

By Andre Weisbrod

Bull Market Continues

An economy growing at a clip of over 7%, mostly good earnings news and no major bad news or events helped power the stock market up 5.5% in October. And it is not just the U.S. that is doing well. International stocks rose over 6%. Small stocks continued to beat large companies, surging over 8% for the month.

Most indicators look strong. Which is what gives me at least a bit of concern. Too much exuberance could cause this market to get ahead of itself again. And the economy is not going to continue such hot growth. There have been only very small corrections in this resurgent bull over recent months. One could argue that a 5% correction is due.

If that occurs, it would be healthy and allow the bull market to retrench and move forward in an orderly manner. A 5% correction would bring the Dow back to 9311 and the S&P to 998. A 10% correction would not be terribly alarming unless it was precipitated by a major reversal in the economy or a huge event (i.e. a major terrorist attack on U.S. soil).

I will be watching this market closely. During the last surge, I added to our stock positions, but cash positions in the STAAR Stock funds are still estimated at around 8%-11% including cash estimated in underlying funds we own.

Traditionally, November and December have been better than average months for stocks. However, one cannot count on historical patterns repeating, especially after such a strong run-up.

From a planning standpoint, if you know you are going to need cash from your investments over the next 6-18 months, the conservative approach would be to sell some of your stock positions now and bank the cash you will need for the rest of this year and into 2004.

Mutual Fund Late Trading and Market Timing Scandals Explained

A number of states, the SEC and Congress have begun investigations against some mutual fund providers, advisors and broker-dealers. Among the issues being addressed include insider trading and after hours trading by market timers. There are a number of associated issues that I hope to address in future issues.

According to the Senate Governmental Affairs Sub Committee and industry sources, the investment industry contains approximately \$20 trillion dollars of which about \$7 trillion are in mutual funds owned by about 95 million shareholder accounts.

Since September a number of fund families, advisors and broker dealers have been implicated in improper trading schemes. Among the names are some large and venerable companies such as Alger, Alliance, Bank of America/Nations funds, Bank One, Federated, Janus, Prudential, Putnam and Strong. Others have or are expected to be subpoenaed for information. Private "hedge" funds such as Canary Capital Partners LLC and Millennium Management LLC are being investigated and brokers from firms such as Prudential and Smith Barney have been fired for involvement in alleged after-hours trading activities. CEO's at Putnam and Strong have resigned.

All in all it is a very disappointing and damaging time for an industry that has had relatively few widespread scandals over the years. As a mutual fund manager I am particularly chagrined to have to write about this. I am sure it will cause more regulatory headaches for the "good guys" as it progresses. Not that I am against these investigations; far from it. I hope that where wrongdoing is clearly shown, appropriate discipline will take place.

Here is what the investigation is about. At the heart of the matter are allegations of special trading privileges given to certain hedge fund managers, brokers and large investors that allowed them to make trades after legal trading hours. Additionally, it has been asserted that some advisors have traded improperly for their own accounts.

Normally, funds stop trading at the close of the stock markets, i.e. 4 PM EST. A large trade or trades made after hours could hurt all other shareholders of a fund. For instance, hours after the close a market timer identifies movement in international markets that gives him a good idea that those markets will go up significantly the next day. He calls up the mutual fund family and asks to buy their international fund at the previous market close, and because he has many millions to spend, the mutual fund makes an exception and allows the trade. The trader (often called a "market timer") makes out well the next day. The problem is that if the trade was a big one, the fund manager may not be able to invest the money in a timely manner and therefore the performance of the fund could be affected negatively.

Or an insider at the mutual fund management firm could make after hours trades for himself. Even if the trading is small and does not affect other shareholders, it would give that person an unfair advantage.

One issue is whether the trade in question is a large enough percentage of the fund assets to have a significant ("material") affect on the net asset value and thereby reduce the Net Asset Value. I suspect that investors should not fear that they have lost a lot of money, if any, in most instances. Perhaps the investigation will show some funds where a material effect was experienced. Some of the fund families already pledged to pay back to shareholders any damages and settlements are being negotiated.

The other aspect has to do with those who may have improperly and/or illegally benefited from such trading. The fund families would benefit from having more fees chargeable to the large trading account's assets. A fund insider could benefit by playing markets after the fact, as described above. A broker could make money on trading and other fees as well as use a special relationship to attract and retain clients. These types of behaviors are unfair and against both the spirit of the regulations as well as the rules.

I want to assure our investors that we have and will continue to place shareholder interests at the top of our priority list. We have done so even to the detriment of our Advisor firm, STAAR Financial Advisors, Inc.

Perhaps an example will help. This year, we received trades from two different market timers that we did not know. These trades came through a national broker dealer and were made properly during business hours. However, when we identified the market-timing nature of the customers, we monitored the trades and after a few weeks called the broker dealer and said we would invoke our prospectus discretion to restrict large timing trades. While the trades did not hurt shareholders, the possibility existed.

As a result, those trades have no longer come our way. This has caused us to lose some potential business, but it seemed in the best interest of the majority of shareholders. An irony is that the timers in question did not trade well, I did not change anything and our shareholders actually made out positively, albeit a very small amount.

Is market timing bad? No. Let me make perfectly clear that I believe that if trading is done according to the rules and the manager can effectively maintain portfolio balance, market timing trades can be and should be accepted. The key is to make sure that the majority of shareholders are not adversely affected.

We have a relationship with one advisor who periodically makes mass changes in clients' portfolios. His clients pay a fee for this oversight. The STAAR Funds advisor firm, STAAR Financial Advisors, may also have clients who pay a fee for us to oversee and periodically change their allocation among funds.

In both cases, we work carefully to do trading as early in the day as possible and to factor in those trades into the fund management considerations. We also work with the advisor to spread out multiple purchases or redemptions over hours or days. In other words, when I know these trades are coming, I can either buy or sell securities to maintain portfolio balance or I can elect to keep more or less cash if that coincides with what I think is best for the Fund and its shareholders. This is a normal function of managers as cash flows in and out of funds.

I am currently formulating a written policy addressing this issue. When it is done and approved by the Trustees, we will forward it to you. In the meantime, I want to emphasize the following:

1. Since we manage funds of funds, we will be following the investigations closely. If it is shown that funds we own have traded improperly and we, as shareholders, have been hurt in a material manner, we will do what we can to participate in the retrieval of any damages. We will also determine whether the problems have been addressed by the funds in question and whether we should retain ownership of such funds. At this time, it is premature to make judgments and we will continue to evaluate funds based on net performance, management style and holdings.
2. We have not allowed anyone to make trades after hours and will continue to uphold this rule.
3. We will continue to monitor any large or mass trades, and if we think such trades will be detrimental to the majority of shareholders, we will invoke our right in the prospectus to refuse or limit such trades. I must point out that it is often impossible to make such a judgment, since no one can predict market behaviors with certainty. A large purchase at the end of a day can help shareholders if the market goes down the following day. Similarly a large redemption could help shareholders if the market goes up and the manager has not had time to sell enough positions to rebalance the holdings. It is an imprecise and difficult issue. Therefore, I hope the regulators will exercise restraint and common sense when contemplating any new regulations, concentrating their energies on those who clearly broke rules for their own gains and not penalizing the majority who have not abused the systems
4. I and members of my family are investors in the STAAR Funds. I do not want any trading practices to hurt those shares. My objective is to achieve the best performance I can given the size, the necessary expenses and the objectives of each Fund.

I hope this helps answer questions you may have about this issue and our response to it. If you have any other questions about this or any other matter, please do not hesitate to call me at 412-367-9076. In the future I hope to address other issues such as expenses, NAV pricing practices, sales practices and disclosure.

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The challenge for someone like me is dealing with the myriad of regulations. Penchant in gov. to focus on details rather than big pictures. Gov. also tends to be reactionary and when the Press gets hold of things, it can sound more alarming than it really is. I will try to provide some perspective.

New legislation in works re: market timing, favoring large investors over small investors, breakpoints, etc. Also looking at expenses, NAV pricing practices, best execution, fee-sharing arrangements, sales practices, fee disclosure, share classes, sales contests and financial advisor definitions as well as after hours trading. SEC preempted a lot in this area; states will be going after people and firms. NASD will address sales practices. (I should address the false statements sometimes made regarding expenses/ratios)
HR 24.20

Market timing issues – late trading & brokerage fees on trades. “95 million individual people inv. In mut fds. Inv. Industry = 20 trillion of which 7 trillion is in mut fds” ---
Senate Governmental Affairs sub committee. Peter Fitzgerald, Senator R-IL