

## **Trading Restrictions Target Disruptive Trading**

By Jim Durning

For most retirement savers, reaching their investment goals is a long term proposition. They set a long term investment strategy focused on their individual goals and risk profile and stick with it.

Unfortunately, some investors -- including those who save for retirement by investing in mutual funds through a retirement plan such as a 401(k) or 403(b) -- act in a manner inconsistent with long-term investment objectives. These investors engage in frequent or excessive trading — buying mutual fund shares, and then selling them quickly, even as soon as the next day — in an attempt to capitalize on short-term movements or pricing disparities in the market.

This type of short term trading is one type of “market timing.” These investors may not be aware of it but, their trading may have implications beyond the performance of their own account. Market timing and other short-term trading strategies may have consequences for other investors in a fund and for the fund’s portfolio manager. Generally speaking, left unchecked, short-term trading in and out of funds by even a small percentage of investors comes at the expense of investors who intend to hold their shares for a longer period of time.

### **The Costs of Market Timing**

A mutual fund’s trading costs tend to increase when short-term investors are moving into and out of funds because the frequent trading tends to increase the number of fund transactions—the buying and selling of company stocks and other securities by the fund. The costs related to this increased trading, like all costs of a mutual funds, reduce the fund’s return and are shared by all fund investors. The costs associated with the excess trading activity, however, are unfairly borne by the fund’s longer term investors, not the market timers because they no longer hold the fund.

Frequent or excessive trading also can present challenges for a portfolio manager because the manager makes investment decisions based in part on shareholder asset flows into and out of fund. Large cash flows in or out of a fund on a short-term basis can disrupt the manager’s ability to implement his or her portfolio strategy and result in having to buy or sell securities at inopportune times or having to carry higher cash balances than desired in order to meet redemption requests .

## **Protecting the Majority of Investors**

In an effort to protect the interests of all of a fund's shareholders, Fidelity Investments<sup>®</sup> has taken a number of steps over time to discourage market timing and other short-term trading activity in Fidelity mutual fund shares. Fidelity believes the policies are effective in protecting the interest of all fund investors without impacting the normal investment activity of the vast majority of Fidelity fund investors. The steps the firm takes as part of this effort and limitations on trading by shareholders are described below.

Fidelity has taken a leadership position in the mutual fund industry in discouraging potentially harmful shareholder trading in a number of ways. Starting in the 1980s, certain Fidelity funds initiated short-term trading fees for shares bought and sold within a specified time period. These "redemption" fees are paid to the funds so that they, and their shareholders, can recover costs associated with short-term trading that would otherwise be borne by longer term fund investors. Redemption fees also help to discourage short-term traders from targeting a fund in the first place. Fidelity also has used Fair Value Pricing for many years to help ensure fund prices are calculated using security values that reflect market information as of the fund's pricing time (normally 4:00 p.m. EST). This valuation process discourages speculators who may be seeking to quickly trade in and out of a fund to take advantage of stale security prices.

Through the fund's prospectus, the legal document that sets out the investment objectives and policies of a fund, Fidelity reserves the right to take additional steps to limit trading activity to protect shareholder interests. More specifically, Fidelity mutual fund prospectuses allow the fund to restrict any investor's privilege to exchange -- that means redeem all or a portion of the shares of one fund and the purchase shares of another fund -- if the investor's trading practices might be disruptive to the fund. Fidelity typically looks at an investor's trading history in the fund, other Fidelity funds, and other accounts the investor may own or control, when making this determination. In addition, each fund's prospectus makes clear that the fund may reject any purchase order, including exchanges, for any reason.

Fidelity has procedures to help identify trading activity that might raise concerns. For example, Fidelity monitors fund investors who conduct repeated exchanges in and out of the same Fidelity mutual fund within a short time period. Fidelity's procedures currently identify a participant who exchanges both in and out of the same Fidelity

fund twice in a one-month period. When such activity is identified, Fidelity generally will attempt to notify the account holder in writing that this trading activity raises concerns and let the account holder know that the fund may temporarily suspend his or her ability to exchange into that fund if the disruptive activity continues, but the firm is not obligated to do so. Under the current procedure, the warning letter explains that if the participant makes another exchange in and out of that fund before the end of the following month in any retirement account under such participant's name or control, a three-month suspension on purchases into that fund would result. Fidelity continues to evaluate these procedures, and may modify them in the future to better protect long term investors.

Trading suspensions do not restrict a retirement plan participant's ability to make loan repayments, transact withdrawals from plan accounts, make investment exchanges out of the fund, or continue to allocate employee and employer contributions to the fund. In other words, the right to redeem is not affected by these policies, but the ability to make subsequent exchanges into the fund will be.

While Fidelity believes that the combination of fair value pricing, redemption fees (on certain funds), and account level monitoring described above is effective in limiting excessive shareholder trading activity in the Fidelity funds, the firm is always looking for ways to improve its processes. Fidelity has made a number of changes over time in developing the current procedures and Fidelity fund investors can be assured that the firm expects to make changes in the future as opportunities for improvements and new developments arise.

Fidelity serves more than 10 million people who are saving for retirement through their workplace retirement savings plans. The policies implemented to control disruptive trading are intended to protect the long-term best interest of the majority of those investors from the potential negative effects of the smaller number of investors who trade disruptively.

*Jim Durning is editor of Connections, the Fidelity Investments magazine for employers.*