Asians continue to save at a high rate, but hold a high proportion of their private wealth in real estate, low-return bank deposits, and common stocks mainly for short term gains. This results in considerable inefficiencies in the allocation of capital and the sharing of risk and adds to market volatility. However, the higher returns achieved recently in Asian stock markets have attracted many more savers into mutual funds/unit trusts. Recent scandals in the U.S. mutual fund industry offer valuable lessons and indicate that the Asian industry requires careful scrutiny.

The mutual fund/unit trust industry provides an important financial link between households and firms. In principle, it can help allocate funds more efficiently by enabling savers to better manage risk and maximize returns, while achieving the economy of scale in transactions and information processing. It can also improve corporate governance by aggregating the bargaining power of small investors. Against this, it poses a new layer of agency problems between investors and fund managers/trustees. These problems have been highlighted by malpractices in the U.S. mutual fund industry. Yet, the U.S. economy enjoys the strongest legal framework, where regulators have the greatest political autonomy and the most professional expertise. This implies that severe problems lie hidden in some Asian economies where regulatory authorities, judiciaries, and financial presses lack independence and expertise.

Mutual funds/unit trusts connect a large number of unit holders or fund shareholders to a small set of their managers and equity owners. It is difficult for typical unit holders or fund shareholders to grasp the process of valuation which depends on the value of underlying assets that are constantly traded. It is even more difficult for them to grasp many ways in which they can be exploited by manipulation of the trading and valuation process. What protects them from manipulation?

1. The sense of responsibility and trusteeship of those who manage the trading and valuation. However, Asian culture inculcates a sense of responsibility on the basis of personal, long-term relationships and shared background. This sense is weak for the managers of unit trusts and/or board of directors of mutual funds held by a large set of anonymous investors.

2. A regulatory framework that clearly defines trustees’/fund board members’ fiduciary responsibility, builds in significant penalties for failures of fiduciary duty and makes it economically feasible for aggrieved unit holders/fund shareholders to initiate legal action. However, Asian legal and regulatory systems
are weak in this area. Legal action is inhibited by the difficulty of mounting class action suits and the exposure to the legal costs should the lawsuit fail.

3. **Well-informed investors.** However, many Asian investors lack information and experience in dealing with complex financial products and are easily confused by marketing techniques.

   If none of these safeguards are in place, the effects can be devastating. Indonesia recently enjoyed a boom in sales of mutual funds marketed through banks to unsophisticated investors who assumed that the banks were backing the product. This boom was followed by a crash in which the investors lost a significant portion of their investment.

   The lesson is clear. The Asian mutual fund/unit trust industry urgently requires a publicly-funded program of investor education; laws that mandate full disclosure and penalize misleading marketing schemes, and identify the fiduciary duty of trustees and mutual fund board of directors; and regulators motivated to enforce these laws.