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## Star Creation: The Incubation of Mutual Funds

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# Star Creation: The Incubation of Mutual Funds

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Alan R. Palmiter  
Ahmed E. Taha

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*Mutual fund incubation is a process by which new funds are initially operated out of public view. The high-performing funds are then marketed to investors, and the low-performing funds are quietly terminated. This selection process is not revealed to investors, thus creating the illusion that the successful funds' returns were the result of skill rather than luck. Also, some fund companies subsidize their incubator funds in ways that do not continue after the funds are sold to the public. As a result, the high returns of successful incubator funds generally do not persist after the funds are marketed to investors. We argue that incubation is a misleading practice that must be better addressed by the SEC. Although SEC rules prevent marketing of funds based on pre-registration performance, the SEC permits companies to engage in post-registration incubation without disclosing to investors the selection process or the typical lack of performance persistence. In addition, the SEC permits funds to selectively use performance data from predecessor and similar funds and private accounts without disclosing the selection process. We recommend greater disclosure, or outright prohibition, of fund incubation and similar deceptive practices.*

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# Star Creation: The Incubation of Mutual Funds

*Alan R. Palmiter & Ahmed E. Taha\**

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## INTRODUCTION

Imagine that a stockbroker sends a mass mailing to 20,000 investors predicting the direction of ABC Corporation’s stock price over the next month. Half of the letters say the stock price will rise; the other half say that it will fall. As luck would have it, ABC’s price rises over the next month.

The broker then sends another mass mailing to the 10,000 investors who received the first letter accurately predicting ABC’s rise. The new letter reminds them of the broker’s prediction about ABC’s stock and makes a new prediction about DEF’s stock for the next month. As before, half of the letters say that DEF’s stock will rise, the other half that it will fall. Over the next three months, the broker sends mass mailings making similarly contradictory predictions about GHI’s stock, then about JKL’s stock, and finally about MNO’s stock. The next month, the broker sends a final letter to the 625 investors who received an unbroken stream of five accurate predictions. The letter points out how much they would have made had they relied on the broker’s predictions and offers his services—for

a large fee. Impressed with his track record, many of the recipients invest through the broker.<sup>1</sup>

Did the broker commit fraud under U.S. securities law? Technically, the letters were truthful. The 625 investors in the broker's final solicitation had actually received five consecutive accurate predictions and could have profited from these predictions. But the misleading nature of the broker's conduct is obvious. The investors were never told that the broker simultaneously had made contradictory, incorrect predictions to other investors. The broker disclosed only his successes, not his failures, and so misled investors into believing that he had stock-picking skill.

This Article argues that the process by which many mutual fund companies bring new funds to market deceives investors much as our enterprising broker did. Through a process known as "incubation," a fund company creates a number of start-up funds ("incubator funds"), typically seeded with the company's or its insiders' own money, that are allowed to operate outside of the public eye for up to several years. During their incubation periods, these funds are not marketed to the public, although they are registered with the SEC because only post-registration performance data can subsequently be reported and advertised. After incubation, the company actively markets the strong performers by advertising their high returns to attract investors. The weak performers are quietly terminated, their existence hidden from the public.

Fund companies mislead investors by marketing high-performing incubator funds without mentioning the process by which they were culled from their low-performing brethren. By highlighting successful incubator funds and not disclosing the failure rate in the incubation process, fund companies make it appear that the high-performing funds' managers have special stock-picking abilities—and that the high returns are likely to continue. Studies show, however, that after being sold to the public, these high-performing funds generally do not continue to outperform other funds. Strong performance during an incubation period is often simply a matter of chance.

To make matters worse, some fund companies artificially inflate the returns of their incubator funds. For example, they overallocate "hot" initial public offerings—which are very likely to rise quickly in price—to their incubator funds. In addition, they keep their incubator funds very small and restrict shareholder redemptions

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1. For a version of this story, see DANIEL R. SOLIN, *THE SMARTEST INVESTMENT BOOK YOU'LL EVER READ* 45–46 (2006).

during their incubation periods, making it easier to generate high fund returns. But this favorable treatment is not clearly disclosed and does not continue after the funds are sold to the public.

Although fund incubation misleads investors, the SEC has paid little attention to the issue. The agency has challenged only a few extreme cases of undisclosed fund subsidization, despite evidence that the practice is widespread. In addition, it has allowed companies to choose to market actively only their high-performing incubator funds without disclosing the resulting selection bias. Fund incubation deserves much more scrutiny. Fund marketing that highlights only incubator funds' successes without also revealing their failures is inherently misleading.

This Article fills a vacuum in the legal literature by identifying and addressing an important regulatory challenge. It is the first article to examine comprehensively both how incubation misleads investors and the SEC's insufficient response to the problem. It also proposes a better regulatory approach to the problem of incubation. Section I presents background information about the size and scope of the mutual fund market, a market that provides a primary vehicle for U.S. retirement savings. It also describes how investors flock to funds with high past performance. Section II, drawing on studies from the finance literature, examines how fund companies use incubation to create and then market new funds with artificially strong performance. Section III describes the limited and inadequate steps the SEC has taken to regulate the misleading marketing of incubator funds. Finally, Section IV proposes and discusses additional steps that the SEC should take to prevent the misuse of incubator funds.

## I. THE MUTUAL FUND MARKET: AN OVERVIEW

### *A. Importance of Mutual Funds*

A mutual fund pools multiple investors' money into a single investment portfolio managed by a fund management company.<sup>2</sup> An investor who purchases shares of the fund is entitled to a proportionate return from the assets held by the fund.<sup>3</sup> Thus, a fund shareholder does not own the fund's assets directly but, rather, owns a

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2. Securities and Exchange Commission, *Invest Wisely: An Introduction to Mutual Funds*, (July 2, 2008), <http://sec.gov/investor/pubs/inwsmf.htm>.

3. *Id.*



piece of the mutual fund.<sup>4</sup> Funds vary considerably in the types of financial assets they hold, their investment objectives and strategies, and their fees and expenses.<sup>5</sup> The SEC is the primary regulator of the mutual fund industry, but no government agency guarantees or insures shareholders' fund investments.<sup>6</sup>

As of the end of 2008, U.S. mutual funds held \$9.6 trillion in assets,<sup>7</sup> including 24 percent of all outstanding equity of U.S. public companies.<sup>8</sup> Investors have a great number of funds to choose from—8,889 as of the end of 2008.<sup>9</sup> Although no single fund family dominates the mutual fund market, the five largest fund families control 38 percent of the industry's total assets.<sup>10</sup> Some fund families, such as Fidelity Investments and the Vanguard Group, offer more than one hundred funds.<sup>11</sup>

Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 52.5 million (or 45 percent) own mutual funds, far more than hold individual securities, such as stocks and bonds.<sup>12</sup> In addition, most households that own mutual funds have moderate income and wealth. The median household income of mutual fund investors is \$80,000.<sup>13</sup> Sixty-three percent of households that own mutual funds have incomes of less than \$100,000, and 22 percent have incomes below \$50,000.<sup>14</sup> Fund-owning households have median total financial assets of only \$200,000 and a median of \$100,000 invested in mutual funds.<sup>15</sup>

Mutual fund ownership is so widespread largely because mutual funds have become a primary way that Americans save for

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4. *Id.*

5. *Id.*

6. *Id.*

7. INVESTMENT COMPANY INSTITUTE, 2009 INVESTMENT COMPANY FACT BOOK 9 fig.1.1 (49th ed. 2009), available at [http://www.icifactbook.org/pdf/2009\\_factbook.pdf](http://www.icifactbook.org/pdf/2009_factbook.pdf) [hereinafter 2009 FACT BOOK].

8. *Id.* at 11 fig.1.4.

9. *Id.* at 15 fig.1.9.

10. *Id.* at 21 fig.2.2.

11. Vanguard Mutual Funds, <https://personal.vanguard.com/us/FundsStocksOverview?Entry=Homeoffer01> (last visited Sept. 12, 2009) (listing current Vanguard funds); All Fidelity Funds Daily Pricing, [http://personal.fidelity.com/products/funds/framesets/daily\\_prices\\_frame.shtml?refpr=zffdfp03](http://personal.fidelity.com/products/funds/framesets/daily_prices_frame.shtml?refpr=zffdfp03) (last visited Sept. 12, 2009) (listing current Fidelity funds).

12. Investment Company Institute, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet*, RESEARCH FUNDAMENTALS, at 3 fig.1 (2008), available at [www.ici.org/pdf/fm-v17n6.pdf](http://www.ici.org/pdf/fm-v17n6.pdf) [hereinafter ICI, *Ownership Trends*].

13. INVESTMENT COMPANY INSTITUTE, PROFILE OF MUTUAL FUND SHAREHOLDERS 6 fig.1.3 (2009), available at [http://www.ici.org/pdf/rpt\\_profile08.pdf](http://www.ici.org/pdf/rpt_profile08.pdf).

14. *Id.*

15. 2009 FACT BOOK, *supra* note 7, at 73 fig.6.2.

retirement. Mainly as a result of the rapid growth of mutual fund investments in defined-contribution retirement plans and Individual Retirement Accounts, mutual funds' total share of retirement assets grew from 5 percent at the end of 1990 to 24 percent in September 2008.<sup>16</sup> Mutual funds now constitute almost a quarter of retirement savings in the United States.

Consistent with the long-term investment horizon of many fund investors, 38 percent of mutual fund holdings are in equity funds, with most of the rest in money market funds (39 percent) and bond funds (18 percent).<sup>17</sup> Equities tend to have higher returns in the long run, but greater risk in the short run, than do bonds and money market securities.<sup>18</sup>

In summary, our nation relies upon mutual funds. Mutual funds constitute a significant portion of our savings and are a particularly important component of our retirement system. Thus, it is essential that investors not be misled when choosing among mutual funds.

### *B. Performance-Chasing by Fund Investors*

Because of their importance, mutual funds have attracted much attention from scholars. An extensive body of research examines how investors choose among the vast number of available funds.

These studies paint an unflattering portrait of the typical mutual fund investor. This research finds that fund investors in general are uninformed and lack financial sophistication. For example, most fund investors are unaware of the investment objectives, composition, and risks of their funds. In addition, most investors are ignorant of the level of fees and expenses charged by their funds; as a result, these costs are often not an important factor in their fund choices.<sup>19</sup>

Although investors pay little attention to a fund's objectives, risk, and costs, they pay great attention to a fund's historical returns.

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16. Investment Company Institute, *The U.S. Retirement Market, Third Quarter 2008*, RESEARCH FUNDAMENTALS, at 11–13 figs.A1–A3 (2009), [www.ici.org/pdf/retmrkt\\_update.pdf](http://www.ici.org/pdf/retmrkt_update.pdf) [hereinafter ICI, *Retirement Market*]. In addition to being in defined contribution plans and Individual Retirement Accounts, retirement assets are in annuities, government pension plans, and private defined benefit plans (i.e., traditional private pension plans). *Id.* at 2 fig.1.

17. Investment Company Institute, *Trends in Mutual Fund Investing* (Apr. 2009), [http://www.ici.org/highlights/trends\\_04\\_09](http://www.ici.org/highlights/trends_04_09).

18. JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN* 12–18, 24–27 (4th ed. 2008).

19. For a survey of these studies, see Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 974–94 (2008).

Studies have found that this may be the most important factor to the typical fund investor.

### 1. Investors Chase Past Returns

Surveys uniformly identify the importance of a fund's past returns to investors. Capon, Fitzsimons, and Rice conducted a telephone survey of almost 3,400 households that invest in mutual funds.<sup>20</sup> They found that a fund's "investment performance track record" is the most important factor in investors' choice of funds.<sup>21</sup> Also, a survey sponsored by the Investment Company Institute—the mutual fund industry's trade association—of 737 mutual fund investors found that 69 percent reviewed a fund's "historical performance" before investing.<sup>22</sup>

Experiments involving investors have similar findings. An experiment by Wilcox asked fund investors to choose among hypothetical stock mutual funds that differed in up to six characteristics: (1) the fund company's name, (2) the fund's load, (3) the fund's annual management fee, (4) the fund's return during previous year, (5) the fund's average annual return during the previous ten years, and (6) the fund's beta.<sup>23</sup> The experiment found that a fund's returns over the past ten years and over the previous year were the two most important factors to investors.<sup>24</sup>

Studies of investors' actual behavior confirm that investors flock to mutual funds with the highest past returns. For example, Del Guercio and Tkac examined fund flow—the aggregate amount that investors put into or withdraw from a particular fund during a particular period—for a large sample of equity mutual funds.<sup>25</sup> They found that a fund's past returns have a strong positive effect on flow.<sup>26</sup> In addition, this positive relationship was strongest for funds with the highest past returns, indicating that investors especially chase the

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20. Noel Capon, Gavan J. Fitzsimons & Russ Alan Prince, *An Individual Level Analysis of the Mutual Fund Investment Decision*, 10 J. FIN. SERVICES RES. 59 (1996).

21. *Id.* at 66.

22. INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 3 fig.1 (2006), [http://ici.org/pdf/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://ici.org/pdf/rpt_06_inv_prefs_full.pdf) [hereinafter ICI, INVESTOR PREFERENCES].

23. Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645 (2003). Beta is a measure of a fund's risk.

24. *Id.* at 650.

25. Diane Del Guercio & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds*, 37 J. FIN. & QUANTITATIVE ANALYSIS 523, 533 (2002).

26. *Id.* at 525. The authors used the fund's excess return (the extent to which it outperforms the S&P 500) as the measure of the fund's return. *Id.* at 539.

highest-performing funds.<sup>27</sup> Similarly, Sirri and Tufano's study of flow into equity mutual funds found that higher returns led to more flow for a fund. This was especially true for the highest-performing quintile of funds, again showing that investors seek funds with the strongest past performance.<sup>28</sup>

## 2. Past Returns Are Poor Predictors of Future Returns

Although investors chase funds that have produced the highest historical returns, there is little reason for them to do so. The finance literature finds only "weak and controversial evidence that past performance has much, if any, predictive ability for future returns."<sup>29</sup> In other words, little evidence of returns persistence exists; top performing funds generally do not continue to outperform other funds by any significant margin.<sup>30</sup>

Furthermore, even to the extent that some persistence exists, such persistence may not be meaningful to investors picking among mutual funds because of the transaction costs, such as loads and capital gains taxes, that would be incurred in chasing recent high performers.<sup>31</sup> In a survey of studies on returns persistence, Cuthbertson, Nitzsche, and O'Sullivan found some evidence of small performance persistence by the highest performing funds, but concluded that "it seems likely that such costs [e.g., loads, rebalancing

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27. *Id.* at 525.

28. Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1599 (1998); see also Travis Sapp & Ashish Tiwari, *Does Stock Return Momentum Explain the "Smart Money" Effect?*, 59 J. FIN. 2605, 2607 (2004) (finding that fund flows into U.S. equity mutual funds "effectively demonstrate[] that fund investors appear to be chasing recent large returns").

29. Wilcox, *supra* note 23, at 651.

30. Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1270 & n.1 (2004) ("The relative performance of mutual fund managers appears to be largely unpredictable using past relative performance. . . . While some controversial evidence of persistence [of mutual fund returns] does exist . . . it is concentrated in low-liquidity sectors or at shorter horizons.").

31. Nicolas P.B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 587-88 (2004). Many mutual funds charge front-end or back-end (deferred) loads that investors must pay when they buy or sell fund shares, respectively. Also, to discourage short-term trading, many mutual funds impose fees on investors who sell shares soon after buying them. In addition, when an investor sells mutual fund shares for a gain, the investor must pay capital gains taxes. Investors who sell fund shares less than one year after buying them pay a higher capital gains tax rate than do investors who hold the shares for more than one year.

costs and taxes] would outweigh” the extra returns that investors could gain by chasing this performance persistence.<sup>32</sup>

Even in situations in which past performance will definitely not be predictive of future returns, investors still irrationally chase past returns. In an experiment involving Wharton MBA and Harvard College students—a group likely more sophisticated than typical fund investors—Choi, Laibson, and Madrian asked participants to allocate an investment among four S&P 500 index funds with different expense ratios.<sup>33</sup> Participants would maximize their expected compensation for participating in the experiment by choosing the fund with the highest future return, which for index funds is the fund with the lowest expense ratio.<sup>34</sup> In the experiment, however, the higher-expense funds had higher reported past annualized returns, but only because they had different inception dates from the other funds.<sup>35</sup> Participants nonetheless chose the index funds that had the higher past returns, even though these higher-expense funds would *necessarily* underperform the lower-expense funds in the future.<sup>36</sup>

In summary, in choosing a mutual fund, investors place far too much emphasis on high past performance, a factor with little predictive ability.<sup>37</sup> The tendency of investors to chase high past returns, however, has important implications for mutual fund companies because management fees are based on the amount invested in the fund.

### 3. Fund Companies Advertise Strong Past Performance

Because investors chase past returns, it is unsurprising that mutual fund companies often advertise strong past performance. Huhmann and Bhattacharyya found that almost 42 percent of mutual fund advertisements in *Barron's* and *Money* magazine over a two-year period mentioned a fund's high or increasing returns, and an

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32. Keith Cuthbertson, Dirk Nitzsche & Niall O'Sullivan, Mutual Fund Performance 69 (Dec. 12, 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=955807>).

33. James J. Choi, David Laibson & Brigitte C. Madrian, Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds 7–8 (Mar. 6, 2008) (unpublished manuscript, available at <http://www.som.yale.edu/faculty/jjc83/fees.pdf>). Participants also included Harvard staff members and a small number of Wharton undergraduate students and Wharton Ph.D. students. *Id.* at 14.

34. *Id.* at 4, 21.

35. *Id.* at 4.

36. *Id.*

37. To the extent that an investor is focusing on past returns, the investor is focusing less on more important factors, such as the fund's costs, and whether the fund's objective and investment strategy are consistent with the investor's objectives and risk tolerance.

additional 26 percent of the advertisements explicitly discussed a fund's risk-adjusted returns.<sup>38</sup>

Similarly, Mullainathan and Shleifer examined mutual fund advertisements that appeared in *Money* and *BusinessWeek* over a nine-year period and a ten-year period, respectively.<sup>39</sup> They found that funds' past returns were mentioned in 62 percent of equity mutual fund advertisements appearing in *Money*, and in 59 percent of equity mutual fund advertisements appearing in *BusinessWeek*.<sup>40</sup> Moreover, they found a high correlation (greater than 0.7) between the percentage of equity fund advertisements that mentioned past returns and the recent performance of the stock market in general.<sup>41</sup>

In addition, Swensen examined the extent of mutual fund advertising from 1997 to 2003 in the first quarter of the *Wall Street Journal's Mutual Funds Quarterly Review*, a quarterly mutual fund supplement to the *Wall Street Journal*.<sup>42</sup> He found that the space dedicated to mutual fund advertisements was highly positively correlated to stock prices. For example, during the bull market from 1998 to 2000, mutual fund advertisements constituted between 40 to 44 percent of the nearly fifty page *Review*. Then, as the bull market ended, fund advertising was significantly reduced, reaching only 16 percent of the thirty-four page *Review* in 2003. In addition, performance advertisements—those that present a fund's past returns—plunged from 61 percent and 56 percent of all fund advertisements in the high-performance years of 1999 and 2000, to only 28 percent and 26 percent in the low-performance years of 2001 and 2002.<sup>43</sup> Thus, total pages of performance advertisements dropped by approximately 83 percent from 12.1 pages in 1999 to 2.0 pages in 2003.<sup>44</sup>

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38. Bruce A. Huhmann & Nalinaksha Bhattacharyya, *Does Mutual Fund Advertising Provide Necessary Investment Information?*, 23 INT'L J. BANK MARKETING 296, 303 tbl.I (2005).

39. Sendhil Mullainathan & Andrei Shleifer, *Persuasion in Finance* 9–10 (Dec. 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=864686>).

40. *Id.* at fig.5. These averages were calculated by counting the percentage of equity fund advertisements each quarter that mentioned the fund's returns, and then averaging these quarterly measures.

41. In particular, they found that the correlation of one quarter lagged S&P 500 returns with the percentage of equity fund advertisements that mention past returns was 0.71 for *Money* and 0.74 for *BusinessWeek*. *Id.*

42. DAVID F. SWENSEN, UNCONVENTIONAL SUCCESS: A FUNDAMENTAL APPROACH TO PERSONAL INVESTMENT 167–69 & tbl.5.4 (2005).

43. *Id.* at 168 tbl.5.4.

44. *Id.* In 1998, the *Review* had forty-eight total pages, 44 percent of the space was mutual fund advertisements, and 44 percent of these advertisements were performance advertisements, so there were a total of 12.1 performance advertisement pages (48 pages x .44 x .44 = 12.1). In 2003, the *Review* had thirty-four total pages, 16 percent of the space was mutual fund

Mutual fund companies are especially likely to advertise particular funds that have performed well. Jain and Wu examined fund flows into 294 equity mutual funds that advertised in *Barron's* or *Money* magazine. They found that advertised funds outperformed non-advertised funds with the same investment objective by an average of approximately 6 percent over the twelve months prior to the advertisements.<sup>45</sup> The advertised funds also outperformed other benchmarks, such as the S&P 500 index, although by less.<sup>46</sup> Similarly, Koehler and Mercer examined equity mutual fund performance advertisements that appeared in *BusinessWeek* and *Fortune* magazines over a four-year period.<sup>47</sup> They found that mutual fund companies tended to advertise their funds that had performed the best.<sup>48</sup>

Fund advertising works. In Capon, Fitzsimons, and Prince's survey, fund investors stated that advertising was their second most important source of information about funds.<sup>49</sup> Also, Jain and Wu found that advertised funds experience approximately 20 percent greater flow than do similar funds that do not advertise.<sup>50</sup> In addition, they found that funds that are advertised more often receive even more flow.<sup>51</sup>

Similarly, Gallaher, Kaniel, and Starks examined the effect of advertising on flows into approximately one hundred fund families. They found that the effect of advertising on flows into fund families is convex: "High relative levels of advertising are significantly related to high fund flows at the family level, while variations of relative levels of advertising within the low advertising group do not have a

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advertisements, and 36 percent of these advertisements were performance advertisements, so there were a total of 2.0 performance advertisement pages (34 pages x .16 x .36 = 2.0).

45. Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 943 (2000). *But see* Steven Gallaher, Ron Kaniel & Laura Starks, *Madison Avenue Meets Wall Street: Mutual Fund Families, Competition and Advertising* 29, 44 tbl.8 (Jan. 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=879775>) (finding a relationship between the past returns of fund families and the amount of advertising only for small, low-performing fund families).

46. Jain & Wu, *supra* note 45, at 943-46 & tbl.II.

47. Jonathan J. Koehler & Molly Mercer, *Selection Neglect in Mutual Fund Advertisements*, 55 MGMT. SCIENCE 1107 (2009).

48. In particular, the advertised funds' median one-year, five-year, and ten-year performance was at the 80th, 100th, and 100th percentile, respectively, of all company-operated equity funds that shared the same investment objective. The advertised funds also had a median one-year, five-year, and ten-year performance at the 79th, 88th, and 88th percentile, respectively, of all company-operated equity funds, irrespective of the investment objective. *Id.* at 9.

49. Capon et al., *supra* note 20, at 66 tbl.1.

50. Jain & Wu, *supra* note 45, at 957 (2000).

51. *Id.*

significant impact on flows to the family.”<sup>52</sup> In other words, fund investors respond to heavy advertising.

In summary, by advertising funds that have performed well, mutual fund companies encourage and exploit investors’ tendency to chase strong past performance. Advertising of high past returns attracts investment, thus increasing the management fees that investors pay these fund companies, even though these high returns generally do not persist.

## II. INCUBATION OF MUTUAL FUNDS

Given the importance that investors place on past performance, fund sponsors have a great incentive to create and market funds with a record of strong returns. Through fund incubation—the process of creating funds outside of the public eye and then selling only the strong performers to the public—companies can generate new funds with misleadingly high returns. In addition, incubator funds are often subsidized to create even more impressive, albeit deceptive, performance records. This section describes the incubation process and its prevalence, the superior performance of incubator funds before they are sold to the public relative to how they perform after, and the reasons for this performance differential.

### *A. Process and Prevalence of Fund Incubation*

In general, mutual fund incubation involves the creation by a fund company of an investment fund, typically with a small amount of seed money supplied by the company or its insiders. After a period of several months to several years, the fund company decides—largely based on the fund’s performance—whether to terminate the fund or actively market it to the public. Before a fund can be sold publicly, it must be registered with the SEC. Sometimes fund companies wait to register a fund until they decide to open the fund to the public; this waiting period is called “private incubation.”<sup>53</sup> Sometimes fund companies initially register the fund but do not actively market it until they see how it performs; this practice is called “public incubation.”<sup>54</sup> This Article refers generally to both approaches as “incubation.”

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52. Gallaher et al., *supra* note 45, at 31.

53. Richard B. Evans, *Mutual Fund Incubation* 7–8 (Mar. 21, 2009) (unpublished manuscript, available at <http://ssrn.com/abstract=1005167>).

54. *Id.* at 7.



Fund incubation, which publicizes high-performance successes and hides low-performance failures, is necessarily opaque. Determining the prevalence of incubation is difficult because fund sponsors do not disclose that high-performing new funds were culled from low performers and actually try to hide the low-performing funds from public view.

Nonetheless, evidence exists indicating that fund incubation is common. Fund companies often terminate the registration of a fund before it is offered to the public or delay in offering a registered fund to the public. The most plausible explanation for such behavior is that the fund company was waiting to see whether the fund's performance would be strong enough to market it to the public. Thus, these cases provide strong evidence of incubation.

### 1. Deregistration of Fund before Going Public Indicates Incubation

One indicator of incubation is the deregistration of a fund before its shares are sold to the public. When a registered fund is terminated, the fund sponsor may file an application for deregistration with the SEC under Section 8(f) of the Investment Company Act of 1940.<sup>55</sup> Deregistration of a fund before it was offered to the public indicates disappointing pre-public performance. Such deregistrations are not rare. For example, Wisen and Chiang found that at least forty-nine funds applied for deregistration from July 1997 to July 2000 before going public.<sup>56</sup> Counting only such deregistered funds, however, greatly understates the prevalence of incubation. Deregistration notices only reveal those unsuccessful, registered incubator funds that fund companies decided to not take public. They do not include registered incubator funds that continue to operate but have not yet been taken public. Nor do they include successful incubator funds that have been taken public and are still in operation.

### 2. Long Lag between Inception and Obtaining a Ticker Symbol Indicates Incubation

Another indicator of fund incubation is a long lag between the fund's inception and when the fund sponsor obtains a ticker symbol for the fund. Fund sponsors can effectively avoid making even registered

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55. Investment Company Act of 1940, 15 U.S.C. § 80a-8(f) (2008).

56. They found these applications for deregistration in the Dow Jones News Archive. Craig Wisen & Kevin C.H. Chiang, *Explaining the Initial Returns of Mutual Funds*, 15 J. INVESTING 53, 54 (2006).

funds available to the public by not seeking a ticker symbol for the fund. Although a fund may legally be sold to the public after it is registered, as a practical matter, the public cannot buy the fund until it receives a ticker symbol.

The practice of delay in obtaining a ticker symbol appears to be widespread. For example, looking at over one thousand domestic equity mutual funds that began operations on or after January 1996 and received a ticker symbol by January 2006,<sup>57</sup> Evans found that 23 percent of these funds had more than twelve-month lags between their inception date and when they received a ticker symbol, and 10 percent had a lag of at least twenty-five months.<sup>58</sup>

The effect of withholding a ticker symbol is dramatic. Evans examined funds with more than a twelve-month lag between their inception date and when they received a ticker symbol, comparing their size before and after they obtained a ticker symbol. He found that the median size of such funds during their incubation period (or pre-ticker symbol) was only \$6.8 million; the median size after incubation (or post-ticker symbol) was \$30.0 million—more than four times as large.<sup>59</sup>

### 3. Long Lag between Inception and Reporting to Data Providers Indicates Incubation

Registered funds can also be kept from public view by not reporting their existence to mutual fund data providers such as Morningstar.<sup>60</sup> Data providers rely upon fund sponsors to notify them of the creation of a new fund. Thus, another indicator of incubation is a long delay between when the fund began operations and when information about the fund appears in a data provider's database.

When a fund first appears in Morningstar, its returns since its inception date are included. Therefore, the length of these "back returns" is a measure of how long the fund sponsor waited to report the fund to Morningstar. Lengthy delays in reporting a fund appear to be common. Ackermann and Loughran examined ninety-five domestic equity mutual funds that entered Morningstar's fund database from

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57. Domestic equity funds have as their objective to invest primarily in the stock of American companies. Evans, *supra* note 53, at 14–15.

58. *Id.* at 15.

59. *Id.* at 16. The mean fund size showed similar growth, from \$38.8 million during the incubation period to \$146.6 million after incubation. *Id.*

60. *Id.* at 10.

2000 to 2003.<sup>61</sup> Of these, sixty-nine (or 73 percent) reported at least six months of back returns, and forty-seven (or 49 percent) reported at least twelve months of back returns.<sup>62</sup>

A fund company can also delay reporting the existence of registered funds to the Center for Research in Securities Prices ("CRSP"), another creator of databases of mutual fund information. The CRSP Survivor Free Mutual Fund Database contains approximate information about when a fund began operations and when it was terminated. Like Morningstar, it relies upon fund sponsors to inform it of the existence of a new fund. Wisen and Young found that relatively new funds make up a very low percentage of terminations in this database. For example, from 1993 to 1999, only 9 percent to 12 percent of the terminated funds in the database were less than eighteen months old. In contrast, 40 percent to 43 percent of the terminated funds were eighteen to thirty-six months old.<sup>63</sup> One possible explanation for this difference is that fund sponsors delay reporting many new funds to CRSP and that many new funds are terminated before their existence is ever reported to CRSP.<sup>64</sup>

### *B. Performance of Incubator Funds*

Though incubator funds that are eventually taken public do outperform during their incubation period comparable seasoned funds, they do not continue to outperform after being sold to the public. Given how incubation-period performance is manipulated, the marketing to investors of funds based on their incubation-period returns is inherently misleading.

#### 1. During Incubation, Incubator Funds Outperform Other Funds

Studies have uniformly found that, during incubation, incubator funds significantly outperform other funds. In his large sample of domestic equity mutual funds, Evans identified the "incubated" funds as those with at least twelve months between their inception date and when they received a ticker symbol. He found that those funds had 9.8 percent higher annualized returns during their

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61. Carl Ackermann & Tim Loughran, *Mutual Fund Incubation and the Role of the Securities and Exchange Commission*, 70 J. BUS. ETHICS 33, 34 (2007).

62. *Id.* at 35 & tbl.2.

63. Wisen & Chiang, *supra* note 56, at 54–55 & exh.1.

64. *Id.* at 54. Other possible explanations are that new funds are terminated less frequently because they perform better than older funds or because fund sponsors often give a grace period to new funds before deciding to terminate them. *Id.*

incubation period than non-incubated funds did during their own first three years of operation.<sup>65</sup> When adjusted for risk, the difference in annualized returns was smaller, although generally still significant, ranging from 1.4 percent to 3.5 percent, depending on which risk-adjusted measure was used.<sup>66</sup>

Using Evans's definition of "incubated funds," Garavito also compared the performance of actively managed domestic equity funds that had been incubated to the performance of those funds that had never been incubated. He found that incubated funds outperformed non-incubated funds by a statistically significant 2.7 percent per year on a risk-adjusted basis during each fund's first three years of existence.<sup>67</sup> Note, however, that because incubation periods are often less than three years, many of the incubated funds' returns likely included post-incubation-period returns.

Ackermann and Loughran defined incubation-period returns as returns occurring before the fund appeared in Morningstar. They examined ninety-five domestic equity funds that appeared in Morningstar's database for the first time from 2000 to 2003. They found that those funds had a statistically significant, 1.8 percent better return than the overall stock market<sup>68</sup> in their last month of incubation (i.e., the month prior to appearing in Morningstar). Those funds also had a 3.6 percent better return than the market during their last twelve months of incubation.<sup>69</sup>

Taking an even broader look at the performance of new funds, Wisen and Chiang compared the performance of "new" and "seasoned" domestic growth funds that appeared in Morningstar's database from 1994 through 1999. They defined new funds as those that were no more than nine months old and seasoned funds as those more than twelve months old. They found that the new funds had higher risk-adjusted returns than even the smallest quartile of similar, seasoned funds. The new funds' outperformance ranged from 0.27 percent to 0.85 percent per month, depending on whether they were large-capitalization, medium-capitalization, or small-capitalization funds.<sup>70</sup>

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65. Evans, *supra* note 53, at 17 & tbl.II.

66. *Id.*

67. Fabian Garavito, Mutual Fund Incubation: Innovation or Marketing Tool 9 (Dec. 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1344642>).

68. They compared funds' returns to the average return of the CRSP value-weighted market index over the same period. Ackermann & Loughran, *supra* note 61, at 35 & tbl.2.

69. *Id.* Because only forty-seven funds in their sample had at least twelve months of back-returns, the 3.6 percent difference between these returns and the overall stock market was not statistically significant. *Id.*

70. New large-capitalization growth funds outperformed similarly-sized, seasoned large-capitalization growth funds by 0.27 percent per month; new middle-capitalization growth funds

These results likely understate the true difference between new and seasoned fund returns because the study included only seasoned funds still operating at the end of 1999; seasoned funds terminated before then were not included. Because funds that perform poorly are more likely to be terminated than those that perform well, a survivorship bias, which inflates the average returns of the seasoned funds, exists in the data.<sup>71</sup>

Wisén and Chiang's data, however, do not distinguish between new funds sold to the public after an extended incubation period and those funds brought to market soon after inception. As a result, the new fund returns represent a mix of incubation and post-incubation returns. In addition, because incubation periods can extend beyond a year, some of the seasoned funds' returns likely include incubation-period returns. However, the new funds' returns contain many more incubation-period returns than do the seasoned funds' returns. Thus, the new funds' higher returns are evidence that incubation returns are generally greater than later returns.

The strong performance of incubator funds may be increasing. Arteaga, Ciccotello, and Grant compared the performance of "new" and "established" aggressive growth mutual funds that appeared in the Alexander Steele Mutual Fund Database from 1988 to 1997.<sup>72</sup> They found that "new" funds (defined as those in their first full year of operations) generally outperformed "established" funds.<sup>73</sup> They further found that the outperformance of new funds increased during the period studied and was particularly high toward the end. For example, new funds actually underperformed established funds in 1988 and 1989, the first two years of their study. But new funds outperformed established funds by a statistically significant 5.9 percent in 1996 and 4.4 percent in 1997, the final two years of the study.<sup>74</sup> As in Wisén and Chiang's study, the data used by Arteaga, Ciccotello, and Grant did not allow them to determine whether a fund had been incubated before being sold to the public. As a result, some of the new fund returns and some of the established fund returns very likely are a mix

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outperformed similarly-sized, seasoned middle-capitalization growth funds by 0.85 percent per month; and new small-capitalization growth funds outperformed similarly-sized, seasoned small-capitalization growth funds by 0.70 percent per month. Wisén & Chiang, *supra* note 56, at 59 exh.4.

71. *Id.* at 56, 59 exh.4.

72. The database was compiled by the Kiplinger Investment Advisory Group. Kenneth R. Arteaga, Conrad S. Ciccotello & C. Terry Grant, *New Equity Funds: Marketing and Performance*, 54 FIN. ANALYSTS J. 43, 44 (1998).

73. *Id.* at 46 tbl.2.

74. *Id.* at 45 tbl.1. The underperformance of new funds in 1988 was not statistically significant. *Id.*

of incubation and non-incubation-period returns. However, the new funds' returns contain many more incubation-period returns than do the "established" funds' returns. Thus, this study is further evidence that incubation returns are generally greater than later returns.

In summary, there is significant evidence that, at least among funds that are eventually sold to the public, funds in their incubation period outperform older, comparable funds.

## 2. After Incubation, Incubator Funds Do Not Continue to Outperform Other Funds

Although, during their incubation period, incubator funds that are eventually taken public outperform comparable funds, they generally do not continue to do so afterward. The same studies that identified high incubation-period returns generally found lower returns once these incubator funds are sold to the public.

As noted above, in his study of domestic equity funds, Evans found that incubation-period returns were 9.8 percent higher (annualized) than those of similar non-incubated funds. However, in the three years after incubation, incubated funds had a 3.2 percent *lower* annualized return than did non-incubated funds during their own first three years of existence.<sup>75</sup> When adjusted for risk, the incubated funds outperformed the non-incubated funds slightly—from 0.03 percent to 2.9 percent annualized, depending on which risk-adjusted measure was used—but only under one of the three risk-adjusted measures was this difference statistically significant.<sup>76</sup>

Also, recall that Garavito found that incubated domestic equity funds outperformed non-incubated funds by approximately 2.7 percent per year on a risk-adjusted basis during each fund's first three years of existence. However, he also found that in the three years after being taken public, incubated funds did not significantly outperform non-incubated funds. This finding indicates that incubation-period outperformance does not continue after the fund is sold to the general public.<sup>77</sup>

Similarly, Ackermann and Loughran's sample of domestic equity funds did not continue their strong performance after incubation. Recall that these funds outperformed the market by 3.6

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75. Evans, *supra* note 53, at 18 & tbl.II.

76. *Id.* In addition, after incubation, the incubated funds' Sharpe Ratio—a measure of excess return per unit of risk—was significantly lower than that of the non-incubated funds. During incubation, the incubated funds' Sharpe Ratio was significantly higher than that of the non-incubated funds. *Id.* at 17–18 & tbl.II.

77. Garavito, *supra* note 67, at 9.

percent in their last twelve months of incubation (i.e., the twelve months prior to appearing in Morningstar) and by 1.8 percent in their last month of incubation.<sup>78</sup> In the first month after inclusion in Morningstar, however, they outperformed the market by only a statistically insignificant 0.6 percent. These funds then quickly fell behind, underperforming the market by a statistically significant 4.2 percent in the first year after their inclusion in Morningstar.<sup>79</sup>

Lack of performance persistence also held true for the aggressive growth funds studied by Arteaga, Ciccotello, and Grant. They found that “new” funds (defined in their article as those funds in their first year of operations) did not continue to outperform “established” funds but instead reverted to the mean. In their study, only 48.6 percent of the new funds that outperformed established funds in their first full year of operations also outperformed them in the next year.<sup>80</sup>

In addition, the authors were able to identify definitively five mutual funds as incubator funds and determine the exact dates that these funds began operations and when they were opened to the public. They found that these five funds outperformed the S&P 500 by an average of 8.0 percent (annualized) during their incubation period but underperformed the S&P 500 by an average of 4.0 percent (annualized) after they were opened to the public.<sup>81</sup> Although a very small sample, the data from these five funds again demonstrate that strong incubation-period performance generally does not continue after a fund is opened to the public.

In summary, funds that are eventually taken public perform strongly during their incubation periods. However, this performance generally does not continue after the funds are opened to the public. We next turn to why strong incubation-period performance does not persist.

### 3. Incubator Funds' Strong Performance Does Not Continue for Multiple Reasons

Why do new funds sold to the public have superior performance during their incubation periods, but only middling performance thereafter? Two likely explanations exist. First, fund sponsors often

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78. Ackermann & Loughran, *supra* note 61, at 35 tbl.2.

79. *Id.*

80. Arteaga et al., *supra* note 72, at 45–46 & tbl.3.

81. *Id.* at 47–48 & tbl.5. The five funds were the John Hancock Global Marketplace, Putnam New Value, State Street Aurora, Transamerica Premier, and Van Kampen American Capital Growth funds. *Id.* at 48 tbl.5.

give incubator funds preferential treatment during their incubation periods. Second, a selection bias exists: funds that have strong incubation-period performances are more likely to be sold to the public. However, strong incubation-period performance is largely just a matter of luck, and this luck generally does not continue after the incubation period ends. This section discusses both explanations.

*a. Fund Companies Give Incubator Funds Preferential Treatment During Incubation*

Fund companies often favor new funds during incubation to generate investor-attracting higher returns. One type of preferential treatment is the overallocation by the fund sponsor of oversubscribed initial public offerings (i.e., so-called “hot IPOs”) to its incubator funds.<sup>82</sup> Because an incubator fund is very small, even a minor allocation of hot IPO shares can significantly boost its returns.<sup>83</sup> Thus, by allocating hot IPO shares to an incubator fund, the sponsor can increase the fund’s returns during the incubation period.

Evidence exists that fund sponsors overallocate hot IPOs to their incubator funds, and such overallocation artificially boosts their incubation-period returns. In their study comparing the returns of new growth funds (which include more incubation-period returns) to those of comparable seasoned growth funds, Wisen and Chiang found that new funds’ returns were more sensitive to IPOs’ first-day returns than were seasoned funds’ returns.<sup>84</sup> This greater sensitivity indicates that new funds contained a greater percentage of IPOs than did

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82. For many reasons, a corporation’s first sale of stock to the general public (i.e., its IPO) is often intentionally underpriced to ensure that the stock’s price will immediately rise. Sean J. Griffith, *Spinning and Underpricing: Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 590–623 (2004). Because the IPO is offered at too low of a price, people offer to buy more IPO shares than are available; in other words, the IPO is oversubscribed. Someone who is able to buy the stock at the initial price (its “offering price”) is therefore virtually assured of a profit in the short-term because the excess demand for the IPO will cause the stock’s price to rise immediately after the IPO is publicly traded. *Id.* at 593 n.29. A mutual fund sponsor that receives an allocation of an oversubscribed IPO at its offering price can choose how to distribute the IPO shares among the funds it sponsors. Edward Wyatt, *It’s a Fund! Bringing Up Baby Mutuals*, N.Y. TIMES, Mar. 16, 1997, § 3, available at <http://www.nytimes.com/1997/03/16/business/it-s-a-fund-bringing-up-baby-mutuals.html?pagewanted=all>.

83. Arteaga et al., *supra* note 72, at 44.

84. An IPO’s first-day return is the increase in the stock price on the first day it is traded publicly. Thus, an IPO’s first-day returns is a measure of degree to which the IPO is underpriced; the more underpriced an IPO is, the more its price will rise when it is first publicly traded. Wisen & Chiang, *supra* note 56, at 60, 61 exh.5.



seasoned funds.<sup>85</sup> As we discuss below, the SEC has taken enforcement action against a few egregious cases of overallocation of hot IPOs to new funds. Wisen and Chiang's study, however, indicates that the overallocation of hot IPOs is a more widespread problem than the infrequency of the SEC's enforcement actions suggests.

Another way that fund companies boost the returns of their incubator funds is by keeping them very small during incubation. To the extent that strong incubation performance reflects stock-picking skill,<sup>86</sup> managers have difficulty in continuing to exhibit this skill after the fund's size grows dramatically when the fund is marketed to the public.

Successful incubator funds typically grow markedly when they are sold to the general public. Evans found that after obtaining a ticker symbol, which allowed them to be sold to the public, the median size of incubator funds more than quadrupled.<sup>87</sup>

Managers of large funds may have greater difficulty producing superior returns than do managers of small funds because they have fewer investment options. For example, a small amount of money can easily be invested in a stock with a low market capitalization. However, investing a much larger sum in the same stock is difficult: there may not be enough shares on the market. And, even if there are, a large purchase of a thinly traded stock would have to be made at a much higher price than would a small purchase.<sup>88</sup> Indeed, a study by Chen, Hong, Huang, and Kubik found a significant negative relationship between fund size and returns for funds that invest in small-capitalization stocks.<sup>89</sup>

The fact that many mutual funds close—i.e., refuse to accept new investors upon reaching a certain size—indicates that fund companies believe that increasing a fund's size makes strong performance less likely. Even though management fees are directly related to fund size and there are great economies of scale in

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85. In particular, they found that new large-cap and mid-cap growth funds' returns were approximately twice as sensitive to IPO first-day returns as were seasoned large-cap and mid-cap growth funds' returns. New small-cap growth funds' returns had approximately the same sensitivity as did seasoned small-cap growth funds' returns, with the exception of the smallest small-cap growth funds. *Id.* at 61 exh.5.

86. In the next section, we point out that strong incubation-period performance generally reflects good luck rather than skill. See *infra* Part II.B.3.b.

87. Evans, *supra* note 53, at 16.

88. Joseph Chen, Harrison Hong, Ming Huang & Jeffrey D. Kubik, *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94 AM. ECON. REV. 1276, 1277 (2004).

89. *Id.*

managing mutual funds,<sup>90</sup> these companies believe that at some point a fund's size can become too large of a drag on its returns.<sup>91</sup>

Other evidence exists that larger fund size makes strong performance more difficult to achieve.<sup>92</sup> Barras, Scaillet, and Wermers examined the lifetime performance of 2,076 actively managed domestic equity funds that existed at any time between 1975 and 2006. They found that a small yet statistically significant percentage (2.4 percent) of domestic equity funds exhibits short-run investing skill after expenses, but a statistically insignificant percentage (0.6 percent) exhibits any investing skill in the long run.<sup>93</sup> This difference might be explained by investors flocking to funds that outperformed in the short run. Such a surge of capital would force fund managers to invest much more than before and thus make the funds unable to continue outperforming in the long run.<sup>94</sup>

Fund companies favor incubator funds in another way too. Because an incubator fund is seeded with the company's or its insiders' own money, it does not need to worry about shareholders withdrawing money from the fund. A lack of concern about withdrawal gives the incubator fund several advantages over other funds. First, the fund can be more fully invested in stocks and other securities because it need not keep cash on hand for shareholder redemptions. Second, it can invest in less liquid securities. For example, stocks that are thinly traded are costly to buy and sell because they often have large bid-ask spreads.<sup>95</sup> An incubator fund can invest more heavily in such stocks because it will not be forced by shareholder redemptions to sell them later. Third, it can take greater risk. During incubation the fund can hold riskier securities or a less

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90. *Id.* at 1276–77.

91. Daniel C. Indro, Christine X. Jiang, Michael Y. Hu, & Wayne Y. Lee, *Mutual Fund Performance: Does Fund Size Matter?*, 55 FIN. ANALYSTS J. 74, 744 (1999).

92. Laurent Barras, O. Scaillet & Russ R. Wermers, *False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas* (May 1, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=869748>).

93. *Id.* at 18–19, 35 tbl.II, 36 tbl.III.

94. *Id.* at 2 (noting that their empirical finding of little long-run skill supports Berk and Green's long-run equilibrium theory, which predicts that funds that exhibit short-run skill will receive so much new investment that they will not be able continue to outperform other funds in the long run).

95. The bid-ask spread of a stock is “the difference between the highest bid and the lowest offer [for the stock] quoted on an exchange.” Jeffrey L. Davis & Lois E. Lightfoot, *Fragmentation Versus Consolidation of Securities Trading: Evidence from the Operation of Rule 19c-3*, 41 J. LEGAL ECON. 209, 214 n.26 (1998).

diversified portfolio because even if such a strategy is unsuccessful, the fund shareholders will not redeem their shares.<sup>96</sup>

There is evidence that incubator funds take advantage of the lack of shareholder redemptions. Garavito found that funds “tend to hold more illiquid and lesser-known securities during incubation.”<sup>97</sup> He also found that during incubation, funds’ portfolios have greater idiosyncratic risk but less systematic risk (e.g., exposure to market risk, value stocks, and momentum strategies).<sup>98</sup> In addition, he found that incubated funds’ portfolios are a little more concentrated than those of non-incubated funds.<sup>99</sup>

*b. Fund Companies Select Strong-Performing  
Incubator Funds to Sell to the Public*

The method by which incubator funds are selected for marketing to the public makes incubator funds perform better during their incubation period than after. Luck is a major factor in the performance of mutual funds. Funds often perform well over a particular time period—including during incubation—because of simple luck, and not because of the fund manager’s stock-picking skill. Because fund sponsors generally choose to take public the funds having strong incubation-period returns, incubator funds that are sold to the public have been lucky, as a group. However, their luck—and their corresponding high returns—generally does not continue after the funds are taken public. Fund companies’ method of marketing incubator funds hides the large role that luck plays in incubation returns. They market a disproportionate number of the lucky, successful incubator funds and do not inform investors that those funds have been culled from many unsuccessful, hidden incubator funds. Thus, investors cannot infer the great role that luck plays in an incubator fund’s performance.

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96. Garavito, *supra* note 67, at 13 (“[T]he incubation period allows funds to take on investment strategies that [they] would not be able to implement otherwise. The advantage of the incubation period is that . . . managers have a high degree of certainty, that bad temporary performance is not going to cause redemptions and the negative costs associated with it.”); see also Roger M. Edelen, *Investor Flows and the Assessed Performance of Open-end Mutual Funds*, 53 J. FIN. ECON. 439 (1999) (estimating that providing liquidity to fund investors reduces fund returns by approximately 1.4 percent annually).

97. Garavito, *supra* note 67, at 13.

98. *Id.* at 9. Similarly, Evans found that the median total risk and idiosyncratic risk—but generally not systematic risk—of incubator funds during incubation was slightly higher than after incubation and slightly higher than those of non-incubated funds. Evans, *supra* note 53, at 19–20 & tbl.III.

99. Garavito, *supra* note 67, at 11.

Luck's role in mutual fund performance should not be underestimated. Because thousands of equity mutual funds exist, a very large number of funds would outperform market indexes even if all fund managers were picking their portfolios randomly. Recent studies have quantified the role of luck.<sup>100</sup> As noted above, Barras, Scaillet, and Wermers examined the lifetime performance of 2,076 actively managed domestic equity funds that existed at any time between 1975 and 2006. They found that, after expenses, only 2.2 percent of funds had statistically significant, abnormal long-term positive returns.<sup>101</sup> However, when the authors accounted for luck—i.e., the fact that out of 2,076 funds, many would outperform solely due to luck—only 0.6 percent of funds actually exhibited skill in their long-term performance.<sup>102</sup> This result was not even statistically significant, so there was not persuasive evidence that *any* fund managers are skillful enough to outperform their benchmarks in the long run.<sup>103</sup>

Fama and French's study of domestic equity mutual funds' returns from 1984 to 2006 reached a similar and perhaps even stronger conclusion.<sup>104</sup> They found that luck could easily explain high-returning funds' performance and concluded that "there is no evidence of fund managers with skill sufficient to cover costs."<sup>105</sup>

Although luck plays a major role in fund performance, this role is hidden from investors in newly public incubator funds. Studies have found that fund sponsors are much more likely to take public their strong-performing incubator funds than their weak-performing incubator funds. For example, Evans compared a sample of 172 incubator funds opened to the public to a sample of fifty incubator funds that were terminated before ever being opened to the public.<sup>106</sup>

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100. Barras et al., *supra* note 92, at 2.

101. *Id.* at 16, 35 tbl.II.

102. *Id.* at 35 tbl.II. Luck was accounted for using a "False Discovery Rate" approach. This approach uses the p-values associated with the t-statistics of the estimated alphas of 2,076 mutual funds to estimate what percentage of high-performing funds are just lucky. For a full description of this approach, see *id.* at 4–10.

103. *Id.* at 16. They found slightly more evidence of short-run skill: a statistically significant 2.4 percent of the funds exhibited skill over five-year periods. *Id.* at 36 tbl.III.

104. Eugene F. Fama & Kenneth R. French, Luck versus Skill in the Cross Section of Mutual Fund Alpha Estimates (Mar. 9, 2009) (unpublished manuscript, available at <http://ssrn.com/abstract=1356021>).

105. *Id.* at 22.

106. Richard B. Evans, Does Alpha Really Matter? Evidence from Mutual Fund Incubation, Termination and Manager Change 7, 30 tbl.1 (June 15, 2006) (unpublished manuscript, available at [http://faculty.darden.virginia.edu/evansr/pdf/do\\_mf\\_risk\\_adjust.pdf](http://faculty.darden.virginia.edu/evansr/pdf/do_mf_risk_adjust.pdf)). In the study, Evans defined incubator funds as funds that both (1) had a lag between their inception date and the first time they were reported to the Morningstar and CRSP mutual fund databases (in other

He found that the opened funds had over 13 percent greater annualized returns during their incubation periods than did the non-opened funds.<sup>107</sup> Even controlling for other factors, a fund's returns during its incubation period were a major factor in the decision to open the fund to the public. A 1 percent increase in incubation returns increased by 8 to 11 percent the probability that the fund would be opened to the public.<sup>108</sup>

In addition, fund companies tend to be strategic in choosing when to open an incubator fund to the public. Garavito's study of domestic equity incubator funds found that fund companies tend to open these funds to the public around the time their twelve-month performance relative to other funds is near its peak.<sup>109</sup>

The speed with which fund companies provide fund data to fund database vendors provides further evidence that fund companies select strong-performing incubator funds over weak performers for sale to the public. Wisen and Chiang's study measuring the lag between a fund's inception date and its first appearance in Morningstar indicated that fund companies quickly bring their strong performers to the public's attention but wait to publicize weaker performers.<sup>110</sup> They found that during the six months following their inception, new funds that were "timely additions" to Morningstar (those first listed within fifteen months of their inception) were much more likely to have outperformed than have underperformed similar, seasoned funds.<sup>111</sup> In contrast, "retroactive additions" (new funds first

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words, there existed an incubation period), and (2) had, during that incubation period, the fund family as its principal shareholder, owning more than 25 percent of the fund. *Id.* at 6.

107. *Id.* at 7, 30 tbl.1. Interestingly, the incubated funds that were eventually sold to the public had an average annualized risk-adjusted return during their incubation period only about 2–4 percent higher (depending on the measure of risk-adjusted return) than did incubated funds that did not go public. *Id.* This is evidence that fund sponsors understand that investors pay little attention to a fund's risk.

108. *Id.* at 8, 34 tbl.2. Other factors controlled for were the fund family's size, whether the family already had a fund with the same investment objective, the amount of time the fund had incubated, the fund's risk-adjusted return, and the total amount of flow industry-wide into funds with that investment objective. *Id.* The incubated fund's risk-adjusted return—unlike the total return—had no statistically significant effect on the decision to open a fund to the public. *Id.*

109. Garavito, *supra* note 67, at 17–18.

110. Wisen & Chiang, *supra* note 56, at 60. Recall that Morningstar relies upon the fund sponsor to notify it regarding the existence of a new fund. Thus, by delaying this notification, a fund sponsor can delay a new fund's inclusion in Morningstar. *Id.*

111. Wisen and Chiang examined the returns of timely additions in fourteen Morningstar categories (such as large-cap growth) in each of the six months following the funds' inceptions, for a total of eighty-four category-months. In sixteen of these category-months, the timely additions' returns were statistically significantly different from those of similar, seasoned funds. For fifteen of those sixteen category-months the new funds outperformed the seasoned funds; in only one category-month did they underperform the seasoned funds. *Id.* at 60, 62, 63 exh.6.

listed in Morningstar more than fifteen months after their inception) were approximately as likely to have underperformed as outperformed similar, seasoned funds.<sup>112</sup> Thus, even among incubator funds eventually taken public, fund companies are quicker to publicize strong performers than weak performers.

Because fund companies are more likely to market their high-performing than low-performing incubator funds to the public, fund investors see a disproportionate number of successful incubator funds. Many investors do not know that the incubator funds they are offered have been culled from less successful incubator funds. Absent this context, investors underestimate the large role that luck plays in funds' strong incubation-period performance.

A recent experiment illustrates how investors are misled if they see only a fund sponsor's successful funds. Koehler and Mercer provided participants with an advertisement that highlighted the strong past returns of two of a company's growth funds.<sup>113</sup> One version of the advertisement noted that the advertised funds were only two of the company's thirty funds. Another version of the advertisement stated that they were the company's only two funds. A third version did not state how many funds the company had. Participants were then asked about their perception of the fund company's quality and the likelihood and amount that they would invest in a new growth fund introduced by the company.<sup>114</sup>

Participants who saw the version disclosing that the fund company had thirty funds not only rated the fund company's quality lower but were also less willing to invest in the company's new fund at all, and they were only willing to invest less.<sup>115</sup> In other words, they were likely less impressed by the two advertised high-performing funds because they knew that they had been selected from a pool of thirty funds run by the company.

Importantly, participants who saw the advertisement that did not state how many funds the company operated acted like the participants who saw the advertisement stating that the fund company had only two funds. They rated the fund company's quality

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112. They examined the returns of retroactive additions in the same fourteen Morningstar categories in each of the six months following the funds' inceptions, again for a total of eighty-four category-months. *Id.* In only five of these category-months were the retroactive additions' returns statistically significantly different from those of similar, seasoned funds. *Id.* Also, in only three of these five category-months did the retroactive additions outperform the seasoned funds; in the other two category-months they underperformed the seasoned funds. *Id.*

113. Koehler & Mercer, *supra* note 47, at 1110–13.

114. *Id.* at 1110–11.

115. *Id.* at 1112–13.

the same, had the same willingness to invest in the new fund, and were willing to invest the same amount in the new fund.<sup>116</sup> In other words, investors who were not told how many funds existed acted as if they had been told that there were only two funds. This result indicates that unless investors are told that advertised high-performers have been culled from lower-performers, they will act as if no such selection has occurred.

In summary, luck plays a major role in the success of incubator funds. However, luck's role is obscured from investors because fund companies are much more likely to market their successful incubator funds than their unsuccessful incubator funds. As a result, investors see a disproportionate number of successful funds, causing them to attribute this success to the fund managers' skill rather than luck.

In this section, we have shown that incubation appears to be widespread, and that tools for creating new funds with strong performance records are readily available to fund companies. By favoring incubator funds and then selectively choosing which ones to sell to the public, fund companies are able to report and market high incubation-period returns. Investors, who generally flock to funds with high returns, are drawn to these new funds.

However, marketing high incubation returns misleads investors. If the new fund does not continue to be favored as it was during incubation, investors will have been "baited and switched." Investors are also often misled by high incubation returns because these returns are unlikely to continue when the fund is sold to the general public and grows dramatically. Even more importantly, fund companies' tendency to take public only their strong-performing incubator funds misleads investors by hiding the element of luck that strongly undergirds incubation-period performance. By concealing how funds are selected for sale to the public, fund companies mislead investors regarding the importance of incubation-period returns.

### III. SEC REGULATION OF INCUBATION

Using performance results generated through an undisclosed incubation process is deceptive and violates federal securities laws, which uniformly prohibit the sale of securities using materially untrue or misleading information.<sup>117</sup> Specifically, Rule 156 promulgated

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116. *Id.*

117. Section 34(b)(1) of the Investment Company Act, echoing the language of Section 17 of the Securities Act and Rule 10b-5 of the Securities Exchange Act, states:

It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account,

under the Securities Act of 1933 explains that performance data presented without context in mutual fund sales literature can be misleading under the antifraud provisions of the securities laws.

Representations [in sales literature] about past or future investment performance could be misleading . . . where [p]ortrayals of past income, gain, or growth of assets convey an impression of the net investment results achieved by an actual or hypothetical investment which would not be justified under the circumstances, including portrayals that omit explanations, qualifications, limitations, or other statements necessary or appropriate to make the portrayals not misleading.<sup>118</sup>

Despite the prohibitions against misleading disclosures in fund prospectuses, shareholder reports, and sales literature, no SEC rule specifically addresses fund incubation. In fact, none of the agency's rulemaking dealing with performance data even mentions the term "incubation."

This section begins with a description of the SEC's regulation of the strategies that fund companies have used to inflate the performance of incubator funds—specifically, overallocating hot IPOs to them, keeping them very small, and restricting shareholder redemptions. The SEC has done little to address these practices. We then examine the SEC's limited and insufficient approach to preventing investors from being misled by how fund companies select the funds to market to the public.

#### *A. Preferential Treatment of Incubator Funds*

Despite studies revealing likely widespread inflation of incubation-period performance through special treatment by fund companies, the SEC has taken little action against this abuse. The SEC has brought only two enforcement actions against companies for manipulating the performance of new funds. Both were brought almost ten years ago and dealt with the artificial boosting of fund returns through large allocations of hot IPOs. Nor has the agency required disclosure of the effect on fund returns of increasing fund size and providing shareholders with liquidity, even though it has generally acknowledged that funds are managed differently before than after registration.

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record, or other document filed or transmitted pursuant to this title . . . . It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

Investment Company Act of 1940, 15 U.S.C. § 80a-34(b)(1) (2008).

118. 17 C.F.R. 230.156(b)(2)(i) (2008).



## 1. SEC Enforcement Actions Have Targeted Only Extreme Allocations of Hot IPOs

The SEC has brought only two enforcement actions for manipulation of new funds' performance. Both of these cases involved artificially inflating a new fund's returns through large allocations of hot IPOs. In each enforcement action, the SEC concluded that marketing the funds to the public based on performance results that were unlikely to continue was inherently misleading—and thus a violation of both Section 34(b) of the Investment Company Act and other securities laws. These enforcement actions also indicate that if the SEC were to investigate fully fund incubation, it would conclude that the marketing of incubator funds is often misleading.

### *a. Van Kampen (1999)*

In a 1999 enforcement action, the SEC censured and fined the Van Kampen Investment Advisory Corporation “for failing to disclose material facts concerning the impact of hot IPOs on their ‘incubator’ Growth Fund’s 1996 performance.”<sup>119</sup> The Van Kampen Growth Fund began operating as an incubator fund in late December 1995 with seed money provided by Van Kampen and affiliated individuals.<sup>120</sup> During its incubation period, the fund usually had net assets of between \$200,000 and \$380,000.<sup>121</sup>

For 1996, the great bulk of its incubation period, the Growth Fund was the best-performing fund in its category according to Lipper Analytical Services.<sup>122</sup> Its 62 percent total return was 20 percentage points higher than any other fund in its category.<sup>123</sup> Partly as a result of its high performance, Van Kampen decided to take the fund public.<sup>124</sup>

The fund was opened to the public in early February 1997, approximately fourteen months after its inception. The fund's sales literature highlighted its 62 percent return and that it was the best-

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119. Press Release, Securities & Exchange Commission, Van Kampen Investment Advisory Corp. and Former Secior Official Censured and Fined For Disclosure Violations Regarding “Incubator” Growth Fund (Sept. 8, 1999), *available at* <http://www.sec.gov/news/press/pressarchive/1999/99-111.txt>. Van Kampen and its former Chief Investment Officer were censured and fined \$100,000 and \$25,000, respectively. *Id.*

120. Van Kampen Inv. Advisory Corp., Investment Advisors Act of 1940 Release No. 1819, Investment Company Act of 1940 Release No. 23996, 54 S.E.C. 355, 357 (Sept. 8, 1999).

121. *Id.*

122. *Id.* at 358.

123. *Id.*

124. *Id.*

performing fund in its Lipper category.<sup>125</sup> The fund's semi-annual shareholder report also reported the 62 percent return.<sup>126</sup> Likely because of this strong performance, investors flocked to the fund, causing its assets to skyrocket to over \$110 million in less than six weeks.<sup>127</sup>

Unknown to investors, however, much of the high incubation returns were from hot IPOs that Van Kampen had allocated to the fund.<sup>128</sup> An internal Van Kampen analysis found the Growth Fund's 1996 return would have been about one-third lower if the fund had purchased the IPOs on the secondary market (i.e., at the true market price), rather than having them allocated to the fund.<sup>129</sup> Moreover, more than 50 percent of the fund's 1996 return came from IPOs.<sup>130</sup>

The Growth Fund's prospectus, shareholder report, and advertising failed to disclose the great impact of IPOs on the fund's performance.<sup>131</sup> On the contrary, Van Kampen representatives made statements to the press that explicitly denied that IPOs had a large effect on the fund's performance.<sup>132</sup>

The SEC found that disclosing the fund's incubation-period performance without also disclosing the effect of the hot IPOs made the registration statement and shareholder report materially misleading. Van Kampen thus violated Section 34(b) of the Investment Company Act and Section 206(2) of the Investment Advisers Act of 1940.<sup>133</sup> The SEC reasoned that

disclosure that a large portion of the Growth Fund's return was attributable to its investments in IPOs would have been material to an investor's decision whether to invest in the Growth Fund, particularly in light of the fact that, given the growth in the fund's total assets, it was questionable whether the fund could continue to experience, by investing in hot IPOs, substantially similar performance as the fund had previously experienced.<sup>134</sup>

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125. *Id.* at 359.

126. *Id.* at 360.

127. *Id.* at 359.

128. *Id.* at 358 n.3. The SEC defined "hot IPOs" as "securities that trade at a premium over their initial public offering price immediately after the initial public offering."

129. *Id.* at 359.

130. *Id.* at 359 n.4. The SEC produced the 50 percent figure by calculating the fund's actual gains on the IPO shares. We believe, however, that Van Kampen's one-third figure better measures the subsidy that the fund received—if the fund had been forced to buy the IPOs on the secondary market, the fund would not have received an advantage over other investors.

131. *Id.* at 361.

132. *Id.*

133. *Id.* at 361–62.

134. *Id.*

*b. Dreyfus (2000)*

In a second enforcement action, the SEC charged The Dreyfus Corporation in 2000 with failing to disclose the large role that IPOs played in one of the company's new mutual funds.<sup>135</sup> The SEC censured and fined both the company and an employee who managed four Dreyfus funds, including the Dreyfus Aggressive Growth Fund ("DAG"), which was a very small, new fund.<sup>136</sup> The DAG's prospectus during its first fiscal year stated that "[i]f . . . other [mutual funds advised by Dreyfus] desire to invest in, or dispose of, the same securities as [DAG], available investments or opportunities for sales will be allocated equitably to each investment company."<sup>137</sup> Despite this claim, IPOs—and especially hot IPOs—were not allocated equitably among the four funds.<sup>138</sup> Proportionate to their sizes, DAG received an approximately thirty-seven-times greater allocation of IPOs than did the other three funds.<sup>139</sup>

As a result of its large IPO allocation, DAG was the top-ranked fund of the 175 funds in Lipper's Capital Appreciation category at the end of its first fiscal year, with a total return of 81.7 percent.<sup>140</sup> The first-day returns from IPOs contributed approximately 70.3 percentage points—or 86 percent—of that total return.<sup>141</sup> Dreyfus advertised DAG's high first-year return and its top Lipper ranking, but the advertisements did not disclose the IPOs' impact on this performance.<sup>142</sup> Unsurprisingly, investors flocked to this high performance, increasing DAG's size from \$2 million at its inception to more than \$154 million only eight months later.<sup>143</sup>

The SEC found that, by failing to disclose the great effect that the IPO allocation policy had on DAG's returns, Dreyfus had breached its fiduciary duty to investors to disclose all material facts.<sup>144</sup> The SEC noted that disclosure was required because it was "questionable whether DAG could replicate its prior performance through continuing

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135. Dreyfus Corp., Securities Act of 1933 Release No. 7857, Investment Advisors Act of 1940 Release No. 1870, Investment Company Act of 1940 Release No. 24450, 54 S.E.C. 635 (May 10, 2000).

136. *Id.* at 636.

137. *Id.* at 639.

138. *Id.*

139. *Id.* at 640.

140. *Id.* at 641–42.

141. *Id.* at 642.

142. *Id.*

143. *Id.* at 641.

144. *Id.* at 644.

to invest in IPOs as the fund grew larger.”<sup>145</sup> In addition, it found that DAG’s prospectus was materially false and misleading by claiming that IPOs were allocated equitably among Dreyfus’ funds.<sup>146</sup>

In summary, the SEC’s enforcement actions against Van Kampen and Dreyfus—while salutary—must be kept in perspective. They represent the *only* cases in which the SEC has challenged the use of hot IPOs to boost artificially a new fund’s returns. The SEC seemed unaware of—and certainly incurious about—how widespread the practice may be. As discussed before, new funds’ returns in general are more sensitive than seasoned funds’ returns to IPO first-day returns, indicating that new funds’ portfolios often contain a greater percentage of IPOs than do other funds.<sup>147</sup> Thus, the Van Kampen and Dreyfus cases likely are only extreme examples of a common practice.

## 2. The SEC Does Not Require Disclosure of How Fund Size and Shareholder Redemption Policies Affect Performance

Successful incubator funds, endowed with a strong performance history, typically grow dramatically when sold to the public. Even if strong incubation performance reflects some stock-picking skill, it becomes more difficult for the manager to continue to exhibit this skill after the fund grows and shareholders are permitted to redeem their shares on demand.<sup>148</sup> For example, it is much harder for a large, open-ended fund that does not restrict shareholder redemptions to significantly boost its returns by investing in small, thinly traded stocks.

The SEC does not require disclosure of the effect of increasing fund size or shareholder redemption policies on performance. Nonetheless, the agency has recognized the effect of fund size, at least in the context of the allocation of hot IPOs. When the SEC censured and fined Van Kampen for not disclosing the large role that hot IPOs played in its new Growth Fund’s high returns, the SEC noted that “given the growth in the fund’s total assets, it was questionable whether the fund could continue to experience, by investing in hot IPOs, substantially similar performance as the fund had previously experienced.”<sup>149</sup> Because during its incubation phase the fund

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145. *Id.*

146. *Id.*

147. Wisen & Chiang, *supra* note 56, at 60, 61 exh.5.

148. *See supra* Part II.B.3.b.

149. Van Kampen Inv. Advisory Corp., Investment Advisers Act of 1940 Release No. 1819, Investment Company Act of 1940 Release No. 23996, 54 S.E.C. 355, 361–62 (Sept. 8, 1999).

generally had assets of only a few hundred thousand dollars, even a small allocation of hot IPOs could—and did—greatly affect the fund's performance. However, when the fund was marketed to the public and grew to over \$100 million, a dramatically larger allocation of hot IPOs would have been necessary to sustain the fund's abnormally high returns.

In addition, the SEC has acknowledged that "funds are likely to be managed differently before they are offered to the public."<sup>150</sup> However, the SEC has not discussed whether it believes that funds' growth and the need to provide liquidity to shareholders are reasons that funds are managed differently after they are taken public.

In summary, nothing requires a small fund to warn investors that its growth may hamper future returns. A very small incubator fund that invested in small-capitalization stocks and was registered with the SEC may baldly advertise its high incubation returns. Under the SEC's current policy, such a fund need not disclose two forces that will make it difficult for high returns to continue: that it is likely to grow dramatically, and that it will have to be prepared for shareholder redemptions.

### *B. Selective Marketing of Incubator Funds*

#### 1. The SEC Generally Prohibits Marketing of Funds' Pre-Registration Performance

Fund companies generally cannot report or advertise fund performance data that precede the effective date of the fund's registration. A fund prospectus must contain a bar chart and table presenting the fund's returns over the past ten calendar years or the life of the fund, whichever is shorter. In the instructions for preparing this chart and table, the SEC explicitly requires that all of the reported returns be "only for periods subsequent to the effective date of the Fund's registration statement."<sup>151</sup>

Likewise, advertisements may disclose performance data arising only after registration. Rule 482 promulgated under the Securities Act of 1933 specifies that any advertising of fund performance must include performance data for "the time period

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150. Investment Company Act Release No. 16254 (Feb. 2, 1988).

151. Securities and Exchange Commission, Form N-1A, Information Required in a Prospectus: Risk/Return Summary: Investments, Risks, and Performance (2)(c)(2)(ii), available at <http://www.sec.gov/about/forms/formn-1a.pdf> (last visited Sept. 12, 2009).

during which the registration statement was in effect.”<sup>152</sup> Advertisement of pre-registration performance is not permitted.

Curiously, when the SEC proposed its advertising rule, it seemed unaware of the potential for incubation and misleading use of manipulated pre-registration performance data. The original proposal would have permitted performance data beginning when a fund started “in business,” thus permitting advertising of returns attained before a fund was registered. Two prescient commentators, however, urged that the SEC permit only post-registration performance data to be advertised. In its final release accompanying Rule 482, the SEC adopted these commentators’ suggestion because “funds are likely to be managed differently before they are offered to the public.”<sup>153</sup>

In summary, although fund companies generally cannot report or advertise fund performance data that precede the effective date of the fund’s registration, the SEC rulemaking on disclosure and advertising of performance data treated the possibility of incubation as an afterthought. The SEC releases accompanying these rules did not mention incubation, referring only in general terms to the possibility that funds may be managed differently after they are registered.

## 2. The SEC Sometimes Allows Funds to Market Performance Data from Other Accounts and Funds

Funds are generally prohibited from using pre-registration performance data in prospectuses, reports, and advertising. The SEC staff, however, has issued a number of no-action letters permitting new funds to report and advertise the returns of other related funds and investment accounts. In doing so, the staff has assumed that investors are not misled when performance data come from other funds or accounts that were both (1) managed in a manner similar to the new fund and (2) not created for the purpose of generating performance records.

During the 1990s, the SEC staff changed its policy from merely permitting new funds to use performance data of *predecessor* funds and accounts to allowing such data from *similar* funds and accounts as

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152. 17 C.F.R. § 230.482(d)(3) (2008) (requiring that any “quotation of the company’s performance contained in an advertisement” be limited to “[a]verage annual total return for one, five, and ten year periods, except that if the company’s registration statement under the Act (15 U.S.C. 77a *et seq.*) has been in effect for less than one, five, or ten years, the time period during which the registration statement was in effect is substituted for the period(s) otherwise prescribed”).

153. Advertising by Investment Companies, Securities Act Release No. 6753 (Feb. 2, 1988).

well. In addition, the SEC staff extended this permission to allow such data to be used not only in prospectuses but also in fund advertising. The SEC staff seemed oblivious to the possibility that fund companies could be misleading investors by selectively choosing which related funds or accounts to use. Selection biases such as these are at the heart of a major problem with incubation.

*a. Funds Can Use Performance Data of  
Predecessor Investment Accounts*

In a 1995 no-action letter, the SEC's Division of Investment Management permitted Massachusetts Mutual Life Insurance Company ("MassMutual") to market prior returns of unregistered separate investment accounts when MassMutual converted the accounts into registered mutual funds.<sup>154</sup>

MassMutual had converted seven separate investment accounts ("SIAs") exempt from registration under the Investment Company Act into new mutual funds.<sup>155</sup> Each of the resulting seven mutual funds had an "investment objective, policies and practices designed to correspond to" those of its predecessor SIA.<sup>156</sup>

The SEC permitted MassMutual to include each SIA's prior returns as the corresponding mutual fund's historical returns in its prospectus, statement of additional information, and sales material. Thus, MassMutual permissibly adopted the SIA's prior, pre-registration performance as the fund's own performance.<sup>157</sup> MassMutual agreed to include the disclosure that "the quoted performance data includes the performance of the SIAs for periods before the Trust's registration statement became effective."<sup>158</sup>

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154. MassMutual Inst., Funds, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 747, at \*7 (Sept. 28, 1995).

155. The SIAs were investment vehicles for pension plans qualified under the Internal Revenue Code § 401, and thus exempted from the Investment Company Act's definition of "investment companies." *Id.* at \*1 n.2. Each SIA held a portfolio of securities, which were contributed to a new mutual fund in exchange for shares of the fund. As a result of the transaction, each SIA owned shares of a mutual fund that owned the same portfolio of securities that the SIA had previously owned directly. In addition, MassMutual provided \$107,000 of initial capital to each new fund. *Id.* at \*14.

156. *Id.* at \*1.

157. *Id.* at \*7. These prior returns were adjusted to reflect the deduction of fees and expenses that would have been applicable if the SIA had been a mutual fund. *Id.* at \*4-5.

158. *Id.* at \*4 n.5. They also included the disclosure that "the SIAs were not registered under the 1940 Act and therefore were not subject to certain investment restrictions that are imposed by the Act," and the disclosure that "if the SIAs had been registered under the 1940 Act, the SIAs' performance may have been adversely affected." *Id.*

The SEC staff offered two primary reasons for granting the no-action letter. First, MassMutual had represented that each fund would be “managed in a manner that is in all material respects equivalent to the management of the corresponding SIA.”<sup>159</sup> Second, the SIAs “were created for purposes entirely unrelated to the establishment of a performance record.”<sup>160</sup>

The SEC suggested that these reasons were consistent with the intent of its rules that normally prohibit the use of pre-registration returns. In one of its few and perhaps most lucid explanations of the dangers of incubation, the staff explained that Rule 482(d)(3)’s prohibition against advertising pre-registration returns was partly intended to “preclude [a fund] adviser from establishing a number of funds for the purposes of generating performance data, and then registering those ‘incubator funds’ with the best performance records so that the newly registered funds can use that performance.”<sup>161</sup> In addition, quoting the SEC release accompanying Rule 482, the staff reiterated that the general prohibition against advertising pre-registration performance was justified because “funds are likely to be managed differently before they are offered to the public.”<sup>162</sup>

In February 1997, sixteen months after the MassMutual no-action letter, the SEC again publicly explained its policy toward incubator funds. Dr. William Greene, then a Department Chair at the NYU Stern School of Business, asked the SEC whether a mutual fund sponsor could create a number of incubator funds for the purpose of creating performance track records—taking only the highest performing funds public and advertising their high returns.<sup>163</sup> In response, Jack Murphy, the Associate Director of the SEC’s Division of Investment Management, wrote that such a scenario would “raise

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159. *Id.* at \*7. The SEC cited a number of MassMutual representations as evidence that the mutual funds were being managed the same as their predecessor SIAs. MassMutual was the investment adviser for all of the funds and the SIAs. Also, each fund that had sub-advisers had the same sub-advisers as its predecessor SIA. In addition, each fund had management practices, investment policies, investment objectives, guidelines, and restrictions that were “in all material respects” equivalent or identical to those of its predecessor SIA. *Id.* at \*2–3.

160. *Id.* at \*3. The evidence the SEC staff cited for this conclusion was the long length of time between the establishment of the SIAs and their conversion into mutual funds. The SEC noted that “[t]wo of the seven SIAs have existed for more than 20 years, and two others have existed for more than 10 years. Of the other three SIAs, one was established in 1987, one in 1989, and one in 1991.” *Id.*

161. *Id.* at \*6.

162. *Id.* at \*6 n.8.

163. Stern Sch. of Bus., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 316, at \*1 (Feb. 3, 1997).



serious concerns under the antifraud provisions of the federal securities laws.”<sup>164</sup>

Murphy stated (without citation) that the SEC had “consistently, for close to thirty years, expressed severe reservations” regarding incubator funds.<sup>165</sup> He reiterated the SEC’s two concerns about incubator funds. First, they might be managed differently after going public than they were during their incubation period. Second, a fund sponsor might adopt the strategy suggested by Dr. Greene: create multiple similar incubator funds and take only the most successful one public without disclosing the performance of the other funds.<sup>166</sup>

Murphy also wrote that the SEC’s no-action letter to MassMutual had been misrepresented by some of the media. He emphasized that MassMutual had represented to the SEC that each of its new mutual funds would be managed in “substantially the same manner as its predecessor account” and that each of the funds’ predecessor accounts were “created for purposes entirely unrelated to the establishment of a performance record.”<sup>167</sup>

*b. Spun-Off Funds Can Use Performance Data of Predecessor Funds*

In 2000, the SEC staff issued a no-action letter permitting Janus Capital Corporation to include in the registration statements, advertisements, sales literature, and prospectuses of new funds the previous performance of registered funds from which the new funds had been spun off.<sup>168</sup> One class of a number of registered Janus funds had been created only for investments in qualified retirement plans.<sup>169</sup> Janus sought to make those funds also available for investments from non-qualified retirement plans and thus spun off that class into new funds that could accept such investments.<sup>170</sup>

The SEC accepted Janus’s argument that the use of the prior performance data would not implicate “the primary concerns against permitting a fund to present performance information prior to the effective date of the fund’s registration statement.”<sup>171</sup> The SEC staff reasoned that the spin-off was not for the purpose of presenting the

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164. *Id.* at \*3.

165. *Id.* at \*1.

166. *Id.* at \*2.

167. *Id.* at \*2–3.

168. Janus Capital Corp., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 826, at \*17 (Aug. 28, 2000).

169. *Id.* at \*2.

170. *Id.* at \*4.

171. *Id.* at \*17.

prior performance records and that the new funds were subject to the same investment restrictions that were imposed on the predecessor funds, which were also registered investment companies.<sup>172</sup> The staff concluded that the new funds “effectively will operate as a continuation of the [old funds] such that the performance history of the [old funds] may be carried forward.”<sup>173</sup>

In a footnote to the no-action letter, the SEC staff indicated its belief that, in certain situations, a fund spun off from another might actually be required to disclose the performance of its predecessor fund.<sup>174</sup> In addition, the letter noted that if Janus had sought to spin off only a portion of a predecessor class of funds—rather than an entire class of funds—then the staff might not have allowed the performance data’s use.<sup>175</sup>

*c. New Funds’ Prospectuses Can Include Performance Data of Similar Non-Predecessor Funds and Private Accounts*

Although the MassMutual and Janus scenarios involved predecessor funds and accounts, the SEC has also allowed a new mutual fund to report the performance of other mutual funds and accounts that were not predecessors of the fund.

In a 1996 no-action letter to Nicholas-Applegate Mutual Funds, the SEC staff permitted mutual funds to include in their prospectuses the performance of private accounts managed by the funds’ adviser that had investment objectives, policies, and strategies substantially similar to the new mutual funds.<sup>176</sup> Unlike MassMutual, these private accounts were not converted into the mutual funds. Indeed, the

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172. *Id.* at \*14.

173. *Id.* at \*17–18. Janus represented that, when presenting the new funds’ performance, it would disclose that each new fund had been previously organized as another fund, the date that each new fund commenced operations, and that the reported information included performance of the predecessor funds. *Id.* at \*5.

174. For example, the SEC warned against a mutual fund that is spun off from a class of another fund presenting performance information but failing “to [also] disclose adequately the performance of the predecessor class (for example, as supplemental, non-standardized performance information in the fund’s registration statement, advertisements or sales literature). . . .” *Id.* at \*18 n.19. The SEC stated that such a fund “could be deemed to have omitted to state a fact necessary in order to make the statements in its registration statement, advertisements or sales literature not materially misleading.” *Id.*

175. *Id.* at \*18.

176. Nicholas-Applegate Mut. Funds, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 674, at \*7 (Aug. 6, 1996). About a decade earlier, the SEC allowed funds in their first year of operations to include in their prospectuses and advertisements the recent performance of similar private accounts. However, this permission was formally limited to closed-end funds. Growth Stock Outlook Trust, Inc., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2026, at \*10 (Apr. 15, 1986).

private accounts continued to operate after the funds were created. Because the private accounts were not predecessors of the mutual funds, the funds were prohibited from reporting the private accounts' historical performances as the funds' *own* performance. However, the funds were permitted to report the private accounts' performance in addition to their own performance.<sup>177</sup>

At almost the same time, the SEC staff granted a no-action letter to Bramwell Growth Fund. That letter permitted a mutual fund to include the performance of another fund in its prospectus when (1) both funds shared substantially similar investment objectives and policies, and (2) the new fund's portfolio manager had previously served as portfolio manager of the other fund.<sup>178</sup> Because the other fund was not a predecessor of the manager's current fund, the performance could be reported only in addition to the current fund's own performance, as in the Nicholas-Applegate letter.<sup>179</sup> Also, both the Bramwell and Nicholas-Applegate no-action letters were limited to including the information about similar funds' and private accounts' returns in the fund prospectus.

*d. New Funds' Advertising and Supplemental Sales Literature Can Include Performance Data of Similar Non-Predecessor Funds and Private Accounts*

In 1997, the SEC staff granted a no-action letter to ITT Hartford Mutual Funds permitting advertisements and supplemental sales literature of new mutual funds to include returns of a company's corresponding funds with investment objectives, policies, and strategies similar to those of the new funds.<sup>180</sup> The corresponding funds were registered and used in the company's variable insurance products, while the new funds were open to all investors. Tax laws prevented those corresponding funds from being converted into the new mutual funds.<sup>181</sup>

On the same date, the SEC granted a no-action letter to GE Funds allowing new mutual funds' advertisements and supplemental sales literature to include returns of corresponding registered

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177. Nicholas-Applegate Mut. Funds, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 674, at \*5-6 (Aug. 6, 1996).

178. Bramwell Growth Fund, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 668, at \*7 (Aug. 7, 1996).

179. *Id.* at \*5-6.

180. ITT Hartford Mut. Funds, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 259, at \*7-8 (Feb. 7, 1997).

181. *Id.* at \*1-2.

institutional funds and private institutional accounts.<sup>182</sup> These corresponding institutional funds and accounts had investment objectives and policies substantially similar to those of the new mutual funds, but unlike the new mutual funds they were open only to institutional investors.<sup>183</sup>

In summary, the SEC staff has shown some willingness to allow fund companies to use performance data of certain other mutual funds and private accounts regardless of whether they were the new funds' predecessors. The staff has recognized that advertised performance data can be manipulated through a selection process that chooses to highlight only strong-performing funds' returns. But it has not fully recognized that other funds' and accounts' performance data can be manipulated in the same way. In none of the requests for no-action letters, for example, did fund companies seek to report and advertise *poor* returns by "similar" funds and accounts.

The SEC incorrectly assumes that investors will not be misled if the other funds and accounts were managed in a similar way to the new fund and were not created for the purpose of producing a strong performance record. However, investors can still be misled if they are unaware of how the fund companies choose which other funds and accounts to use. For example, a fund company could establish a number of private investment accounts because of demand from certain customers. Even if the account managers possessed no stock-picking skill, some of the accounts would likely perform well because of luck. Because the accounts were not established for the purpose of creating a track record, the SEC would permit the company to convert the strong-performing accounts into mutual funds and advertise the performance of the predecessor private accounts. However, unless investors are also told of the weak-performing private accounts that were not converted into mutual funds, they would be deceived into believing that the managers of the converted funds have stock-picking skill.

Without disclosing the performance of all the accounts and funds from which new funds could have been converted or spun off, fund companies provide investors with only a partial, biased picture of a new fund's performance pedigree. The risk of deception exists whenever a fund company can select which funds to bring to market without fully disclosing its underlying selection process.

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182. GE Funds, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 269, at \*10 (Feb. 7, 1997).

183. *Id.* at \*14.

### 3. The SEC Does Not Regulate “Public” Incubation

As discussed above, the SEC generally prohibits funds from marketing their pre-registration returns. Because funds must register with the SEC before they can be sold to the public, this prohibition prevents many incubator funds from marketing returns achieved before the fund was publicly available.

However, fund companies can create an incubator fund, register it with the SEC, yet neither advertise it nor obtain a ticker symbol for it. Thus, although the fund would technically be public because it is registered with the SEC, it would be effectively private. Without a ticker symbol, the public would be unable to buy the fund, and without advertisement few potential investors would even know of the fund's existence. Indeed, some major fund companies have used such an approach.<sup>184</sup>

Because such an incubator fund was registered during its incubation period, the SEC's general prohibition against marketing pre-registration performance does not apply to it. However, because it is not actively marketed, potential investors will not be aware of the fund during this “public” incubation period. As a result, if the fund company chooses to market actively only the funds that have performed well during their public incubation periods, investors will be unaware that the lesser-performing funds existed. Unassuming investors are thus likely to be misled into believing that the high-performing funds reflect managerial skill rather than luck. The SEC, however, has not taken any steps to protect investors from such misleading public incubation.

## IV. ADDRESSING INCUBATION ABUSE

Incubator funds' returns can mislead investors in two ways. First, returns arising from special treatment—i.e., hot IPO allocations, the funds being kept very small, and shareholder redemptions being restricted—are deceptive in the absence of disclosure that the special treatment will not continue. Second, when the fund sponsor chooses to market high- rather than low-performing incubator funds, it creates the impression that the high performance reflects managerial skill rather than luck.

This section discusses ways of addressing these problems. Regulatory intervention is necessary because market forces have not

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184. Wyatt, *supra* note 82 (giving examples of large fund companies that registered new mutual funds with the SEC but kept them hidden from the general public until the funds had a strong performance record that could be advertised).

stopped incubation's misuse. One might expect fund companies that do not misuse incubation to advertise this fact in order to give them a competitive advantage over fund companies that do misuse incubation.<sup>185</sup> However, we have not discovered any instance of such advertising.

Why have fund companies not used such advertising? One reason might be that a fund company would be unlikely to recoup the costs of such an effort. The fund company would have to educate investors about incubation—what it is and how it can be misleading—as well as inform them that the company does not engage in the practice. Advertising is costly, however, and it is unclear how many investors would pay attention to such advertising and understand the implications of fund incubation even if it were explained to them.

In addition, there is a potential free-riding problem. Even if a company's education campaign is successful, the company may not be able to recoup its investment. After investors were educated, other companies that do not misuse incubation could advertise that they do not misuse incubation either. These companies would obtain the benefit of the first company's education efforts without having incurred the costs of education. In addition, some companies misusing incubation might stop doing so and then advertise that they do not misuse incubation either.<sup>186</sup>

Whatever the reason, market forces are not stopping the abuse of incubation. We next discuss what steps the SEC might take to protect investors from this behavior.

#### *A. Reforms That Address Special Treatment of Incubator Funds*

Fund companies often subsidize incubator funds by overallocating hot IPOs to them. In addition, incubator funds are kept very small and shareholder redemptions are restricted, often giving them an advantage over larger, open-ended funds.

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185. In a survey of fund companies, most denied ever incubating funds while others admitting doing so or declined to answer. Jason Zweig et al., *The Good, The Bad and The Ugly: Which Fund Companies Put Investors First?*, MONEY, Feb. 1, 2004, at 74.

186. For a fuller discussion of how such free-riding on educational efforts to correct consumer misperceptions may prevent a seller from making such investments, see Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749, 758–61 (2007).

### 1. The SEC Should Treat Overallocation of Hot IPOs as Inherently Misleading, or At Least Require Its Disclosure

In fining and censuring two fund companies for failing to disclose that returns of particular new funds were dramatically boosted through hot IPOs, the SEC has addressed only two extreme examples of a common practice. Wisen and Chiang's study showing that new funds' returns are generally more sensitive to IPO first-day returns provide clear evidence that new funds' portfolios contain a greater percentage of IPOs than do other funds.<sup>187</sup>

At the very least, the SEC should require all funds to disclose what percentage of their incubation returns come from IPOs—especially hot IPOs. However, such disclosure still may not prevent investors from being misled. Surveys show that fund investors are uninformed about their mutual funds. For example, most investors do not even know the type of mutual funds they own.<sup>188</sup> Capon, Fitzsimons, and Rice found that 72 percent of the surveyed investors did not know if their primary fund invests in domestic or international securities, and 75 percent did not know whether the fund invests in equity or fixed income securities.<sup>189</sup> Thus, investors might not read or appreciate the significance of a disclosure that an incubator fund's returns were boosted by a large allocation of hot IPOs.

A better approach, therefore, would be for the SEC to bring enforcement actions against fund companies that significantly reduce the allocation of hot IPOs to their funds after their incubation periods. Because these funds' incubation returns were achieved using hot IPOs and these allocations did not continue, the high incubation returns reported by the funds mislead investors. The appropriate remedy would be for the fund company to compensate the fund (and any investors who have sold their shares) for any shortfall in post-incubation returns due to the reduced allocation of hot IPOs.

### 2. The SEC Should Require Disclosure of the Effect of Fund Size and Shareholder Redemption Policies on Performance

Incubator funds are typically kept very small and are shielded from shareholder redemptions. This protection often gives them an advantage relative to funds that are larger and must be prepared for redemptions. However, when a strong-performing incubator fund is marketed to the public, its resulting dramatic growth—and the

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187. *See supra* Part II.B.3.a.

188. Capon et al., *supra* note 20, at 77.

189. *Id.* at 68.

possibility of shareholder redemptions—make it difficult for the fund to continue to generate high returns. This practice creates another way to mislead investors by incubation-period returns.

One approach to addressing this problem would be to require wherever a fund reports or advertises incubation returns to include a warning such as, “These returns were achieved when the fund was very small and had not been marketed to the general public. It generally is more difficult for a fund to achieve high returns as it grows.” Such a warning is especially appropriate for funds, such as small-capitalization equity funds, that face declining investment options as fund size and shareholder redemptions increase.

### *B. Reforms That Address Selective Marketing of Incubator Funds*

Investors are also misled by the selective marketing of incubator funds. Funds with strong incubation performance records are actively marketed to the public, while funds with weak track records are never seen. This selective marketing creates the illusion that managerial skill, rather than luck, is behind the high-performing funds. A number of possible solutions to this problem exist.

#### 1. The SEC Could Require Disclosure of the Existence and Performance of All Incubator Funds

One solution to selective marketing would require fund companies to disclose the existence and returns of all of their incubator funds. For example, when an incubator fund is taken public and a company reports and advertises its incubation-period returns,<sup>190</sup> the fund’s prospectus and advertising would also disclose the returns of the fund company’s other incubator funds over the same time period. Such disclosure would provide a context for the incubation returns of the newly public fund and indicate whether the new fund’s returns were representative of the returns of all of the company’s incubator funds.

However, such a policy would pose several difficulties. First, there would be questions about which returns must be disclosed. For example, in the MassMutual no-action letter, separate accounts were converted into mutual funds. Similarly, with ITT Hartford, insurance funds were copied into new mutual funds. Thus, to be comprehensive, a fund company would have to disclose the returns of all its separate

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190. Recall that the SEC generally does not allow pre-registration incubation returns to be reported, but has created some exceptions to this policy.



accounts and insurance funds as well. Such an approach might overwhelm already confused investors.

In addition, even if the returns of non-public incubator funds were disclosed, investors might not understand the implications. The message intended by including the returns of other incubator funds is that the advertised high-performing incubator fund may have been lucky. If the company's other incubator funds did not perform well, the existence of one high-performing fund should not be considered significant evidence of managerial skill. However, this message is subtle, and investors might miss it. Even though studies have found little evidence that funds that have performed well in the past continue to perform well, investors still flock to high-performing funds. Koehler and Mercer's recent experiment, however, suggests that providing investors with such context may be helpful.<sup>191</sup> Thus, informing investors about the number and performance of the funds and accounts from which the offered fund was selected may lead investors to discount high incubation performance. Giving context for the high incubation returns may make investors less likely to attribute these returns to skill and thus less likely to be misled.<sup>192</sup>

Of course, to facilitate investor understanding, the purpose of the disclosure could be made more explicit. For example, advertisements of incubation-period returns could be required to include the following warning:

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191. See Koehler & Mercer, *supra* note 47. Recall that in their experiment they provided participants with a fund company's advertisement that highlighted the strong past returns of two of the company's funds. One version of the advertisement stated that the advertised funds were only two of the company's thirty funds. Another version stated that those were the company's only two funds. A third version of the advertisement did not state how many funds the company had. A fourth version (the control) did not mention the funds' past returns at all. Investors were then asked their perception of the quality of the fund company and the likelihood and amount that they would invest in a new fund being introduced by the company.

Participants who saw the version that stated the fund company had only two funds and those who saw the version that did not state how many funds existed responded similarly. However, participants who viewed the advertisement disclosing that the fund company had thirty funds rated the fund company's quality lower, were less willing to invest in the company's new fund, and were willing to invest only a smaller amount in the new fund. In fact, they did not respond differently from participants who viewed the control advertisement, which lacked any information about past performance. In other words, they "gave little weight to the excellent (but selected) performance data that they saw in the ad." Koehler & Mercer, *supra* note 47, at 1113.

192. Two studies reached opposite conclusions regarding whether investors already somewhat discount performance data from fund companies that incubate. Garavito found that funds that were incubated receive less flow than similar-performing funds that were not incubated. Garavito, *supra* note 67, at 19–20, 34 tbl.8. Evans, however, found that investors don't differentiate between incubated and non-incubated funds with similar past returns. Evans, *supra* note 53, at 23 & tbl.IV.

This fund was selected to be marketed by its sponsor from a number of other new funds it operates, many of which did not have as high returns. Studies show that a new fund's strong initial performance usually does not persist. A fund's performance is often a matter of chance.

## 2. The SEC Could Prohibit Use of Incubation-Period Performance Data

Another possible solution is to prohibit funds from reporting and advertising performance data from their incubation periods. A complete prohibition would prevent much of the current abuse of incubator funds. A fund sponsor would have no incentive to create an incubator fund for the purpose of creating a strong track record if it could not market that track record later. Similarly, it would eliminate the incentive to overallocate hot IPOs to incubator funds because the resulting higher returns could not be marketed.

A primary objection to banning reporting and advertising of incubation-period returns is likely that investors want to know these returns. Many investors considering investing in a newly public fund will be interested in the fund's incubation-period returns. Indeed, investors' tendency to chase past returns shows the great weight that they give to past performance.<sup>193</sup>

A second possible objection is that incubation helps fund companies test new investment strategies or new fund managers.<sup>194</sup> For example, a senior managing director at Putnam Investments, a major mutual fund company, has argued that it is " 'very important' to incubate funds before bringing them to market. 'We believe we have a fiduciary responsibility to prove an investment concept' before selling new funds based on it."<sup>195</sup> Also, Garavito found that during incubation, funds invest in more illiquid and lesser-known stocks and hold a more concentrated portfolio than do non-incubated funds. This is consistent with fund companies using incubation to investigate lesser-known stocks.<sup>196</sup>

However, neither of these objections justifies the reporting or advertising of incubation-period returns. Investors desire past performance data because they believe high past returns foretell high future returns. However, this belief is generally erroneous. Studies show that incubator funds that outperformed comparable funds

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193. See *supra* Part I.B.1.

194. Garavito, *supra* note 67, at 21.

195. Mark Hulbert, *Strategies: Survival of the Fittest? Or Is That Lion a Lamb?*, N.Y. TIMES, Jan. 11, 2004, § 3, available at 2004 WLNR 5662248 (Westlaw) (quoting Stephen Oristaglio, Senior Managing Dir., Putnam Invs.).

196. Garavito, *supra* note 67, at 13–14.

during their incubation period do not continue to do so after.<sup>197</sup> Thus, rather than provide valuable information to investors, the high incubation-period returns actually mislead them. Also, the failure of high incubation returns to predict post-incubation performance demonstrates that incubation-period returns provide a poor test of an investment concept or a fund manager.<sup>198</sup>

In addition, a company can test a strategy or a fund manager by using a simulated mutual fund instead of a real incubator fund. The manager can manage a hypothetical portfolio, and the company could determine what that portfolio's returns would have been had the fund been real.

Finally, if a fund company truly believes that real incubation-period performance provides it with valuable information, it would still be permitted to use incubation, but it just could not report or advertise the incubation-period performance to potential investors.

### 3. The SEC Should Broadly Define "Incubation"

Regardless of which steps are taken to regulate incubator funds, the SEC must use a broader definition of "incubation." Any regulation could be circumvented if incubation-period returns are defined only as those occurring before a fund is registered with the SEC. For example, the SEC restricts the advertising of incubation returns by generally prohibiting the advertising of pre-registration returns. However, a fund company can avoid this restriction by registering an incubator fund with the SEC but not advertising or obtaining a ticker symbol for the fund. Although the fund would technically be public because it is registered, it would be effectively private and thus hidden from potential investors. Indeed, major fund companies have sometimes used this approach.<sup>199</sup>

To prevent such easy circumvention, the SEC must define incubation more broadly. A fund's incubation period should be defined as the period until the fund is actively marketed to the public. Returns achieved before the acquisition of a ticker symbol and the commencement of advertising efforts should be subject to the same regulations as returns achieved before the fund was registered with the SEC.

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197. See *supra* Part II.B.2.

198. Further evidence that incubation doesn't help identify good managers is that fund families that incubate have higher fund manager turnover than do fund families that do not incubate. Evans, *supra* note 53, at 25.

199. Wyatt, *supra* note 82.

## V. CONCLUSION

Mutual fund companies promote their funds on the basis of past performance because historical returns are key to investors. Therefore, the possibility that performance data will be manipulated is an important regulatory concern. Although the SEC has closely regulated how funds calculate and present performance data, it has failed to recognize fully how fund companies deceptively create new funds with strong performance records.

The incubation of mutual funds—a process in which many new funds are initially operated outside of public view but only some are later selected to be marketed to the public—can be manipulative and misleading if the selection process is not fully disclosed. Like the enterprising stockbroker who sends out a series of contradictory stock predictions, mutual fund companies that market only their high-performing incubator funds create the illusion of investment acumen.

Moreover, fund companies further mislead investors by favoring incubator funds in ways that do not continue after the funds are marketed to the public. By allocating to them hot IPOs, keeping them unsustainably small, and restricting shareholder redemptions, fund companies artificially boost the returns of their incubator funds. That is, fund companies mislead by failing to disclose that their new stars will soon be treated like all other funds in the fund company's constellation.

Studies find that an incubator fund's strong initial performance generally does not continue after the fund is sold to the public. Why do high incubation returns not persist? First, the returns-boosting special treatment that many incubator funds receive does not continue after the funds are sold to the public. Second, strong incubation returns are largely a matter of luck, and luck generally does not continue either. For these reasons, investors who chase high incubation-period returns will usually be disappointed.

The SEC indirectly regulates incubation by generally proscribing the reporting or advertising of pre-registration returns. However, this regulation does not prevent fund companies from quietly incubating *registered* funds. Nor has the SEC generally prevented companies from giving preferential treatment to their incubator funds.

Just as troublesome is the SEC's willingness to allow fund companies to market performance data of predecessor investment accounts, and even of similar funds, without requiring disclosure of the many accounts and funds whose performance data are not being used. If fund companies can select which performance data to tout,

investors will be misled if they do not understand the selection criteria.

What can be done to protect investors? At the very least, fund companies should be required to disclose the special treatment they give to their incubator funds and how they selected which incubator funds to market to the public. This disclosure will provide the context in which the funds' returns should be viewed. For example, it must include the number of other incubator funds that the company operates and yet chooses not to market to the public. A clearer disclosure might also explicitly warn investors that high incubation-period returns are largely a matter of luck, and that fund companies generally choose to market only their high-performing incubator funds.

Simple disclosure, however, may not be enough. The special treatment that incubator funds receive and the way they are selected for marketing make incubation-period returns inherently misleading. No amount of disclaimers, explanations, or contextual information can fully cleanse its misleading character. Given that strong incubation performance generally does not continue, arguably this performance should not be permitted to be marketed at all.

Fund incubation, the mutual fund industry's dark and unsavory secret, merits an examination in the full light of day.