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Deutsche Bank's Strange Curse

by: Gwailo

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Introduction: This article is about conflicts within the investment fund industry, using the Deutsche Bank/DWS fund group as a case example. Several of the funds are now the subject of proxy fights that expose the diverging interests of the shareholders who put up the money, the professionals who manage the assets, and the independent directors who are supposed to monitor the managers. This is a practical article: the author has invested in DWS funds and will participate in the proxy vote.

Part 1) The Deutsche Bank Curse

Part 2) Temptation by Proxy (to be posted)

Part 3) Beyond the Ethical Edge (to be posted)

I) **A Strange Curse** appears to be hovering over the Deutsche Bank (DB) this summer. New Yorkers were recently jolted awake by the headline: "Demolition of Cursed Deutsche Bank Building Halted Once Again". A safety switch malfunction in the Bank's empty, ruined skyscraper at the edge of the 9/11 blast zone in lower Manhattan had revived memories of a far more serious blaze in August 2007, when two firefighters died in what the Daily News called the "Deutsche Deathtrap." Higher up on Wall Street, at the Alex Brown brokerage operation (which the Bank picked up when it took over Bankers Trust in 1999 as its North American beachhead), the top story has been SEC charges that the firm mislead investors about the safety and liquidity of Auction Rate securities. This June, the Bank agreed to restore $1.3 billion of liquidity to its customers, to pay a $15 million penalty and to be yet again permanently enjoined from violating the securities laws. (Back in 2004 the Bank paid $87.5 million and consented to an injunction (.pdf) in order to settle SEC charges that its research reports had been improperly slanted to further its investment banking business.)

Meanwhile, June's release of tax fraud indictments against two former Bank employees and the former head of the BDO Seidman accounting firm reminded attentive readers that the Bank is still trying to resolve an ongoing Federal criminal investigation into its role in facilitating crooked tax shelters. (See fn. 25 to Deutsche Bank's 2008 financial statements.) In late July the Financial Times reported that the Bank "is involved in a probe into possible criminal wrongdoing after it hired detectives to carry out surveillance of board members in the latest in a series of “spying” scandals at top German companies." And in other news, on July 30 the Bank was hit with a subpoena from a US Senate committee investigating fraud in last year's mortgage market meltdown, while the news of a 67% increase in second quarter profits just sent the stock down 10.7% on "quality-of-earnings" concerns.

The evil influence also reached the Bank's Asset Management Division, which includes DWS Investments (fund management) and RREEF -- a US-based real estate and alternative asset firm that the Bank has owned since 2002. As a result of the Auction Rate securities scandal at the brokerage arm, the asset managers had to beg the SEC for an exemption from Section 9 of the Investment Company Act, which bars affiliates of enjoined entities from acting as investment advisers. The SEC was merciful, and by a July 7th order, (.pdf) it allowed the managers to stay in business.

For those in the know, however, this was an uncomfortable reminder of earlier problems with securities regulators, such as the SEC censure of DWS back in 2006 (.pdf) for illegal mutual fund market timing practices (.pdf). This scandal, which involved improper conduct at the Zurich/Scudder/Kemper mutual fund subsidiaries that the Bank had picked up four years before, cost $145 million in fines and restitution, and obliged DWS to reduce fund management fees for five years and undergo the humiliation of bringing in an "Independent Compliance Consultant" to monitor its behavior. This punishment came on top of an earlier spanking from the SEC, when DWS/Scudder was censured and penalized (.pdf) $20 million for concealing from investors and from its own independent fund directors its practices in steering trades and commissions to certain favored brokers who also distributed its funds.

The malign force has also touched the DWS funds themselves, judging by the most recent Fund Family Scores from Morningstar. Although DWS' exempt muni funds score fairly well, its domestic stock funds come in overall at 2.6, its international stock funds at 2.4 and its taxable bond funds at 2.7, where "a score below 2.5 is an indication that the firm has met with little success in that asset class. A score between 2.5 and 3.5 indicates the firm is about average."

The closed-end funds in the DWS "family" are also affected. Other articles have described the curious case of SRO and SRQ, closed-end specialty real estate funds managed by DWS and sub-advised by RREEF, which last year set new records for abysmal performance. (As of 7/31/09, SRQ's 1-year market return was -83.7%, while SRO had lost 93.6% -- over $400 million.) The group's stab at a "deep value" fund, the DWS Dreman Value Income Edge (DHG), was deep in the red, having managed to lose 51.9% (the Vanguard 500 Index was down just 19.9% for the period), while the European Equities at EEA, down 34.6%, lagged their index by 10% or so. Since closed-end funds do not ordinarily redeem their own shares, investors seeking exit have had to accept very substantial haircuts from asset value: at July 31 four of the 14 DWS closed-end funds were trading more than 20% below asset value (SRO = -26.2% SRQ = -25.4% DRP = -23.1% DHG = -22.6%) and three more languished with discounts over 15% (GF = -19.2% EEA = - 15.5%, KST -15%).

Large spreads between asset values and market prices inevitably attract attention from "activist" investors, who try to induce changes in fund structure that will unlock the discounts, such as having funds tender for their own shares at full asset value, convert to an open-end or ETF format, or liquidate. Management companies like DWS naturally resist such changes, since they can diminish or interrupt the stream of fees generated by the captive assets in closed-end funds. (Fees are generally based on the value of the assets a fund holds, rather than the market value of the fund's outstanding shares, so the managers are insulated from the deadweight loss that discounts impose on shareholders.

The fund Directors -- thirteen individuals who sit simultaneously as Boards of Directors for 129 different DWS investment funds -- are now on the spot. They are supposed to be governance "watchdogs" representing the interests of the investors, but their fiduciary duties are in conflict with their collegial association with the DWS managers and with their own self-interest in resisting change. At three of those funds, incumbent Directors now find themselves opposed for re-election in upcoming proxy contests. Part two of this article will describe the recent developments at these funds (SRO, SRQ and GCS) and show how good men and women can be tempted to abandon their principles in order to defend their perquisites, and how independence can be corrupted by incumbency.

Disclosure: long SRQ, GCS, DHG

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