Review of *The Investor's Dilemma: How Mutual Funds are Betraying Your Trust and What to Do About It*. By Louis Lowenstein. John Wiley & Sons. 220 pp. $29.95

Directly or indirectly, more than ninety million Americans invest about $10 trillion in mutual funds. Bidding for their business are about 4,800 stock funds (up from 300 in 1980), designed for every nook and cranny in the market. The vast majority of them, alas, do not consistently beat benchmarks in their sector—or outperform the overall market. After all, as the physicist Niels Bohr once said, "prediction is very difficult, especially if it's in the future."

In *The Investor's Dilemma*, Louis Lowenstein argues that precious few fund managers "seem to be using their brains." An emeritus professor of finance and law at Columbia University, Lowenstein is an advocate of values investing, in the tradition of Ben Graham and Warren Buffett. And a curmudgeon, who doesn't trust anyone under forty. Lowenstein believes that Efficient Market Theory is "wrong—woefully so;" computer-driven trades, based on mechanical formulas, are "literally mindless;" diversification is "diworsification;" and portfolio re-balancing is a form of market timing akin to "investing with a Ouija board."

Though it repeats, almost obsessively, the same quips and quotations, Lowenstein's book is a valuable text for passive investors (millions of whom are bafflingly blasé about their selection of mutual funds), whether or not they embrace the principles of values investing.

Lowenstein makes a cogent case that "something is rotten in the mutual fund industry." Most fund managers, he points out, have a built-in conflict of interest. They're heavily invested in their fund management company—but not the fund they run. Consequently, managers make far more money by increasing assets under management (AUM) than through a stellar fund performance. And "the dirty little secret" of the mutual fund industry, Lowenstein insists, is the
damage that size does to performance, given the difficulty of finding stocks at prices that offer a margin of safety.

When AUM grows, mutual funds do not typically pass back to customers in reduced fees the sums secured from economies of scale. Since 1980, thanks to SEC ruling 12b-1, they use them to help cover advertising and marketing costs. Nor do regulators prohibit funds from sharing revenues with the 600,000 brokers currently advising clients in the United States. All too often, these brokers push funds "that pay them well, not necessarily those they expect to perform well"—and fail to disclose the factors influencing their recommendations.

To attract investors, management companies also slice and dice funds, into large, mid, and small cap, science and technology, pharmaceuticals, energy, emerging markets. Although he cites no empirical data, Lowenstein rejects the notion that, for example, large cap growth companies "move in sync" and serve as a counterweight to, let's say, small cap blends. He maintains as well that once customers commit to a sector, like high tech, funds have no incentive to rotate them out of it, even if stocks have become too pricey relative to the fundamentals of their businesses.

What's an investor to do? Index funds, Lowenstein indicates, are far better than the typical managed fund, which turns over its portfolio 100% a year, often mindlessly, generating substantial tax liabilities for customers. But the best option, he maintains, is a fund with a small portfolio, managed by experienced generalists, who consider business risk more important than market risk, and sit on cash when they can't find a good buy. Lowenstein acknowledges that the stock exchange is "less a weighing machine than a voting machine." But, since over the long haul, across cycles of boom and bust, "markets are rational, at least much of the time," he exhorts investors to look past the next election—and be patient. It's a quality in short supply these days.
Glenn C. Altschuler is the Thomas and Dorothy Litwin Professor of American Studies at Cornell University.