

BusinessWeek

JUNE 22, 1998

A PUBLICATION OF THE MCGRAW-HILL COMPANIES

\$3.95

Profit Squeeze



What companies will do

The FTC vs. Intel

Why it's a weak case



Corporate Loyalty

It's back—sort of



China and the U.S.

Any hope for a real partnership?

Our **ANNUAL REPORT** on Information Technology

doing business in the internet age

PAGE 121

.commerce



MUTUAL FUNDS

WHAT DREYFUS DIDN'T DIVULGE

A fund chief loaded up on Chromatics—a stock he owned

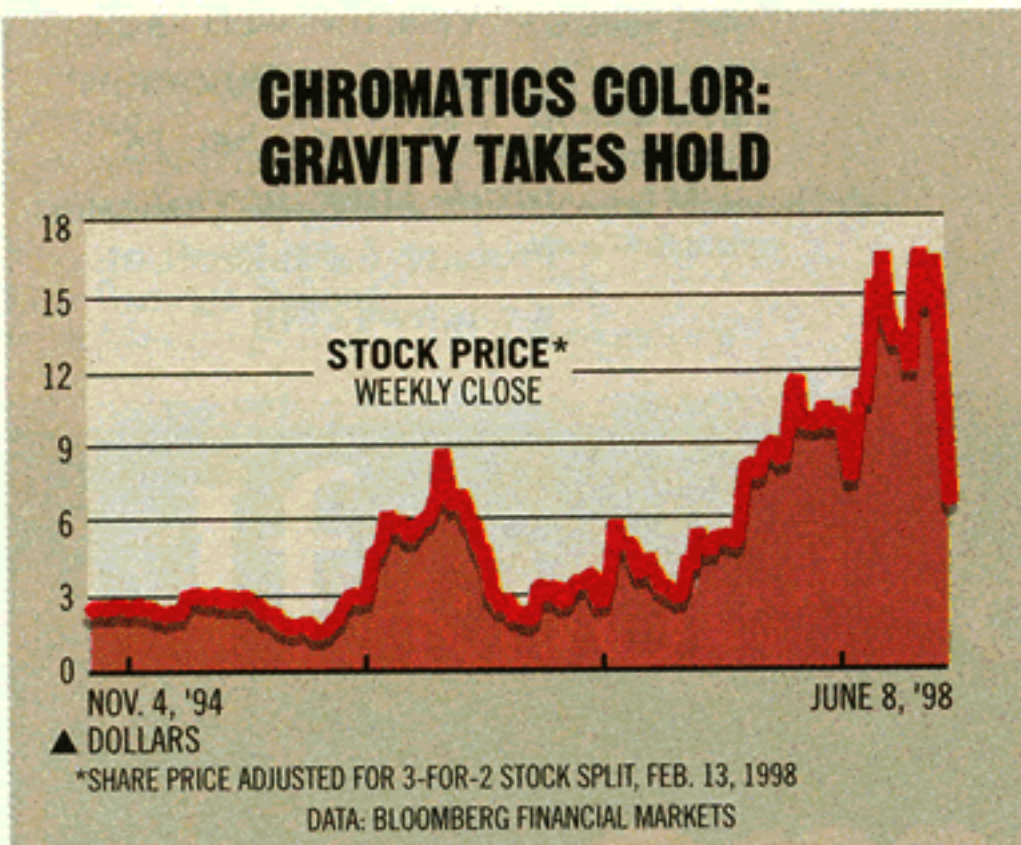
Michael L. Schonberg was a star. When he arrived at Dreyfus Corp. from the prestigious Omega Advisors Inc. hedge fund in August, 1995, he was on a rescue mission: to salvage the company's lackluster Strategic Growth and Premier Capital Growth funds. The funds' performance numbers were more than just bad. They were embarrassing. Both were managed by Dreyfus Chief Executive Howard Stein, who had proven far less adept at money management than at running a fund company.

But now, the 47-year-old Schonberg is no longer a star. His management of two small-cap stock funds—the Premier Aggressive Growth and Aggressive Growth funds—has been a disaster. In April, a money manager named Paul LaRocco was put in charge of the

Chromatics in his personal account—shares he had obtained at half-price a few months before he joined Dreyfus. His aggressive buying of Chromatics for Dreyfus helped support the stock's share price—to the point that, by late May, Schonberg had unrealized paper profits of 860% in his personal holdings.

TROUBLING QUESTION. Schonberg's personal position in Chromatics, disclosed in the company's filings with the Securities & Exchange Commission, has troublesome implications for Dreyfus, now a Mellon Bank Corp. subsidiary with a squeaky-clean reputation. Dreyfus is standing by Schonberg, saying in a statement that though it is conducting its own "review of the facts" based on its knowledge to date, "Michael Schonberg has complied with Dreyfus' personal securities trading policies." Dreyfus called "baseless" allegations that Schonberg traded for personal gain. Schonberg did not return phone calls to his office.

In a sense, Dreyfus is right—Schonberg did no wrong by Dreyfus standards. A Dreyfus spokesperson says the company was informed of Schonberg's Chromatics holdings when he was hired by Dreyfus. But that raises a troubling question: Are Dreyfus' ethics policies sufficient to protect their investors? The two funds' prospectuses and recent disclosures contain not a word about

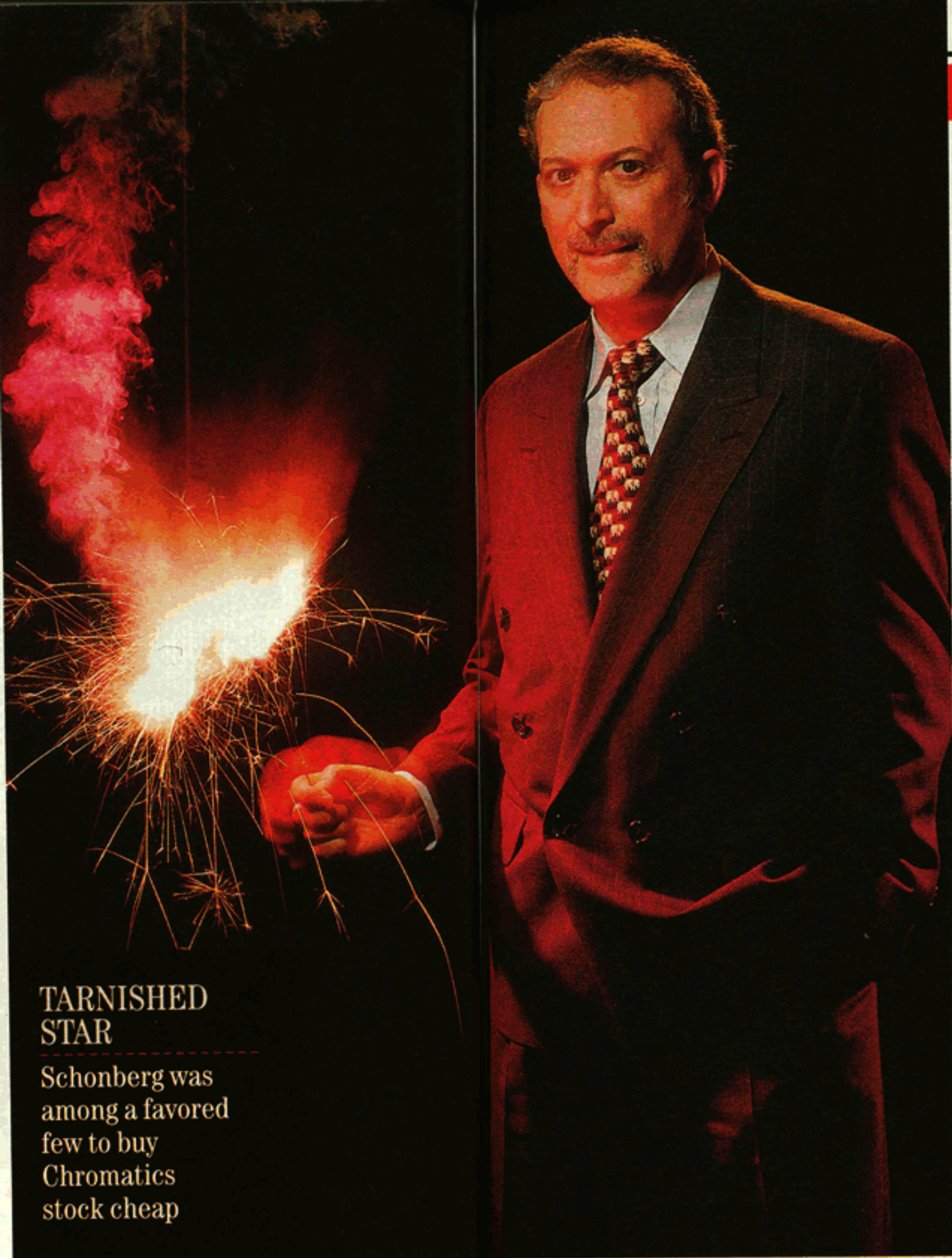


funds, though Schonberg remains a portfolio manager. Again, Dreyfus has an embarrassment on its hands—but this time it isn't a simple case of crummy stock-picking.

Not long after Schonberg was hired by Dreyfus, he began aggressively buying for the funds a micro-cap stock called Chromatics Color Sciences International Inc. At the same time he was loading up on the stock for Dreyfus, Schonberg held 20,000 shares of Chro-

Schonberg's position in Chromatics—which he still holds in his personal portfolio—even though it tops the list of both funds' holdings.

In the past, the SEC has taken a dim view of conflicts of interest by fund managers. Late in 1995, the SEC fined an Invesco Inc. fund manager named John Kaweske for having traded, in his own account, shares held by Invesco. Kaweske neither admitted nor denied the charges. Kaweske allegedly did not



TARNISHED STAR

Schonberg was among a favored few to buy Chromatics stock cheap

disclose his personal stock position either to his employers or his investors. That makes his situation different from Schonberg's. But since his investors have been left in the dark, what are the implications for Dreyfus? The answer is far from clear. SEC rules don't ban fund managers from buying stocks they personally own—but the securities laws carry broad prohibitions against deceptive conduct. "Investors have a right to know the personal proclivities of the persons in charge of investing their money," says Melvyn I. Weiss, a prominent securities lawyer.

Chromatics' rendezvous with Schonberg took place not long after the Kaweske case first hit the headlines in 1993. The New York-based Chromatics, which makes a skin-color monitor for medical and cosmetic uses, was brought public in February, 1993, by Investors

Associates Inc., a brokerage that has been a subject of numerous enforcement actions by regulators. Schonberg was introduced to Chromatics management in 1993 by Peter W. Janssen, a partner in Janssen-Meyers Associates, a New York brokerage. According to Janssen, Schonberg became enthused about the stock and subsequently bought Chromatics for his employer at the time, Omega. Schonberg's enthusiasm brought him a reward accorded only the favored few—an opportunity to get in on a cheap-stock deal.

When Janssen-Meyers managed a private placement for Chromatics of 1.8 million shares in 1994 and 1995, Schonberg was made part of the deal. Among the dozens of lucky investors were the principals of Investors Associates. The price: \$2.50, or half the open-market price in December, 1994, when Janssen

SCHONBERG AND CHROMATICS —A CHRONOLOGY

DECEMBER, 1994 Schonberg buys 20,000 shares of Chromatics at \$2.50 apiece in a private placement

AUGUST, 1995 Schonberg becomes portfolio manager of Dreyfus Aggressive Growth and Premier Aggressive Growth

JANUARY, 1996 Dreyfus reports that it holds 260,000 shares of Chromatics in its portfolios

MARCH, 1996 Dreyfus reports 155,000 Chromatics shares held by Premier Aggressive Growth alone

MAY, 1996 Chromatics registers the private placement stock with the SEC, allowing the shares to be freely traded

MARCH, 1998 Chromatics is now the largest holding of Aggressive Growth (397,500 shares) and second-largest holding of Premier Aggressive Growth (1.1 million shares), and Dreyfus is the fund's largest institutional shareholder

APRIL, 1998 Schonberg is replaced by Paul LaRocco as portfolio manager of the funds, but remains involved in investment decision-making

DATA: BUSINESS WEEK; COMPANY FILINGS

says Schonberg bought the shares. The "cheap stock" generated in the offering could not be freely traded until the company registered it. That didn't happen until May, 1996.

Fortunately for Schonberg and his fellow cheap-stock investors, Chromatics performed nicely in the months ahead—and Schonberg's funds may have helped the stock in its climb. An SEC filing discloses that Dreyfus took a 260,000-share position in Chromatics by Jan. 24, 1996. At about the same time, Chromatics staged a rally. It ended 1995 trading at just \$4.25 a share. By the end of January, it was trading at more than \$10. Share prices declined a bit in the next couple of months, but they were always well above the \$2.50 a share Schonberg paid for his shares. In May, 1996, when the private placement shares were registered for sale, the stock had climbed

back to just over \$10. Although share prices then moved downward, evidently pushed lower by private placement shares and other cheap stock sold at instant profits, Chromatics never traded below \$7 in the next two months.

Chromatics share prices did not stay in the single digits for long—and Schonberg, wearing his portfolio manager hat, became its most enthusiastic buyer. As the months went on, the Chromatics stock position of his two funds grew to the point that Dreyfus became its largest institutional investor by early 1998. By last Mar. 31, the Premier Aggressive Growth fund held some 1.1 million shares of Chromatics, worth \$13.7 million, while the Aggressive Growth fund held 397,500 shares, worth \$4.9 million. Meanwhile, Chromatics shares climbed above \$17 in January, 1998—such strong performance that the company announced a 3-for-2 stock split in early February. Despite Chromatics, Schonberg's funds were horrendous performers, with Aggressive Growth falling 15.8% and Premier Aggressive dropping 13% in 1997. Year to date, they are down 18.5% and 13.5% respectively.

STRONG DENIAL. Chromatics stock itself has been in a state of near-collapse—and the company is blaming short-sellers. One major short in Chromatics has been outspoken in his attacks on the company. Manuel Asensio, a New York short-seller, asserted publicly on June 9 that the company is a fraud and its shares nearly worthless. The company did not return phone calls to its offices, but on June 9, Chromatics issued a statement strongly denying Asensio's allegations.

LaRocco, the new fund manager at Dreyfus, appears to be less bullish on the stock than his predecessor. In an SEC filing on June 8, Dreyfus disclosed that it had cut its Chromatics holdings roughly in half, to 780,000 shares. And Schonberg's private holdings? Schonberg isn't talking, but according to Dreyfus, he still is holding the stock. And despite a dramatic decline in the stock—encouraged by Asensio's public pronouncements and, perhaps, Dreyfus' dumping of the stock—it is still worth a heck of a lot more than he paid for it.

Even though Chromatics is down 50% in just a few weeks, Schonberg could still more than triple his money if he decides to cash in his Chromatics nest egg, now 30,000 shares because of the split. The stock now trades at about \$6—which would mean a gain of \$130,000. A nice piece of change. Too bad his investors haven't been quite so fortunate.

By Gary Weiss in New York