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STUDY COMMISSIONED BY THE INSTITUTE ON SOLUTIONS TO THE MARKET TIMING PROBLEM

[18098] October 14, 2004 TO: BOARD OF GOVERNORS No. 65-04 INDEPENDENT DIRECTORS COUNCIL No. 9-04 RE: STUDY COMMISSIONED BY THE INSTITUTE ON SOLUTIONS TO THE MARKET TIMING PROBLEM The attachment is a study commissioned by the Institute concerning remedies to the problem of market timing that was discussed at the Board of Governors Meeting on Friday, October 8. The study is entitled On Solutions to the Mutual Fund Timing Problem and was authored by Gregory Bryant Kadlec, Pamplin Professor of Finance at Virginia Polytechnic Institute. Drawing upon published research, Professor Kadlec concludes that fair valuation and other trading frictions (such as redemption fees or trading restrictions) are necessary to stop market timing in mutual funds. He notes that market timing stems from the predictability of net asset values. This predictability can arise from the use of stale prices to value securities and from other sources that are inherent in the determination of securities prices. In line with SEC guidelines, fair valuation of portfolio securities only involves the removal of staleness; it does not, and should not, eliminate other sources of predictability. In the absence of trading frictions, as Professor Kadlec observes, market timers and arbitrageurs can exploit the predictability in net asset values that persists even after fair valuation. Thus, trading frictions are essential to a comprehensive solution to market timing. In light of the Commission’s ongoing consideration of proposed rules designed to curb the potential for market timing of fund shares, the Kadlec study is important and timely. We have shared it with the Commission and other interested parties. John D. Rea Vice President - Research Chief Economist Attachment (in .pdf format)