THE GREED MACHINE

The problem at Putnam is not just fund managers illicitly trading their own funds. It's that the firm and others like it put profits first and investors last

If you're like most investors, you probably think that the insider trading scandal at Putnam Investments, the nation's fifth-largest fund company, is a sordid but simple tale of portfolio managers picking investors' pockets. But the real scandal is behind the headlines. For over a decade, Putnam has epitomized nearly everything that has gone wrong with the mutual fund business. Quietly, relentlessly, Putnam has morphed from an investment firm into a marketing monster that all too often pursued its own growth at the expense of its fund investors. ■ The insider trading that has dominated this fall's headlines cost Putnam's investors an estimated $1 million. But Putnam's long history of bad practice has cost the investing public billions—both in potential gains forgone and in actual

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losses on funds that never should have been created at all. Meanwhile, in the past five years Putnam generated $3.7 billion in operating profits for its parent, Marsh & McLennan. Putnam's former chief executive, Lawrence Lasser, earned at least $105 million over the same period. Your losses were their gains.

All you can reasonably ask of a fund company is safe, affordable investments that will help you reach your financial goals. Instead, Putnam has led many other fund companies—and millions of American investors—into a nightmare of costly, risky, misleadingly marketed funds. This story will take you into the cold heart of Putnam's $263 billion marketing machine and show why all too many fund companies have ended up shoving the investor out of the driver's seat and into the trunk. It illustrates what John Bogle, retired founder of the Vanguard funds, calls the transformation of "stewardship" into "salesmanship." By seeing what has gone wrong, perhaps we can all learn how to begin to set it right.

THE PRUDENT MAN

Putnam began as a conservative company with a blue-blooded heritage. In 1937 George Putnam, trustee of the Lowell and Putnam family fortunes, founded a money-management firm. George was the great-great grandson of Justice Samuel Putnam, the Massachusetts jurist who in 1830 wrote the Prudent Man Rule, a legal principle that has guided money managers ever since: "Those with the responsibility to invest money for others should act with prudence, discretion, intelligence and regard for the safety of capital as well as for income." Putnam still trumpets those words in its promotional materials. And until the 1980s, the firm did an admirable job of following its ancestral credo.

Then came two huge bull markets—first in bonds, then in stocks—and Putnam's guiding principles changed. The firm embraced one of Wall Street's oldest and most cynical sayings: "When the ducks quack, feed 'em." Putnam began selling any fund that gave—or appeared to give—investors what they wanted, regardless of whether it was a prudent, intelligent or safe way to invest. The firm pandered to the worst instincts of investors—and to the brokers who are supposed to help those investors. First, Putnam introduced a raft of dangerously complex and risky bond funds. Then it leaped on to the stock bandwagon, rolling out new funds at just the right time to sell them—and the worst time for investors to buy them. Putnam became a model of how to get investors to buy high, sell low—and pay fat fees for the privilege.

THE WATCHDOGS THAT DIDN'T BARK

Every mutual fund, no matter how large or small, has a board of directors (or "trustees"). The board's job, to quote a Putnam proxy statement, is "ensuring that your fund is managed in the best interests of its shareholders." But at Putnam, the directors failed chronically and abysmally. The watchdogs never barked.

The head of a rival fund firm, who asked not to be named, remembers calling a Putnam trustee in 1987. The outsider warned the trustee that Putnam's "government-plus" funds, which were then claiming to generate 12% yields out of bonds paying only 8% interest, were "a time bomb." A week later, the Putnam trustee called back. "They assured me it will work for us," he told MONEY's source. Perhaps it did work for Putnam, which took in roughly $100 million in management fees on its High-Income Government Trust from 1989 to 1993. But it was a disaster for Putnam's investors, as the fund's value shrank 12% during one of the bond market's biggest upswings of all time.

Sometimes the watchdogs even bit the shareholders. When Putnam asked in 1994 to

SHOULD YOU DUMP YOUR PUTNAM FUND?

Putnam is taking strong steps to cleanse the taint of its recent insider trading scandal, and new CEO Charles "Ed" Haldeman seems determined to do the right thing. But the firm has a long history of shareholder-unfriendly behavior. It could be years—if ever—before Putnam makes investing, not marketing, its No. 1 priority. On that basis alone, some investors may decide that they simply want nothing further to do with the company. Yet others may want to stay put to give Putnam a chance to clean up its act. ■ If you're unsure what to do, here are some factors you'll want to consider. If your money is in a nontaxable account, such as an IRA or 401(k), you don't have to worry about incurring capital-gains tax if you sell your shares. If you have a big gain in a taxable account, you'll be paying tax of up to 15% on your profits when you sell. On the other hand, if you have a loss in a taxable account, cashing in your shares will give you a potential tax deduction. ■ Finally, regardless of whether your account is taxable, check to make sure that a sale will not subject you to a deferred sales charge ("back-end load" in fund-speak). Typically, if you own class-A shares, you won't face a toll on your way out. But B and C shares can whack you with nasty fees if you sell. If you face a deferred sales charge, it may pay to ask your broker to waive it in light of the cloud that has come over the firm. —A.C.

jack up the management fee on its High Yield Advantage fund by 27%, the directors agreed—although Putnam already ran a phenomenal 41% after-tax profit margin on the fund. When the fund's investors failed to approve the fee hike, the chairman of the fund's board sent out a letter declaring that Putnam would keep soliciting votes. That, added the letter, "may end up costing the fund more money." In effect, the directors were threatening to spend the fund's money until shareholders cried uncle. (The chairman later apologized, saying the letter was "against our practice.")

Why have Putnam's directors been such lapdogs? For starters, they get paid a boatload of money. In 2002 the 13 trustees who oversaw Putnam's 101 funds earned $203,000 to $388,000 apiece for roughly two dozen days' worth of board meetings. Until 2000, even Putnam CEO Lasser and A.J.C. Smith (former chairman of Putnam's parent, Marsh & McLennan) earned directors' fees of around $200,000 a year—in addition to the lavish management fees that investors were already paying Putnam. And John Hill, the ostensibly independent chairman of the trustees, was once president of a major Marsh & McLennan unit.

It's no wonder these people looked the other way as Putnam rolled out one fund after another that injured its own investors. It's no wonder they let Putnam hike its fees at will. Is it any surprise that they fell asleep at the switch while a half-dozen of Putnam's employees spent the past few years racking up hundreds of thousands of dollars in allegedly illegal gains by trading the firm's own funds?

THE FUND THAT WOULDN'T DIE

The right time to introduce a fund is when it offers a simple, safe way for investors to fill a legitimate need. The people at the American Funds, run by Capital Research & Management of Los Angeles, understand this. In the past decade, they've introduced a total of only three new portfolios. They rolled out an emerging markets fund not in 1993, when Third World stocks were hot, but in 1999, when demand was lower—and the potential return for new investors was high.

At Putnam, however, the only question anyone seems to have asked about introducing funds is, "Can we sell 'em?" To see how this works, consider the sad tale of one Putnam fund that has twice been brought back from the dead.

»Putnam's primary focus is on the brokers who sell its funds—not the ordinary people who invest in them

As part of its "style consistency" campaign, Putnam poked fun at portfolios with misleading labels. Yet, in the end, some of its own funds sounded like Fluffy but acted like Fang.

In January 1988 the firm launched Putnam Capital Preservation/Income Trust, which promised attractive income and preservation of capital. If you'd been spooked by Oct. 19, 1987, when U.S. stocks crashed 23% in a day, this fund seemed tailor-made to give you peace of mind. With a 4.75% sales load, it amassed $60 million, yielding more than $400,000 in annual management fees for Putnam. What did it yield for investors? Over the next three years, the fund trailed the bond market by a pitiful 2.7 percentage points annually.

In mid-1991, Putnam put Capital Preservation out of its misery, renaming it Putnam Adjustable Rate U.S. Government Trust—a fund that pandered to income-starved investors fleeing low-yielding money-market funds. Between 1991 and year-end 1995, this "new" fund earned an annualized gain of 3.9% while the bond market returned 9.4% annually. By the time Putnam mercy-killed Adjustable Rate, its value had fallen about 10% from Capital Preservation's 1988 level. Neither the original investors nor the new ones got what they had been led to expect. The fund that took over Adjustable Rate in late 1996, Putnam Intermediate U.S. Government Income, has yet another mandate and has been a mediocre performer.

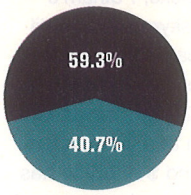
"WHAT THIS FUND USED TO BE"

This forced migration of investors from one fund to another was hardly unusual. Over the past decade, Putnam created at least 36 new funds and euthanized no fewer than 13 of them—sometimes after just a few years. When an investment category caught fire, Putnam created a new fund. When it went cold, Putnam killed the fund, leaving investors in the ashes.

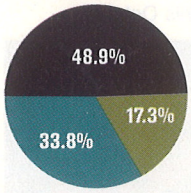
TRUTH IN LABELING?

Putnam claimed that its Voyager and Vista funds were "diversified" and would not invest more than 25% of assets in a single industry. By early 2000, however, they had enormous stakes in technology, telecommunications and media stocks.

PUTNAM VOYAGER



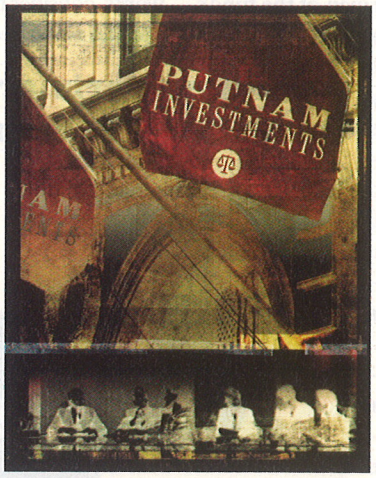
PUTNAM VISTA



TECHNOLOGY/TELECOM
MEDIA
OTHER

Note: As of Jan. 31, 2000.
Source: SEC filings.

Consider Putnam New Century, born on Jan. 21, 2000, when the hype about New Economy stocks was at its height; by the fall of 2002, the fund had lost 69%, and Putnam merged it into its Discovery Growth fund. Putnam Technology was born June 14, 2000, shortly after Nasdaq hit its all-time high; by September 2002 it had lost 63% and was also absorbed into the Discovery Growth fund. Poof! Just like that, the disastrous track records of New Century and Technology disappeared, replaced by the better history of Discovery Growth.



This kind of performance hocus-pocus has been a Putnam hallmark. In 1993 Putnam Strategic Income Trust—a $334 million fund that had racked up a lousy record selling call options to boost dividends—was merged into Putnam Equity Income, a fund with barely $1 million in assets. Strategic Income's horrid history disappeared into the conservative record of Equity Income. Stephen Gibson, then Putnam's retail marketing director, explained that for a potential buyer of Equity Income, Strategic Income's history was "not really relevant. He's buying an equity income fund. He's not buying what this fund used to be."

» The new CEO wants to "redefine our business, from selling mutual funds to taking care of people's money"

There, in a nutshell, is Putnam's marketing philosophy: Focus your energy on getting new customers in the door. Your old customers will just have to fend for themselves. New sales, not existing investors, are what count.

"TRUTH IN LABELING"

To understand the problems at Putnam, you have to understand this: The people who put their money into Putnam's funds are not the firm's real customers. Instead, Putnam's business has been built on catering to and caring for the brokers who sell its funds—because they are the ones who bring the money in the door. To keep brokers happy, Putnam has set its sales charges as high as the market will bear (these days, up to 5.75%).

Putnam also pushed the "multi-class" share structure that has richly compensated brokers while bewildering investors. Until the 1980s, most load funds came in one flavor: Pay your broker once, up front (now called "A shares"). Then came B, C, M, R and Y shares, each with their own set of fees and expenses.

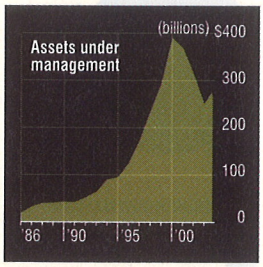
Putnam was far from the first load fund company to dish out this alphabet soup, but the firm grew so fast after adding it to the menu that this way of selling funds became the industry standard. Brokers loved being able to tell their customers that B shares, with no up-front commission, were "just like no-load funds." And many brokers seemed to develop an odd habit of never mentioning that large purchases of A shares are entitled to cut-rate commissions, while orders for most of the other share classes get no fee discount. The National Association of Securities Dealers and the Securities and Exchange Commission recently found that nearly 450 brokerage firms had failed to provide mandatory commission discounts. (In 2001 and 2002, regulators estimate, investors were overcharged by $86 million.)

Putnam played to the brokers in other ways as well. In 1995 Jeffrey Vinik, manager of the world's biggest stock fund, Fidelity Magellan, caused a furor when he suddenly shifted a third of the fund's assets into cash and bonds. As a result of the controversy, "style purity" became a hot tool for fund salesmen in the late '90s. Putnam cashed in with a marketing blitz. Putnam's funds, the firm stated, would conform strictly to Morningstar's style boxes. "Putnam's disciplined investment philosophy is based on STYLE CONSISTENCY," blared the firm's website. "Our truth-in-labeling approach ensures that we adhere to every fund's stated objective, style, and risk positioning."

At the same time, several Putnam funds were making a mockery of "style consistency" and "risk positioning." Putnam Voyager invests mainly in large growth stocks; Putnam Vista buys mid-size growth shares. The prospectuses of both funds stated that each portfolio would remain "diversified" and never put more than 25% of assets in a single industry. Yet just before the tech-stock bubble blew in early 2000, the funds hardly seemed well

GROWTH AT ALL COSTS

Fueled by the big bull markets in bonds and then stocks, Putnam's assets skyrocketed until they peaked at $400 billion or so in 2000. But the 2000-02 bear market hit Putnam and its investors hard. And $14 billion has left the firm since news of Putnam's trading scandal broke this October.



Notes: As of Nov. 7, 2003. Year-end data through 2002.
Sources: Putnam, SEC filings.