

# American Funds' Dilemma

Will too much growth make it a victim of its own success?

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They're the biggest money managers you've never heard of. American Funds Group, owned by Capital Group Cos., doesn't advertise its mutual funds in any mainstream media. Managers and company higher-ups, such as Executive Committee Chairman Paul G. Haaga Jr., routinely turn down press interviews. Although the firm is the largest tenant in its downtown Los Angeles skyscraper, you won't find a single sign of its presence.

All this is because American doesn't want its own brand name to upstage those of brokerage firms such as Edward Jones, A.G. Edwards (AGE), and Merrill Lynch (MER), through which it sells its funds. The strategy is paying off. For the second year in a row, American has been the top recipient of new money in the mutual-fund industry, raking in nearly \$84 billion last year, more than a third of all new fund investments, according to Boston-based Financial Research Corp. Three of its funds -- the \$95 billion Growth Fund of America (AGTHX), now the country's largest actively managed fund, and Washington Mutual (AWSHX) and the Investment Company of America, each with \$76 billion -- are bigger than Fidelity Investments' Magellan Fund (FMAGX), the former champ. If the trend keeps up, American will overtake Fidelity Management & Research and Vanguard Group as the nation's top fund manager.

## STEEP FEES

All three fund giants have benefited from big inflows in the wake of scandals at other fund families. But the avalanche of new money potentially poses more problems for American than the others. Its assets under management have nearly doubled, to \$656 billion, over the past five years, a dizzying growth rate far faster than those of its rivals. American operates just 29 funds, vs. 360 at Fidelity

and 110 at Vanguard, so its individual funds tend to swell much faster. Unlike many other fund families, American refuses to close its funds to new investors to limit the amount of money it needs to deploy.

The risk is that American's funds will get so big that they become little more than index funds and can no longer justify charging investors steep initial fees of up to 5.75% -- of which brokerages typically get five percentage points or more -- to buy a fund. A similar problem cramped Fidelity's Magellan Fund in the 1990s. Such worries could encourage defections. Says Michael J. Francis, president of Francis Investment Counsel LLC, a retirement plan consultancy in Hartland, Wis.: "I'm telling my clients to consider other funds." Besides, much of the money that flooded into American came in the last three years when the large-company value stocks that its managers tend to favor did well. Should the market shift toward companies with faster-growing earnings, performance could suffer.

Nor has American emerged from the fund scandals completely unscathed. It's under investigation by the Securities & Exchange Commission and the California Attorney General's office for allegedly making undisclosed payments to brokerage firms that gave it preferential treatment. American says it did nothing wrong. "We disclosed what was considered an acceptable level at the time," says spokesman Chuck Freadhoff. "The SEC saw our prospectuses and never raised the issue."

American has been popular with brokers mainly because of the returns it has earned. Its stock and bond funds have beaten most competitors over the past 1, 5, and 10 years, according to mutual-fund researcher Lipper Fund Analysis. American's 15 stock funds returned an average of 12.08% a year through the 10 years ending last Dec. 31, vs. 9.9% for competing funds. While American's initial sales charges are high, ongoing annual expenses average just 1.1% of assets, vs. 1.4% for the industry, according to fund

researcher Morningstar Inc. Also, American's funds tend to have a low turnover in their holdings of just 27% a year, less than a quarter of the industry's 106% average. That keeps costs low -- and reduces taxes for investors.

American was founded by Jonathan B. Lovelace, a stock analyst who sold his stake in a Michigan money management firm in 1929, because he thought the market was too frothy. Setting up his own shop in Los Angeles two years later, he steered it conservatively for decades. American has avoided industry fads, such as sector funds focusing on one industry. "They tend to not hurt anybody," says fund industry consultant Geoffrey H. Bobroff. "I don't believe they've ever had a fund blow up on them."

Lovelace, who died in 1979, helped create American's unique management structure. Most funds are run either by individuals or a team of managers. American uses a combination. Within each fund, individuals manage specific amounts of money. Their compensation is tied both to their performance and that of the fund. It's calculated on a rolling, four-year average, so no one has an incentive to take big risks to boost their annual bonus.

## \$84 Billion Net inflows into American Funds last year, up 30% from '03

American's Freadhoff says this structure is key to dealing with big inflows. Rather than closing a fund, American simply adds managers. Five years ago, for example, the Growth Fund of America had four main managers. Today it has eight, so although its assets have tripled, the amount supervised by each manager has not risen as much.

## RISKING SAMENESS

This way, American avoids the risk of a star manager going cold or a team

paralyzed by consensus building. Still, the formula has its downside. By continuing to add managers to a fund, it risks diluting the performance of the other managers. "You do have to worry about the asset growth," says Don Phillips, managing director at Morningstar. "Their strategy assumes they can bring in new people who are just as talented. Think about expansion teams in baseball. If you bring in 10 more teams, it waters down the talent."

Most of American's managers preside over pieces of two or three funds and rely on the same pool of in-house analysts, who also manage parts of each fund. The results: Many of the funds have similar stocks in their portfolios. For example, the firm's two equity-income funds, Capital Income Builder Fund (CAIBX) and the Income Fund of America (AMECX), have 59 of their top 100 stocks in common. Says T. Clifton Green, an associate professor of finance at Emory University: "If you spread your money across these funds thinking you're getting diversification, you're not."

Freadhoff argues that since American sells its funds only through brokers, clients are getting advice that encourages them, for example, to diversify their portfolios between growth and income funds. "Often [American] funds are designed to do similar things, but there are subtle differences," says Drew Taylor, a vice-president at Capital Research & Management Co., the Capital Group unit that manages the American Funds. "One may have a little more money in bonds. Another may have more overseas. You don't want to own both."

American uses that same matter-of-fact logic in its handling of the probes it is facing. Investigators are focusing on two kinds of payments made to brokers. In one, a practice called directed brokerage, the mutual-fund companies funneled stock trading orders -- and fat commissions -- to brokerages that sell its funds. Federal and state investigators are also looking into revenue sharing. That's when fund managers rebate a portion of their fees to brokerages, based on how much client money that they put and keep in the fund family. The practice isn't illegal if it's disclosed. But it can encourage brokers to put their clients into funds that rebate the most rather than the ones best suited to their needs.

American discontinued directed

brokerage in late 2003, shortly before the SEC banned it, says Freadhoff. He acknowledges that the company still makes payments to firms that keep large amounts of client money in its funds but says the payments are small -- averaging no more than \$20 for every \$10,000 invested -- and disclosed in the fund prospectus. Last year, Franklin Templeton and some Pimco stock funds settled suits over these issues with the SEC and the California AG for \$38 million and \$20 million, respectively. American has not.

By stubbornly sticking to its convictions, the firm has done well over the years. Even now, the investigations haven't slowed the money flowing into American. "They take care of the brokers, and brokers are taking care of them," says Steve Blankenship, a principal at Heritage Financial Planning in Grapevine, Tex. Now, American has also to take care of the money that's pouring into its funds.

## A Flood of Money

American has been the top recipient of new cash, despite nagging questions about the firm

### GROWTH

American hasn't closed any of its 29 funds even though some saw assets jump by 50% last year. The biggest, the Growth Fund of America, manages \$95 billion.

### INVESTIGATIONS

Federal and state regulators are looking at the firm for allegedly making undisclosed payments to brokers who sell its funds. Unlike other fund families, the company hasn't settled, saying it has done nothing wrong.

### INVESTMENT STYLE

Its conservative, value-oriented stocks are hot right now, but their performance could wane if growth stocks come back into vogue.