representative industry accounts included in Table 14 of Chapter IX were only 2.2 percent and 1.8 percent respectively—less than one-tenth of the 26.4 percent and 28.9 per-

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[140] Investment Company Act § 18(f), in effect, limits borrowings to 50 percent of net assets.

[141] The data contained in Table IX-14 were as of a date nine months later than the data contained in Table IV-97.

[142] The Amex listed stocks of the representative industry accounts were as follows as of September 30, 1969: all institutions 2.4 percent; registered investment companies 5.7 percent; and other accounts of investment advisers 2.3 percent.

cent of OTC common stocks held by the hedge funds and the registered speculative funds. The percentages of OTC common stocks held by the registered speculative funds and the hedge funds were also substantially in excess of the 6.2 percent of assets held in OTC common stock by a group of 37 investment companies of various sizes and investment objectives for dates between June 30 and November 4, 1970.[143] Similarly, the 25.3 percent holdings of OTC traded convertible securities by the registered speculative funds and the 21.6 percent holdings of such OTC traded securities by the hedge funds at December 31, 1968 substantially exceed the 6.5 percent of OTC traded bonds and preferred stocks held by the 37 funds in the ICI industry sample for the latter part of 1970.[144]

These marked differences in the exchange listings of the portfolios of the registered speculative funds, the hedge funds and the broader samples, are an indication of the extent to which the registered speculative funds and the hedge funds were investing in more volatile stocks.

14. Common Stock Turnover and Activity Rates

The active stock market of 1968 began with a steep decline during the first quarter, was followed by a sharp and pronounced recovery during the second quarter and subsequent smaller gains in each of the two remaining quarters. Table IV–98 indicates the common stock turnover and activity rates for registered speculative funds and hedge funds and ICI members by quarter during 1968.[145] It also shows the quarterly changes in the NYSE Composite Index and the quarterly purchases and sales, both long and short, for the funds.

The hedge funds were much more active than their registered counterparts. The quarterly turnover rates for the hedge funds' common stock portfolios averaged almost 95 percent during the first half of the year, while the comparable rate for the registered speculative funds was about 36 percent per quarter. In the second half of the year hedge funds had an average turnover rate of 65 percent per quarter while the registered speculative funds had an average turnover rate of 30 percent per quarter. These produced annual turnover rates for the registered speculative funds in the neighborhood of 143 percent and for the hedge funds of 317 percent.[146] The annual turnover rate for members of the ICI approached 45 percent.[147] Thus, the registered speculative funds engaged in substantially greater short-term trading than did ICI member funds in general and the hedge funds

[143] Source ICI. The 37 funds included in this sample had total assets of $20.7 billion.

[144] Source ICI. Sample includes convertible and non-convertible preferred stocks and bonds.

[145] Portfolio turnover is the lesser of purchases or sales divided by the average asset value of the securities concerned during the period in which the transaction occurred. "Activity rate" measures the market impact of all portfolio transactions and is defined as the average of purchases and sales divided by the same base used to compute turnover. Since this formula uses the average of purchases and sales, the activity rate will always be larger than the turnover rate.

[146] For 1969, the 17 hedge funds which submitted Form I–26 to the Study had an annual turnover rate of 393%. A similar 1969 turnover rate, 360% was indicated by seven offshore funds (three publicly and four privately offered) which submitted form I–26 to the Study.

[147] Similarly, the annual turnover rate for 1968 was 44 percent for a group of 18 registered closed-end investment companies which submitted Form I–26 to the Study.

engaged in substantially greater short-term trading than did the registered speculative funds.

The registered speculative funds showed their greatest portfolio activity in the rising market of the second quarter of 1968 and were least active in the fourth quarter and in the declining market of the first quarter. In contrast, the hedge funds' transactions were particularly heavy in both the first and second quarters, with activity rates exceeding 100 percent in both periods.

The short sales turnover and activity rates for the registered speculative funds were higher than the corresponding rates for the hedge funds in each quarter. However, the rates for the registered speculative funds were based on a significantly smaller volume of short sales. The short sale turnover rate for the registered speculative funds exceeded 100 percent in each quarter and was highest, 277 percent, in the first quarter. For the second and fourth quarters the short sale turnover rates of the hedge funds were approximately equivalent to their long sale turnover rates. On the other hand, the short sale turnover rates for the registered speculative funds far exceeded their long sale turnover rates.

The ratios of short sales to total sales for the hedge funds were 10 times as high as those for the registered speculative funds during the first two quarters of 1968 and ranged during the year from 41.6 percent to 17.5 percent per quarter compared to a range of 2.3 percent to 9.3 percent for the registered speculative funds.[148] This is evidence of the significant role that short selling played in the hedge funds' market strategy for 1968 and of the relatively minor importance of short selling to the registered speculative funds as a group.

15. Purchases of New Issues [149]

During 1968, 654 stock issues were offered to the general public by issuers registering their securities with the Commission for the first time. Most of these new issues were small offerings by companies with assets of less than $5 million. Gross proceeds realized from these offerings amounted to approximately $1.9 billion.

Of the 43 registered speculative funds, 30 purchased initial offerings during 1968. The 30 funds participated in over 200, or about 30 percent, of the initial offerings. Their purchases of new issues were valued at almost $8 million at the initial offering price, or slightly less than 0.5 percent of the value of all new issues. The $8 million worth of new issues was also equal to 0.06 percent of the 1968 year-end total assets of the 30 registered speculative funds which participated in the new issue market. This 0.06 percent does not differ markedly from the 0.04 percent to 0.05 percent of new issues to year-end total assets acquired by the funds in the 33 advisory complexes described in chapter XIV.

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[148] It is also interesting to note the contrast in the trends of short selling rates. While the resgistered speculative funds almost doubled their rates of short sales to total sales (from 4.7 percent to 9.3 percent) during the final quarter of 1968, the hedge funds cut their rate almost in half (from 30.4 percent to 17.5 percent).

[149] The definition of new issues differs from the one used in Chapter XIV.

Of the 134 hedge funds reporting this information, 82 purchased initial offerings of new common stock from registrants during 1968. The 82 hedge funds participated in 421, or 64 percent, of the number of initial offerings. The value of their purchases amounted to $23 million or 1.2 percent of the value of all new offerings in 1968 and represents 0.02 percent of these 82 hedge funds' yearend total assets.

In some instances the combination of the registered speculative funds and the hedge funds received a large portion of a given new issue. Table IV–99 ranks, by descending order of concentration, the percentage participation by the combined group in the 15 most highly concentrated issues. The registered speculative funds and the hedge funds combined received about 9.7 percent of the shares offered in the 15 most concentrated new issues.[150] The hedge funds received about 5.8 percent and the registered speculative funds about 3.8 percent[151] of these shares. Stated differently, of the 15 new issues most popular with the hedge funds and registered speculative funds during 1968, the hedge funds received, on average, three shares for every two shares the registered speculative funds received.

The largest percentage participation was 22 percent of one (100,000 share) new issue. In three of the other new issues the registered speculative funds and hedge funds combined received between 11.9 and 13.1 percent. The largest number of registered speculative funds which purchased a single new issue was four, while as many as 18 hedge funds purchased one of the new issues.

16. Expense and Advisory Ratios

The ratios of operating expenses and of advisory fees to average net assets for the registered speculative funds by size group for their fiscal years ended during 1968 and 1969 are set forth in Table IV–100. For 1968 the average expense ratio of the registered speculative funds was 1.16 percent of average net assets on a weighted basis. This expense ratio is significantly greater than the weighted expense speculative funds, 0.70 in 1968, was exactly dotuble that of the ICI funds representing 90 percent of the assets of its members in 1968.[152] Similarly, the weighted average advisory fee ratio of the registered speculative funds, 0.70 in 1968, was exactly double that of the ICI sample.

For fiscal years ended during 1969 the ratio of operating expenses to average net assets of the registered speculative funds declined to 0.94. To a large extent this decline resulted from the decline in the average advisory fees of the registered speculative funds to 0.46. The 1969 advisory fees of the registered speculative funds were much closer to those for the industry sample, 0.39, for the 320 funds shown in Table IV–43.

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[150] These figures are not weighted by value, but refer to numbers of shares purchased only. While the method used could have resulted in a bias in the event a large fraction of a large offering was purchased, in fact no such bias exists. The average percentage of shares acquired, 9.6 percent, in each of the 15 offerings does not differ substantially from the average of 9.7 percent shown in the text.

[151] Numbers do not add to total due to rounding.

[152] *1969 House Hearings* 429. But see, *id.* 874–877 for the Commission's criticism of these averages.

The differences between the 1969 advisory fees of the registered speculative funds and the industry sample are most likely attributable to the relatively smaller assets size of the registered speculative funds. The higher 1968 advisory fees for the registered speculative funds relative to fiscal years ended during 1969 and also relative to the industry sample of other funds for 1968 is traceable to the large proportion of performance fees among the registered speculative funds.

Of the 35 registered speculative funds included in Table IV–100, 51 percent paid performance fees while only 17 percent of the funds in the industry sample [153] reported performance fees for 1969. Such performance fees decreased substantially from 1968 to 1969. In 1968 the average advisory fee for the registered speculative funds which paid performance fees was 0.73 percent of average net assets (weighted); in 1969 this figure declined to 0.35 percent. In contrast, the average advisory fee (weighted) for the registered speculative funds which paid their advisers on a straight percentage of assets basis remained relatively constant, moving from 0.59 in 1968 to 0.61 in 1969.[154]

After deducting advisory fees from the expense ratios, the other expenses of the registered speculative funds are nevertheless considerably higher than those of the industry sample. On a weighted basis the other expenses in 1968 were 0.46 for the registered speculative funds (1.16 less 0.70) and 0.11 for industry sample. An examination of the income and expense statements of the registered speculative funds indicated that the higher ratio of their other expenses to average net assets was largely traceable to a combination of disproportionately higher legal and accounting fees (six funds), interest expenses (five funds), and bookkeeping and clerical expenses (two funds).

The expense ratios of the hedge funds were not reported on the same basis as the registered funds. Their advisory compensation can best be presented on a descriptive rather than a statistical basis.[155] The general partners are commonly the managers of the partnership portfolios. Of the 28 largest hedge funds, 23 compensated their managers on the basis of a percentage of the fund's realized capital gains. Of these funds, 19 utilized the figure 20 percent of net realized capital gains, operating profit, or income.[156] Only two partnerships based their

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[153] Table IV–45.

[154] On an unweighted basis a similar picture emerged. The mean advisory fee for the registered speculative funds which paid performance fees was 1.22 percent of average net assets in 1968 and 0.52 percent in 1969. For the registered speculative funds which paid their advisors on a straight percentage of assets basis the mean advisory fee declined from 0.58 percent of average net assets in 1968 to 0.49 percent in 1969.

[155] The partnership agreements generally provided for adjustments to the capital accounts of the general partners depending upon performance of the fund. "Compensation" may carry the unwanted connotation that general partners are akin to salaried employees of the fund. If payments to a general partner "for services" were not based upon the level of partnership income, then under Section 707(c) of the Internal Revenue Code, such payments would be ordinary income to the general partner. Conversely, where a payment is based on partnership income, it is taxed at capital gains rates to the extent that the sum was derived from the partnerships' sale of capital assets.

[156] In addition, five of these 19 funds expressly stated that the general partners also share in the remaining 80% of gains pro rata according to their invested capital.

There were some variations in this fee arrangement by those funds which compensated their partners on a percentage of capital gains basis. Four funds expressly stated that general partners were compensated on a percentage of both realized and unrealized capitals gains. Another of the funds permitted a management fee to its general partner only if, after past losses were repaid to all partners, the fund's capital earned more than 6%.

general partners' compensation on a percentage of the funds' net asset value. Two other funds compensated their managers on the basis of salary plus bonus. One fund compensated its managers on a straight salary basis.

17. Postscript

A survey of the 28 largest hedge funds, as of September 30, 1970, and of the 43 registered speculative funds as of June 30, 1970, found them significantly smaller. The assets of the hedge funds were 70 percent less than they were on December 31, 1968 and the number of their limited partners had declined by one-third. Some of these hedge funds had distributed portions of their assets, at least five, including the hedge fund which was previously the largest,[157] had either dissolved or were in the process of liquidating. Table IV-101 indicates the total assets of the 28 largest hedge funds as of December 31, 1968, and their total assets as of September 30, 1970, and shows the percentage decrease or increase (one fund) in the total assets of each fund over the period. It also sets forth the numbers of their general or limited partners on both dates.

The net assets of the 43 registered speculative funds on December 30, 1968 and June 30, 1970, are set forth in Table IV-102. The net assets of these registered speculative funds on June 30, 1970, were about 60 percent of their net assets on December 31, 1968. Only four of the 43 registered speculative funds showed an increase in assets during the one and one-half year period. The five largest registered speculative funds which had combined net assets of $862.6 million at December 31, 1968, had net assets of $532.7 million at June 30, 1970.

The decrease in the size of the registered speculative funds and hedge funds may be explained to an extent by dissolution, distributions and withdrawals. However, it may also be explained by different amounts of borrowings at the hedge funds and by decreases in general market values of securities during the period and the higher volatility of the registered speculative funds' and hedge funds' portfolios relative to the market. Regardless of the reasons, these funds had become substantially smaller.[158]

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[157] A liquidating distribution of approximately $98 million, representing approximately 95% of the fund's capital was distributed to the partners in early January, 1970.

[158] For a discussion of measures of volatility see sec. F.4 and the appendix to Sec. F.

TABLE IV-81

Distribution of Total Assets Among Hedge Funds and Registered Speculative Funds Surveyed as of December 31, 1968

Asset Size (million)	Hedge Funds 1/ Number	% of Total	Aggregate Assets Total $(000)	Aggregate Assets % of Total	Registered Speculative Funds Number	% of Total	Aggregate Assets Total $(000)	Aggregate Assets % of Total
Less than $1	49	35	18,873	1.5	2	5	714	0.0
$1 to $4.9	50	36	123,550	9.5	13	30	32,666	1.9
$5 to $9.9	13	9	90,052	7.0	2	5	18,354	1.0
$10 to $24.9	15	11	244,550	18.9	11	26	188,925	11.3
$25 to $99	10	7	478,470	37.0	10	23	493,633	29.4
$100 and over	3	2	338,439	26.1	5	11	944,499	56.3
	140	100	$1,293,934	100.0	43	100	$1,678,791	100.0

1/ Includes fiscal year rather than calendar year data for three funds.

TABLE IV-82
Classification of Registered Speculative Funds and
Hedge Funds by Asset Size, and Year of Formation or Registration under
the Investment Company Act of 1940

Total Assets As Of December 31, 1968 (million)	Before 1964		1964		1965		1966		1967		1968		TOTAL	
	R	H	R	H	R	H	R	H	R	H	R	H	R	H
Less than $1	0	3	0	0	0	0	0	2	1	8	1	36	2	49
$1 to $4.9	7	8	1*	1	0	2	2	1	2	8	1	30	13	50
$5 to $9.9	1*	0	0	1	0	0	0	3	0	2	1	7	2	13
$10 to $24.9	4*	0	0	2	0	0	3*	1	2	7	2	5	11	15
$25 to $99.9	2	0	0	1	1	3	2	4	2	2	3	0	10	10
$100 and over	3	3	0	0	0	0	1	0	1	0	0	0	5	3
	17	14	1	5	1	5	8	11	8	27	8	78	43	140

Year of Registration or Formation

R -- Registered Speculative Funds
H -- Hedge Funds
* -- Includes one registered fund which switched to a speculative investment policy during 1967 or 1968.

TABLE IV-83

Numbers of Shareholder Accounts Among
40 Registered Speculative Funds by Size of Fund
at December 31, 1968

	Number of Shareholder Accounts					
Total Assets (million)	less than 1,000	1,000-4,999	5,000-9,999	10,000-24,999	25,000-and over	Total Registered Speculative Funds
less than $1	2	0	0	0	0	2
$1 to $4.9	7	4	0	0	0	11
$5 to $9.9	0	2	0	0	0	2
$10 to $24.9	0	7	3	0	0	10
$25 to $99.9	0	2	5	3	0	10
$100 and over	0	0	0	1	4	5
	9	15	18	4	4	40

TABLE IV-84

Distribution of Limited Partners of Hedge Funds
By Asset Size as of December 31, 1968.[1]

Asset Size (million)	Number of Limited Partners: less than 15	15-29	30-49	50-74	75-99	All Funds
	(number of funds)					
Under 1.0	31	4	3	0	1	39
1.0 to 4.9	19	19	5	4	1	48
5.0 to 9.9	3	6	4	0	0	13
10.0 to 24.9	1	6	6	1	0	14
25.0 to 99.9	0	0	3	6	1	10
100 and over	0	0	0	2	1	3
Total	54	35	21	13	4	127

1/ Includes only those hedge funds with two or more limited partners.

TABLE IV-85

Minimum Initial Investments Required of Limited Partners
For 71 Hedge Funds By Asset Size
as of December 31, 1968

Minimum Initial Investment 1/ ($)	Asset Size ($millions) Under 1.0	1.0 - 4.9	5.0 and over	All Hedge Funds Reporting Minimum Investments
	(number of funds)			
5,000 or less	11	3	_	14
10,000 - 20,000	4	2	_	6
25,000 - 40,000	3	2	_	5
50,000	3	5	_	8
100,000 - 125,000	_	10	8	18
150,000 - 200,000	_	1	6	7
250,000	_	_	7	7
300,000	_	_	1	1
500,000	_	_	5	5
Total	21	23	27	71

1/ No instances were found other than within the classes indicated.

TABLE IV-86

YEAR OF FORMATION, ASSETS, NUMBER OF PARTNERS AND CAPITAL CONTRIBUTIONS OF 28 LARGEST INVESTMENT PARTNERSHIPS

Name of Partnership	Year of Formation	Total Assets 12/31/68 ($ mil)	No. of Partners On 12/31/68		Average Cap. Contribution by Partners at Time of Formation		Minimum Capital Contribution for New Limited Partners 1/ ($)
			General	Limited	General ($)	Limited ($)	
A	1956	118 3	1	85	100	15,000	--
B	1961	113 6	8	55	119,000	145,000	--
C	1949	106.6	8	70	20,000	2/	--
D	1964	89 6	5	77	112,000	101,000	500,000
E	1965	75 1	3	73	303,000	158,000	--
F	1965	63.1	5	69	371,000	208,000	300,000
G	1966	50.5	4	32	1	100,000	--
H	1967	47.3	3	47	213,000	153,000	250,000
I	1966	37.4	4	50	112,000	106,000	--
J	1967	33.5	3	46	47,000	366,000	200,000
K	1966	29.4	2	50	284,000	142,000	500,000
L	1966	26.7	1	67	2,000	1,000	200,000
M	1965	26.0	3	41	100	238,000	--
N	1967	23 9	3	62	46,000	74,000	200,000
O	1968	19.8	3	34	425,000	280,000	250,000
P	1968	19.4	2	31	100,000	318,000	--
Q	1967	19.0	3	27	246,000	381,000	500,000
R	1967	18.9	1	11	1,000,000	800,000	--
S	1968	18.2	1	24	50,000	141,000	100,000
T	1967	17.4	1	43	100,000	63,000	500,000
U	1968	14.8	2	25	250,000	342,000	250,000
V	1966	14.7	4	36	34,000	63,000	--
W	1964	14.5	5	36	25,000	33,000	--
X	1964	13.3	2	36	60,000	36,000	--
Y	1967	13.2	2	20	102,000	330,000	250,000
Z	1967	13 0	6	1	1,027,000	2/	--
AA	1967	12.5	2	27	36,000	212,000	--
BB	1968	12.1	1	26	10,000	317,000	200,000

1/ Where no figure is shown, either the partnership has no minimum capital requirement or it has not admitted new partners. Evidently, because of the appreciation in the value of the fund's net assets, some funds now require a larger minimum capital contribution than they did at the time of their inception

2/ Reported that they had no limited partners at the time of their formation.

TABLE IV-87

NET CASH INFLOWS[1/] OF THE REGISTERED SPECULATIVE FUNDS DURING 1968

	35 Funds in Operation Throughout 1968 $(000)	8 Funds Which Began Operation During 1968 $(000)	Total 43 Registered Speculative Funds $(000)
Net Assets December 31, 1967	511,853	--	511,853
Net Assets December 31, 1968	1,233,916	265,351	1,499,267
Capital Received in 1968 Initial Offerings	--	194,757	194,757
1968 Net Cash Inflows	538,513	38,857	577,370
Total New Capital Received 1968	538,513	233,614	772,127

1/ Estimated on a monthly basis by following formula:

Net Inflow for Month = {number of shares outstanding at end of month - number of shares outstanding at beginning of month} times (average net asset value per share in the month) minus (distributions paid during the month)

TABLE IV-88

Monthly Net Cash Inflow For
35 Registered Speculative Funds in Operation Throughout 1968

	Net Assets At Beginning of Month	($000) Net Cash Inflow	Net Cash Inflow as % of Assets at Beginning of Month	Net Cash Inflow as % of Assets at Beginning of Year
January	$ 511,853	$43,666	8.5%	8.5%
February	501,896	33,284	6.6	6.5
March	515,856	31,524	6.1	6.2
April	548,523	64,262	11.7	12.6
May	692,085	47,014	6.8	9.2
June	790,033	42,792	5.4	8.3
July	827,071	42,340	5.1	8.3
August	842,258	45,611	5.4	8.9
September	922,050	56,105	6.1	11.0
October	1,052,900	39,540	3.8	7.7
November	1,087,785	52,093	4.8	10.2
December	1,229,611	40,282	3.3	7.9
Monthly Average	$ 793,493	$44,876	5.7%	8.8%

Total Net Cash Inflow $538,513.

Total Net Cash Inflow as Percentage of Assets at Beginning of Year 105.2%.

TABLE IV-89

Net Cash Inflow by Performance
Ranking for 35 Registered Speculative Funds in Operation
Throughout 1968

Year-End Relative Unadjusted Performance Ranking of the 35 Registered Speculative Funds Operating Throughout 1968	Net Assets As of December 31, 1967 (000)	Net Inflow (000)	Net Inflow as a Percentage of Net Assets on December 31, 1967
top 5	3,217	$148,166	4605.7
second 5	293,787	263,530	89.7
third 5	39,704	5,114	12.9
fourth 5	45,420	20,407	44.9
fifth 5	84,951	58,622	69.0
sixth 5	34,889	41,434	118.8
seventh 5	9,885	1,240	12.5
	511,853	538,513	105.2

TABLE IV-90
NET ADDITIONAL CAPITAL INFLOW OF
28 LARGEST INVESTMENT PARTNERSHIPS

Hedge Fund	Year of Formation	Total Net Additional Capital Inflow* (Millions) 1966	1967	1968	Total Assets (Millions) As of Dec. 31, 1968	Percentage Additional Inflow to Assets As of Dec. 31, 1968
A	1964	$ 5.4	$ 9.5	$ (8.5)	$ 89.6	(9.5) %
B	1965	10.1	8.6	8.0	63.1	12.7
C	1967	---	4.4	5.0	47.3	10.6
D	1967	---	13.3	20.3	33.5	70.2
E	1966	5.1	7.5	.5	29.4	1.7
F	1966	---	4.4	16.5	26.7	61.8
G	1967	---	2.6	4.3	23.9	18.0
H	1968	---	---	7.0	19.8	35.4
I	1967	---	---	1.8	19.0	9.5
J	1968	---	---	5.8	18.2	31.9
K	1967				17.4	
L	1968	---	---	4.4	14.8	29.7
M	1967	---	.9	5.1	13.2	38.6
N	1968	---	---	8.3	12.1	68.6
O	1956	1.6	1.1	(7.1)	118.3	(6.0)
P	1961	(3.7)	(7.7)		113.6	
Q	1949	(1.6)	(5.8)		106.6	
R	1965	6.1	(1.0)	13.7	75.1	18.2
S	1966	1.0	10.0	13.6	50.5	26.9
T	1966				37.4	
U	1965	3.4	12.0	(7.5)	26.0	(28.9)
V	1968	---	---	9.7	19.4	50.0
W	1967	---	8.9	3.0	18.9	15.9
X	1966	.6	4.6	(.3)	14.7	(.2)
Y	1964	1.8	1.2	3.0	14.5	20.7
Z	1964	.7	4.4	2.5	13.3	18.8
AA	1967	---	---	4.6	13.0	35.4
BB	1967	---	---	(.3)	12.5	(2.4)
	Total	$ 30.5	$ 78.9	$113.4	$1,061.8	10.7 %
	Average	$ 2.5	$ 4.4	$ 4.7	$ 37.5	

* Cash, securities and reinvestment of dividends & capital gains.
Notes: (1) Blanks indicate incomplete information.
(2) Figures in parentheses indicate capital outflow exceeded inflow.

TABLE IV-91
Percentage Asset Comparison
as of December 31, 1968

	Registered Speculative Funds	Hedge Funds	ICI Members[c]
ASSETS			
Cash	8.8	9.5	6.1
Receivable Securities Sold	2.9	7.9	——
Common Stocks	74.3	61.2	84.3
Convertible Preferred	5.4[a]	6.7[a]	3.2[b]
Non-Convertible Preferred	1.6[a]	2.0[a]	——
Corporate Bonds	*	*	6.5
Warrants	2.1	4.2	——
Other Securities	.0	4.8	——
Other Assets	4.9	3.6	——
Total Assets	100.0	100.0	
Net Assets	89.2	70.5	
Liabilities	10.8	29.5	
Number of Respondents	43	129	
Total Assets $(000,000)	1,679	1,245	52,677

a/ Includes debt securities

b/ Includes non-convertible preferred stock.

* Included in entries for convertible preferred and non-convertible preferred.

c/ ICI members reported only cash, common stock, preferred stock, corporate bonds, and total net assets.

TABLE IV-92

Total Assets and Cash Position of Registered Speculative Funds, Hedge Funds and ICI Members Classified by Fund Asset Size 1/

Classified by Asset Size ($ millions)	1968															
	March 31				June 30				September 30				December 31			
	No. Funds	Total Assets	2/ Cash	Per-3/ cent	No. Funds	Total Assets	2/ Cash	Per-3/ cent	No. Funds	Total Assets	2/ Cash	Per-3/ cent	No. Funds	Total Assets	2/ Cash	Per-3/ Cent
Registered Funds	35	$591	$119	19.8	36	$1,024	$85	8.3	38	$1,289	$128	9.9	41	$1,653	$140	8.5
Less than 2.5	14	12	1	11.5	11	10	1	6.3	11	12	1	7.1	9	11	1	9.4
2.5-9.9	7	39	9	22.9	5	24	4	16.8	6	30	5	17.3	8	40	6	15.2
10.0-24.9	8	119	22	18.5	10	150	14	9.2*	8	139	12	8.8	9	163	7	4.3
25.0-49.9	4	136	15	11.1	66	224	8	3.5	6	219	11	5.1	6	242	15	6.3
50-0-99.9	0	---	---		2	172	20	11.7	5	368	75	20.4*	4	252	15	5.9
100.0 and over	2	285	70	24.4	2	444	39	8.7	2	520	24	4.6	5	944	96	10.1*
Hedge Funds	42	$695	$106	15.3	55	$860	$67	7.8	67	$993	$109	11.0	74	$1,007	$ 85	8.4
Less than 1.0	8	3		6.2	12	5	1	14.4	15	6	1	10.2	18	7	1	9.8
1.0-4.9	10	24	5	19.9	15	41	9	21.7	18	42	4	10.0	23	55	4	8.1
5.0-9.9	7	47	5	10.1	8	59	4	6.2	10	69	8	12.0	10	69	4	6.3
10.0-24.9	9	137	25	18.1	10	156	10	6.5	14	222	25	11.1	13	208	20	9.7
25.0 and over	8	484	72	14.8	10	599	44	7.3	10	655	71	10.9	10	668	55	8.2
All Speculative Funds	77	$1,286	$223	17.3	91	$1,884	$152	8.1	105	$2,282	$237	10.4	115	$2,660	$225	8.5
All Members of the ICI		$42,412	$3,919	9.2		$48,426	$3,272	6.8		$51,030	$3,747	7.3		$52,677	$3,187	6.1

* Includes one fund which experienced huge cash inflow.

1/ Quarterly comparability, i.e., each member of the population reported for the four consecutive months concerned.

2/ Includes U. S. Governments and short-term corporates.

3/ Cash as a percent of total assets computed before the amounts were rounded to millions of dollars.

TABLE IV-93

Liabilities of Registered Speculative Funds
and Hedge Funds
as of December 31, 1968
(stated as a percentage of total assets)

Liabilities	Registered Speculative Funds	Hedge Funds
Short positions	0.8	11.6
Loans payable to Broker-Dealer (margin)	none	4.5
Other loans payable to Broker-Dealer	0.8	none
Loans payable to Bank (secured under Regulation U)	0.8	0.3
Loans payable to Banks (good faith)	none	9.8
Loans payable to Banks (unsecured)	0.8	0.0
Loans due to others (secured)	0.0	none
Loans due to others (unsecured)	0.0	0.0
Other Liabilities	1.3	1.0
Payable for Securities Purchased	6.3	4.5
Total Liabilities	10.8	31.7
Number of Funds	43	74

TABLE IV-94
Use of Speculative Investment Techniques
By 28 Largest Hedge Funds
During the Year 1968

Name of Partnership	Maximum Month-End Short Position as % of Long Position 1/	Maximum Month-End Borrowings As % of Total Assets: From Banks	From Broker-Dealers 2/	Value of Put and Call Options Held as % of Common Stock Holdings 3/
A	30 1	39 6	--	--
B	54 6	4.2	12 4	0.8
C	23 8	8 3	--	1 2
D	7.6	5.5	0 8	--
E	72.1	11.9	13 6	--
F	84 4	17 1	--	-- 4/
G	117.1	14 5	9.6	1 2 5/
H	54 8	22 6	15 2	--
I	79 1	12 1	10.9	-- 4/
J	49.2	19 7	--	4 9
K	97.3	13.1	3.1	20.6 5/
L	14.7	15 0	31.7	4 5
M	38.4	2.0	3.9	0 4
N 6/	--	--	--	--
O	40.0	15 4	20 1	0 8
P	67.4	17 4	6.6	1 6
Q	70 5	17.2	10 8	0.1 5/
R	94.1	14 7	13 3	0.1
S	41.6	9 6	--	--
T	54.7	20 2	33 8	--
U	--	15 6	--	--
V	67.3	18.2	32 3	1 6 5/
W	-- 7/	22.7	10.9	0 2
X	27.4	29.1	6.0	--
Y	23.6	21.5	13 2	1.6 5/
Z	30.1	19.3	38 2	2.5
AA	127 9	4.8	24.2	--
BB	35.5	19.2	18.3	--

1/ Based on dollar value. Different months are included for different funds.
2/ Margin accounts.
3/ Maximum value of options held at the end of any calendar quarter compared with common stock holdings at the end of the same quarter. Value of options based on premium paid.
4/ Less than 0 05 percent.
5/ Partnership also wrote options during the year
6/ Partnership was formed in November 1968.
7/ Long position not available for month of maximum short position.

TABLE IV-95

REGISTERED SPECULATIVE FUNDS WHICH INDICATED THEY COULD ENGAGE IN INVESTMENT ACTIVITIES INVOLVING SPECIAL RISKS

Name of Investment Company	Total Assets Dec. 31, 1968 ($000,000)	Borrow from Banks	Purchase Securities on Margin	Sell Short	Hedge 1/	Short-term Trading 2/	Write Put & Call Options	Buy & Sell Put & Call Options of Others
Allen, Leon B. Fund, Inc.	3.2	X						
Berstein-Macaulay Special Fund	4.7					X	X	X
Blair Fund, Inc. (The)	10.3	X	X	X	X		X	X
Chase Frontier Fund, Inc.	59.2	X						
Dilewood Fund, Inc	.4	X				X		X
Doll Fund, Inc.	.4	X		X	X			
Emerging Securities Fund	13.6	X	X	X				
Fairfield Fund, Inc.	103.3	X				X		
First Mutual Fund of Rhode Island	1.6	X						X
Gibraltar Growth Fund, Inc. (The)	58.0	X						
Greenfield, Samuel Fund, Inc.	1.4							X
Hanover Fund (The)	3.1	X	X	X	X	X	X	X
Hartwell & Campbell Fund, Inc.	43.8	X						
Hartwell & Campbell Leverage Fund, Inc	72.6	X	X	X	X	X		X
Hedge Fund of America, Inc.	105.3	X	X	X	X	X		
Heritage Fund, Inc. (The)	3.3	X	X	X	X	X		
Hubshman Fund, Inc.	13.8	X		X	X	X		X
Imperial Growth Fund, Inc.	18.0	X		X				
Industries Exchange Fund, Inc.	19.0	X				X		
Investment/Indicators Fund	4.9	X						
Investors Research Fund, Inc.	8.8	X						
Josten Growth Fund, Inc.	1.6	X						
Ling Fund, Inc.	9.5	X	X	X	X			X
Mates Investment Fund, Inc.	22.5	X						
Naess & Thomas Special Fund, Inc.	24.5	X		X				
Neuwirth Fund, Inc.	101.9	X						
Northeast Investors Trust	37.2	X						
Olympus Fund	3.0	X						
O'Neil Fund	62.1	X						
Oppenheimer Fund, Inc.	278.3	X		X				
Pennsylvania Mutual Fund, Inc.	19.0	X					X	
Pilot Fund, Inc.	47.4	X						
Republic Technology Fund, Inc.	39.8	X				X		X
Revere Fund, Inc.	22.7	X		X	X			
Samson Fund, Inc.	1.6	X		X			X	
Securities Fund, Inc. (Hedburg & Gordon Fund, Inc.)	13.2	X						
Shiff Hedge Fund, Inc.	1.1	X		X	X	X		X
Sigma Capital Shares	28.7	X						
TMR Appreciation Fund, Inc.	44.9	X						
Tower Fund, Inc. (The)	12.3	X		X			X	X
Value Line Special Situations Fund, Inc. (The)	355.7	X						
Whipple, Clarence M. Fund (The)	1.1	X	X	X	X			
Worth Fund, Inc.	2.1	X						
	1,678.9	41	8	17	11	11	6	12

1/ The use of investment techniques, most commonly selling short, to protect the value of a portfolio in the event of a general decline in securities prices.

2/ The purchase and sale of a security within a six month period.

TABLE IV-96

Registered Speculative Investment Companies
Net Amount Payable Quarterly for Securities Purchased

$(000,000)

	3-31-68	6-30-68	9-31-68	12-31-68
Receivable for Securities Sold	18	21	35	48
Payable for Securities Purchased	23	59	91	105
Balance Payable for Securities Purchased	5	38	56	57
Net Assets	370	648	911	1109
Balance as a Percentage of Net Assets	1.4%	5.9%	6.1%	5.1%
Number of Funds Reporting	20	23	26	28

TABLE IV-97

Composition of Portfolios
of 43 Registered Speculative Funds and 27 Hedge Funds
by Market Listing as of December 31, 1968

Exchange Listing	Registered Funds $(000,000)	Registered Funds Percentage of Total	Hedge Funds $(000,000)	Hedge Funds Percentage of Total
Common Stocks				
NYSE	656	49.4	302	46.7
Amex	265	20.0	159	24.6
Regional Exchange	13	1.0	2	.3
OTC	384	28.9	171	26.4
Not Publicly Traded	9	.7	13	2.0
TOTAL	$1327	100.0	$647	100.0
Convertible Securities				
NYSE	28	30.7	21	26.8
Amex	30	33.0	24	29.9
Regional Exchanges	—	—	—	—
OTC	23	25.3	17	21.6
Not Publicly Traded	10	11.0	17	21.7
TOTAL	$91	100.0	$79	100.0

TABLE IV-98
Common Stock Turnover and Activity Rates for Registered Speculative Funds, Hedge Funds and ICI Members 1/

(1968 Quarterly and Annual Rates)

	Registered Speculative Funds					Hedge Funds				
Common Stock Ratios	Jan.-March	April-June	July-Sept.	Oct.-Dec.	Year	Jan.-March	April-June	July-Sept.	Oct.-Dec.	Year
(percentage)										
Long										
Purchases/Sales	107.2	190.0	129.8	170.9	139.6	107.5	126.2	91.9	115.3	110.7
Turnover Rate 2/	33.6	39.4	35.8	25.6	143.2	97.7	90.8	67.6	63.6	316.7
Activity Rate 3/	34.8	52.2	41.3	34.7	171.5	101.4	102.8	70.5	68 5	333.3
ICI Members										
Turnover Rate	9.3	11.8	11.3	12.8	44.7					
Activity Rate	9.7	13.1	11.4	13.9	46.6					
Short										
Sales/Total Sales	4.1	2.3	4.7	9.3	4.5	41.6	25.2	30.4	17.5	29.6
Turnover Rate 4/	277.5	148.8	106.3	185.0	712.3	133.8	92.0	104.1	63.0	458.1
Activity Rate 3/	346.5	186.1	153.0	187.2	747.2	150.4	119.6	111.9	76.8	474.1
Common Stock Transactions	(dollars in millions)					(dollars in millions)				
					Sum of Quarters					Sum of Quarters
Long										
Purchases	149	477	397	485	1508	401	554	376	451	1,772
Sales	139	251	306	284	1080	373	431	409	391	1,604
Net	10	226	91	201	528	28	113	(33)	60	168
Long Position	390	784	940	1;232	3,346	325	549	594	637	2,105
Short										
Sales	4	9	8	30	51	266	145	179	83	673
Purchases to Cover	6	6	15	29	56	213	232	156	119	720
Net Short	2	(3)	7	(1)	5	53	(87)	23	(36)	(47)
Short Position	2	4	11	12	29	184	134	162	117	597
NYSE Composite Index	(7.0)	12.0	2.9	2.1		(7.0)	12.0	2.9	2.1	
Number of Funds	35	36	38	41		42	55	67	74	

1/ Quarterly comparability, i.e. each member of the population reported for the four consecutive months concerned.
2/ Lesser of purchases or sales divided by the average market value of the respective common stock position during the period.
3/ Average of purchases plus sales divided by the same base as in footnotes (2) and (4)
4/ Lesser of purchases or sales divided by the average dollar amount of the short position.

TABLE IV-99

ALLOCATION OF 15 INITIAL STOCK OFFERING TO REGISTERED SPECULATIVE FUNDS AND HEDGE FUNDS IN 1968

(Ranked By Total Percentage of Participation by Both Groups of Funds Combined)

Issuer	Total Shares Offered	Shares Bought By Funds	TOTAL Percent of Fund Participation	Number of Funds Buying	HEDGE FUNDS Shares Bought	Percent of Participation	Number of Funds Buying	REGISTERED SPECULATIVE FUNDS Shares Bought	Percent of Participation	Number of Funds Buying
A	100,000	22,000	22.0	1	--	--	--	22,000	22.0	1
B	137,500	18,000	13.1	10	10,300	7.5	8	7,700	5.6	2
C	700,000	91,000	13.0	6	90,850	13.0	6	---	--	-
D	345,000	41,050	11.9	8	25,550	7.4	6	15,500	4.5	2
F	200,000	18,300	9.2	10	16,400	8.2	8	1,900	1.0	2
G	225,000	19,320	8.6	10	9,820	4.4	6	9,500	4.2	4
H	562,500	48,050	8.6	7	11,700	2.1	5	36,350	6.5	2
I	400,000	31,600	7.9	4	2,000	0.5	1	29,600	7.4	3
J	100,000	7,700	7.7	6	7,700	7.7	6	---	--	-
K	220,000	16,600	7.6	9	4,860	2.2	6	11,800	5.4	3
L	150,000	11,200	7.5	4	5,200	3.5	2	6,000	4.0	2
M	257,142	19,015	7.4	21	13,790	5.4	18	5,225	2.0	3
N	100,000	6,750	6.8	3	6,750	6.8	3	---	--	-
O	296,000	20,100	6.8	2	20,100	6.8	2	---	--	-
P	100,000	6,200	6.2	2	2,200	2.2	1	4,000	4.0	1
	3,893,142	376,885	avg. 9.6	103	227,220	avg. 5.2	78	149,575	avg. 4.4	25

The Percentage of combined registered speculative fund and hedge fund participation was 9.7% of the number of shar offered. The Percentage of hedge fund participation was 5.8 % of the number of shares offered.
The Percentage of registered speculative fund participation was 3.8% of the number of shares offered.

TABLE IV-100
Registered Speculative Funds
Operating Expenses and Advisory Fees as A
Percentage of Average Net Assets

NET ASSETS ($000,000)	For Fiscal Years Ended During 1968: No. of Funds	1968 Operating Expenses: Weighted Average	1968 Operating Expenses: Unweighted Average	1968 Advisory Fees: Weighted Average	1968 Advisory Fees: Unweighted Average	For Fiscal Years Ended During 1969: No. of Funds	1969 Operating Expenses: Weighted Average	1969 Operating Expenses: Unweighted Average	1969 Advisory Fees: Weighted Average	1969 Advisory Fees: Unweighted Average
100.0 and over	2	0.95	0.94	0.71	0.70	2	0.74	0.73	0.52	0.45
50.0 - 99.9	1	1.47	1.47	0.67	0.67	4	0.92	1.02	0.43	0.43
25.0 - 49.9	8 1/	1.02	1.03	0.61	0.64	7 1/	0.79	0.80	0.43	0.43
10.0 - 24.9	6	1.39	1.26	0.76	0.67	8	1.85	1.77	0.39	0.39
2.5 - 9.9	6	3.39	3.21	1.21	1.22	6	1.59	1.59	0.65	0.63
less than 2.5	11	2.20	3.48	0.75	1.20	8	1.49	2.24	0.59	0.69
Total	34 1/	1.16	2.26	0.70	0.94	35 1/	0.94	1.51	0.46	0.50
ICI Members 2/		0.46		0.35						
87 Funds With June 30, 1968 Net Assets of $100 Million and Over 3/			0.61		0.47					
320 Investment Companies Advised by 86 Advisory Firms 4/									0.39	0.45

1/ Includes one fund which reported operating expenses but which did not report advisory fees.
2/ As reported by the ICI in Hearings Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 1st Sess., Ser. No. 91-33, pt 1, at 429 (1969). but see, id. pt. 2 at 874-880.
3/ For fiscal years ended July 1, 1967 to June 30, 1968, reported in 1969 House Hearings cited in footnote 2 above at 879-880.
4/ Source: Forms N-1R filed for fiscal years ended during 1968 and 1969, except as otherwise indicated.

TABLE IV-101
TOTAL ASSETS AND NUMBER OF PARTNERS OF 28 LARGEST HEDGE FUNDS
AT DECEMBER 31, 1968 AND SEPTEMBER 30, 1970

Hedge Funds' Assets and Partners 1/

	Total Assets As of Dec. 31, 1968 ($ mil.)	Total Assets As of Sept. 30, 1970 ($ mil.)	Percentage Change 10/	General Partners Dec. 31 1968	General Partners Sept. 30 1970	Limited Partners Dec. 31 1968	Limited Partners Sept. 30 1970
A 2/	118.3	5.4	(95.4)	1	1	85	85
B	113.6	12.5	(89.0)	8	7	55	30
C	106.6	18.2	(82.9)	8	7	70	46
D	89.6	20.0	(77.7)	5	3	77	39
E	75.1	15.0	(80.0)	3	4	73	73
F	63.1	27.6	(56.3)	5	5	69	50
G	50.5	23.0	(54.5)	4	3	32	27
H	47.3	49.7	5.1	3	3	47	50
I	37.4	12.5	(66.6)	4	4	50	41
J	33.5	33.1	(1.2)	3	3	46	50
K	29.4	8.0	(72.8)	2	3	50	35
L 3/	26.7		(100.0)	1		67	
M	26.0	5.9	(77.3)	3	3	41	22
N 4/	23.9		(100.0)	3		62	
O	19.8	5.3	(73.2)	3	4	34	36
P 5/	19.4	6.7	(66.5)	2	0 5/	31	12 5/
Q	19.0	12.1 6/	(36.3)	3	3	27	26
R	18.9	11.7	(38.1)	1	1	11	17
S	18.2	6.5	(64.3)	1	1	24	26
T	17.4	1.0	(94.3)	1	1	43	12
U	14.8	10.5	(29.1)	2	2	25	22
V	14.7	1.0 7/	(93.2)	4	3	36	21
W	14.5	1.9	(86.9)	5		36	18 8/
X 8/	13.3	1.7	(87.2)	2		36	22 8/
Y 8/	13.2	11.3	(14.4)	2	2	20	18
Z	13.0	7.8	(40.0)	6	5	1	1
AA 9/	12.5		(100.0)	2		27	
BB	12.1	6.0	(50.4)	1	1	26	16
Totals	1,061.8	314.4	(70.4)	88	69	1,201	795

1/ Many of the figures are approximate because the partnerships do not have monthly trial balances.

2/ Dissoved 12/31/69 - Distributed approximately $98 million or about 95% of partnership capital in January 1970.

3/ Could not be located.

4/ Dissolved 12/31/69.

5/ Last General Partner died 9/25/70 - in process of liquidation.

6/ Figures are for Aug. 31, 1970.

7/ Figures are approximate due to problems of valuation of letter stock.

8/ Partnerships have become corporations Numbers shown refer to shareholders.

9/ Dissolved 9/30/70.

10/ "Percentage Change" should not be construed as investment performance, it also includes dissolutions, withdrawals and different borrowings.

TABLE IV-102

CHANGES IN THE ASSETS OF THE REGISTERED SPECULATIVE FUNDS (DECEMBER 31, 1968 TO JUNE 30, 1970)

Name of Investment Company	Net Assets 12/31/68 ($000,000)	Net Assets 6/30/70 ($000,000)	Percent Change
Allen, Leon B. Fund, Inc.	3.2	2.1	(34.4)
Berstein-Macaulay Special Fund	4.2	2.5	(40.5)
Blair Fund, Inc. (The)	7.6	11.5	51.3
Chase Frontier Fund, Inc.	53.8	22.6	(58.0)
Dikewood Fund, Inc.	.4	.3	(25.0)
Doll Fund, Inc.	.3	.3	NONE
Emerging Securities Fund	13.6	5.4	(60.3)
Fairfield Fund, Inc.	90.1	39.0	(56.7)
First Mutual Fund of Rhode Island	1.4	.7	(50.0)
Gibraltar Growth Fund, Inc. (The)	51.4	34.9	(32.1)
Greenfield, Samuel Fund, Inc.	1.3	1.1	(15.4)
Hanover Fund (F-D Capital Fund)	3.0	1.2	(60.0)
Hartwell & Campbell Fund, Inc.	38.5	11.5	(70.1)
Hartwell & Campbell Leverage Fd, Inc.	60.4	21.4	(64.6)
Hedge Fund of America, Inc.	79.1	33.7	(57.4)
Heritage Fund, Inc. (The)	1.0 1/	1.6	37.5
Hubshman Fund, Inc.	3.8 1/	1.9	(50.0)
Imperial Growth Fund, Inc.	18.0	13.6	(24.4)
Industries Exchange Fund, Inc.	18.8	8.3	(55.9)
Investment/Indicators Fund	3.6	7.3	102.8
Investors Research Fund, Inc.	6.8	4.4	(35.3)
Josten Growth Fund, Inc.	1.6	2.3	43.8
Ling Fund, Inc.	6.5	1.5	(76.9)
Mates Investment Fund, Inc.	15.8	6.1	(61.4)
Naess & Thomas Special Fund, Inc.	22.3	12.8	(42.6)
Neuwirth Fund, Inc.	94.5	43.0	(54.5)
Northeast Investors Trust	35.5	34.9	(1.7)
Olympus Fund	1.0	.5	(50.0)
O'Neil Fund	49.7 2/	14.9	(70.0)
Oppenheimer Fund, Inc.	262.7	279.1	6.2
Pennsylvania Mutual Fund, Inc.	14.7	10.3	(29.9)
Pilot Fund, Inc.	44.7	33.7	(24.6)
Republic Technology Fund, Inc.	33.0	16.3	(50.6)
Revere Fund, Inc.	22.1	13.0	(41.2)
Samson Fund, Inc.	1.4	.4	(71.4)
Securities Fund, Inc. (Hedberg & Gordon Fund, Inc.)	12.0 3/	10.6	(11.7)
Shiff Hedge Fund, Inc. (Integrated Growth Fund, Inc.)	.7	.6	(14.3)
Sigma Capital Shares	27.8	24.3	(12.6)
TMR Appreciation Fund, Inc.	40.0	15.2	(62.0)
Tower Fund, Inc. (The)	11.0	4.4	(60.0)
Value Line Special Situations Fund, Inc. (The)	336.2	136.7	(59.3)
Whipple, Clarence M. Fund (The)	1.0	1.2	20.0
Worth Fund, Inc.	1.8	1.2	(33.3)
Total	1,496.3	888.3	(40.6)

1/ As of June 30, 1968.

2/ As of November 30, 1968.

3/ As of October 31, 1968.