Case Study: Changing Investment Objectives

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The U.S. Securities and Exchange Commission (SEC) sanctioned Mitchell Hutchins Asset Management (Mitchell Hutchins), a registered broker-dealer and investment adviser, for the failure to trade securities for an investment fund within the limits of the stated fund objectives.

Mitchell Hutchins commenced management of the PaineWebber Short-Term U.S. Government Income Fund (the Fund) in 1993, marketing it as a higher-yield and somewhat higher-risk alternative to money market funds and bank certificates of deposit. The prospectus disclosed that the Fund’s investment objective was to achieve the highest level of income consistent with preservation of capital and low volatility of net asset value. The appendix to the prospectus also disclosed that the Fund had “no present intention” of investing in certain classes of interest only (IO) and principal only (PO) stripped mortgage-backed securities.

Contrary to the Fund’s low-volatility investment objective and “no present intention” statement, the Fund’s portfolio manager began investing in certain IO and PO securities in the fall of 1993. When interest rates increased sharply in February 1994, the Fund incurred significant losses, performing well below comparable funds.

The SEC found that the fund manager improperly deviated from the investment policy recited in its registration statement without shareholder approval. The SEC also found that Mitchell Hutchins violated the antifraud provisions of the federal securities laws by marketing the Fund as a low-volatility investment, when ultimately it was not.

By investing in securities outside the Fund’s stated objectives, the portfolio manager’s conduct violated Standard III (C.2.) Duties to Clients and Standard V (B.1), Communication with Clients and Prospective Clients, of CFA Institute’s Standards of Professional Conduct. Standard III (C.2) states that when members and candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio. Standard V (B.1) states that members must disclose to clients the basic format and general principles of the investment processes by which securities are selected and portfolios are constructed and shall promptly disclose to clients and prospects any change that might materially affect those processes.

Standard III (C.2) protects investors by ensuring that when members manage a portfolio to a specific mandate or strategy, such as in the case of a mutual fund, that they adhere to the stated investment strategy. This allows investors to judge the suitability of the fund for themselves and protects them from style drift and exposure to investment strategies, asset classes, and risks other than those explicitly stated.

In much the same way, Standard V (B.1) protects investors by supplying them with enough information to have an adequate understanding of and to make informed decisions about an investment product or service that is being offered. Undisclosed changes by a manager in the investment strategy of a portfolio may be contrary to the investor’s goals. Knowing the key elements of and principles behind the investment
allows investors to choose investment products and services that are suitable and appropriate to their investment objectives.

CFA Institute members can take several steps to help ensure that they abide by the principles of Standard III (C.2) and V (B.1). First, when managing a separate portfolio, members should make a reasonable inquiry into a client’s financial situation, investment experience, and investment objectives. This information should be updated at least annually. Second, members should disclose the basic format and general principles of the investment processes by which securities are selected and portfolios are constructed at the outset of the relationship, and on a regular basis thereafter. Third, members should implement regular internal checks for each account to ensure that portfolio characteristics meet the account’s investment mandate, or the stated investment strategy in the case of pooled funds. Finally, if members wish to change the investment objectives or strategies of portfolios they manage, then members must notify clients and investors of the potential change. Members should fully disclose the impact that the change will have on the portfolio and secure documented authorization of the change in strategy from the client.

The SEC censured the firm, issued a cease-and-desist order, imposed a civil penalty of $500,000, and ordered the appointment of an independent consultant to review and make any appropriate recommendations concerning Mitchell Hutchins’ policies and procedures.