

Financial circles try to make sense of claims against Strong

Entrepreneurial risk-taking, past trouble with regulators noted

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Facing the challenges of a damaged reputation and a potential run on his Strong family of mutual funds, Richard S. Strong finds himself this weekend the subject of two fundamental questions:

Absent any public evidence, why is everyone so ready to crucify Strong, an American success story who built a \$42 billion mutual fund business by aggressively competing with entrenched competitors?

If the allegations prove true, why would one of the wealthiest men in the country, worth an estimated \$800 million, make improper trades that are said to have netted him no more than \$600,000?

Some of the answers heard in the past few days in financial and legal circles - especially on the second question - are sobering, if fairly predictable.

"They do it because they can," said Ted Siedle, a former Securities and Exchange Commission attorney who owns Benchmark Financial Services in Lighthouse Point, Fla., and makes his living investigating securities fraud for pension fund clients. "These people have a sense of entitlement, and nothing's ever enough."

"Sheer greed on a level that I don't understand," said Sherrie Savett, an attorney with the law firm of Berger and Montague in Philadelphia who is representing plaintiffs in one of the many class-action lawsuits filed against Strong and his organization.

But research into what makes entrepreneurs such as Strong tick indicates that there's a lot more involved here than the possibility of greed and arrogance.

Pointed accusations

In early September, New York Attorney General Eliot Spitzer accused Strong's Menomonee Falls-based firm, and three other mutual fund companies, of allowing a New Jersey hedge fund to make improper trades in several of its mutual funds that potentially hurt those funds' shareholders.

It's the game itself that drives people; it's wanting to win. And when you win, you just automatically set higher goals.

- Werner F.M. De Bondt, behavioral finance professor, DePaul University in Chicago

Wednesday, Spitzer shot a dagger at Richard Strong personally. Spitzer indicated he would take action against Strong on allegations that he made improper trades in his firm's mutual funds from 1998 through at least 2001 - trades that benefited him, his family and friends.

The Strong funds' directors reacted by hiring a law firm and starting their own probe. Strong said he would step down if necessary, pledged to reimburse Strong funds for any financial losses that resulted from his alleged improper trading and promised to expand the firm's corporate board. Strong also hired a former U.S. Securities and Exchange Commission chairman as a consultant.

In a statement last week, Strong admitted that he made the trades in question but that he did not believe they were "disruptive" to the funds. He added that he was fully cooperating with federal and state investigators.

Strong is known as a complex man who does more listening than talking, favors hiring hard-working, academically successful farm kids over Ivy League MBAs and is famous for conducting quirky interviews in which he never asks a question directly related to the job he's hiring to fill.

He's also very detail-oriented. Strong wants the window shade in a certain position when he arrives at the Heinemann's on Mayfair Road for breakfast. He once interrupted a meeting at company headquarters to call the janitor about a screw in a light-plate switch that wasn't vertically aligned.

His investment style is much more free-form, and he doesn't lock on to one theme or idea.

Don Phillips, president of Chicago-based Morningstar Inc., says Strong has always been an active trader who was willing to move, as evidenced by the high turnover in the portfolio of the mutual funds he managed. So it might not be surprising that he might have been using the same trading style in his personal accounts.

"My guess is he thought it was preferable investing in his own funds," Phillips said. "I sincerely think Dick Strong is an ethical human being, but you've got to scratch your head and say, 'Why has he bumped up against regulators so much in his career?' "

You've also got to wonder why Spitzer - whose probes have been successful enough to reap a \$1.4 billion global settlement from 10 Wall Street investment banks and a \$100 million fine from Merrill Lynch, and prompt radical changes in how the investment world operates - would be making such high-profile accusations against Strong.

"Eliot Spitzer isn't pulling any punches. He is looking for a poster boy for the mutual fund industry," said Andrew Stoltmann, an attorney with Maddox Hargett & Caruso in Chicago who handles securities cases.

After Spitzer's initial round of allegations, Morningstar made a blanket recommendation that investors

sell all of their shares in mutual funds offered by Strong and the three other firms.

Still, Phillips said, "In my heart of hearts, I do not believe Dick Strong thought he was doing something wrong."

Overreaching entrepreneurs

The conclusion of Phillips, who has known Strong since the 1980s, jibes with research into why entrepreneurs so often tend to overreach.

Money alone doesn't drive pure ambition, says Werner F.M. De Bondt, the Richard Driehaus professor of behavioral finance at DePaul University in Chicago.

"It's the game itself that drives people; it's wanting to win," said De Bondt, a former University of Wisconsin-Madison finance professor. "And when you win, you just automatically set higher goals."

Richard Strong has consistently done that. He is driven by the dream of making his firm one of the biggest in the industry. He had T-shirts distributed to all Strong employees several years ago with the slogan, and the firm's goal, "Number 2 in 2002" printed on them. Today, Strong is far short of being the No. 2 mutual fund firm, but rather is considered one of many midsize mutual fund companies.

But he is enormously powerful within his circle.

"You go to that firm and you look around - they're trembling," said De Bondt, who knows Strong and has been to the company's headquarters. "Powerful people just don't get that much feedback. He doesn't get a lot of honest criticism anymore."

In his 1961 book "The Achievement Motive," David C. McClelland describes experiments he did with children throwing rings at a pole. The better they got at landing the rings on the pole, the more they tended to move backward and make it more challenging.

"Entrepreneurs think, 'Throwing a ring this far over a pole might be risky for others, but I'm very skilled,'" De Bondt said. "They don't see themselves as gamblers in any sense - they see themselves as calculated risk-takers."

Others, such as Siedle, who investigates securities fraud for pension funds, see investment professionals like Strong differently.

"When I investigate, it's not once. They do this year in and year out, particularly when you're playing with other people's money," Siedle said. "I don't ever see cases where the portfolio manager's wife has cancer and that's why he needs the money."

A spotty history

Stoltmann agreed - pointing to Strong's past run-ins with regulators.

"He's gotten away with this in the past, with his hand in the cookie jar," Stoltmann said.

Strong and his firm in 1994 were sanctioned by the SEC for making improper trades among its funds and certain Strong-managed accounts in the late 1980s, and for not telling investors about conflicts of interest. Two years later, in response to an action filed by the U.S. Department of Labor, the firm agreed to reimburse certain pension accounts \$5.9 million over related allegations.

Less than a year later, in February 1997, Strong was in hot water again when the firm bailed out three of its money market funds that were holding short-term debt of Mercury Finance, a used-car lender that had failed to meet a payment. Strong said then that the default involved fraud and that it was doing the "right thing" by reimbursing investors. Mercury Finance is no longer in business.

But many professional investors who thought the Mercury Finance securities too risky viewed the incident as just another example of Dick Strong's aggressive style of investing.

Still, Strong's peers and other industry observers say they're not ready to judge him until they know exactly what Spitzer is accusing him of.

"I don't know the facts, so how can I comment?" said James B. Kitzinger, principal and equity portfolio manager at Kitzinger Lautmann Capital Management Inc. in Milwaukee. "Spitzer gives you a conclusion and not the charges or evidence. It makes poor Dick Strong look like public enemy number one."

It also frustrates a lot of money managers who live in an industry where innuendo damages confidence and essentially equals a death sentence. Those managers were complaining last week about the leaks coming out of Spitzer's office - leaks not yet backed up by formal criminal charges.

Damaging confidence

Even if Spitzer never files charges, he has raised questions about Strong's commitment to his shareholders. Trading in and out of mutual funds, as Spitzer is accusing Strong of doing, isn't necessarily illegal, but it isn't exactly confidence-inspiring either.

Say, for example, that someone wanted to trade in and out of a mutual fund and moved in because he thought some of the stocks in the fund were undervalued and would gain value soon. A market timer might justify such a move by saying he was buying in at a fair price - the current net asset value. But, in reality, his actions would slightly dilute the value of all of the shares in the fund, because the increased

value would be spread over more investors.

If Strong was doing what Spitzer alleges, shareholders could ask why he wasn't trying to get the fund's stocks properly valued rather than diluting the value of all the other shareholders by buying in at a low price.

"The very basic answer is that Dick Strong in no way thought that what he was doing was detrimental to shareholders," Phillips said, referring to Spitzer's allegations. "He could not have seen it as something that would jeopardize the trust that investors put in Strong funds."

Some wonder if Strong might have used a built-in advantage he had as an insider.

"I assume with a couple clicks of his keyboard he can pull up the portfolios of the funds he was trading," said Roy Weitz, publisher of FundAlarm.com, an online newsletter that offers advice on which mutual funds to sell.

"That will be a question - whether he was trading with real-time portfolio information because, presumably, he could know the trades as they're being made."

A Strong representative declined to comment for this story, and Strong is not making himself available for interviews. But Strong said in a statement Thursday that only a small number of the trades he made in and out of Strong-managed funds were "next-day" transactions.

"We haven't seen the evidence," Phillips said. "If you go by the tone of what Eliot Spitzer is saying, it looks bad - but I suspect when all the evidence has been heard it may paint a very different picture."

Eventually Strong will get his day in court, Phillips said.

But it will be a long, difficult road to that day.

"In the end, people are vulnerable," De Bondt said.

From the Nov. 2, 2003 editions of the Milwaukee Journal Sentinel