CHAPTER 1

Hobson's Choice

For the Model T, you may have any color as long as it's black.
—Henry Ford

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"Hobson's choice" originated from English liveryman Thomas Hobson, who kept at least 40 horses for hire but never let a customer choose his own horse in the stable. He offered only the horse nearest the door or no horse at all.

No choice at all has been the theme for many retail investors when securing investment choices from most FAs [financial advisors, consultants, and brokers]. In 2004 a distressed friend told me of a difficult situation she was experiencing with her FA, also a family friend of hers, making solutions even more awkward. She is a well-educated, intelligent, professional person and has maintained a long-term relationship with her FA who was associated with a well-known national firm. She had a variety of small accounts, which the advisor loaded up with high fee mutual funds that pay a share of the recurring annual fees back to the firm and advisor.

She had become increasingly dissatisfied with the low returns, so she asked the FA if she could consolidate her accounts and invest in exchange-traded funds [ETFs] or index funds instead since she had read and heard so many positive things about them. Rather than accommodate her, the advisor just told her no, that it wouldn't be appropriate for her and to stick with what she had. Further she was told that what positive attributes she had heard about ETFs and index funds was nonsense, that if she went down that road, the commissions to make these changes would be too high both in redemption penalties and transaction commissions. Frustrated and very

reluctantly, she did as she was told but her relationship with her family friend and FA was forever changed.

So, you might ask, how did she allow her FA to set up the accounts in this manner? Didn't she know about the penalties for early redemption? The facts are straightforward but this type of situation occurs more often than most expect and with the same unpleasant results. A typical problem might start with a client calling their FA saying, "I have some funds to invest. What do you recommend?" The FA will give what they consider a good recommendation and then most busy clients accept the advice and give the go-ahead. Both are too impatient. The FA wants the client to buy their recommendation and if avoidable not be bothered explaining alternative choices. The client isn't interested in listening to lengthy and complex alternatives, either. The clients don't ask a lot of questions since they're busy and just want to get this task scratched from the "to do" list and get on with their work. It's just human nature, but down the road problems often surface. Whose fault? Both are to blame.

CURRENT SITUATION: THE CAPTIVE CLIENT

Most firms have set up their investment plans like Las Vegas would design a typical casino—easy to find your way in but almost impossible to find your way out. If you get dissatisfied with what you own, or you didn't ask all the right questions up front, you will find just impractical or costly surprises to make needed or desirable changes. And in the end, like my friend, you will just find frustration and feelings of helplessness.

Many individual investors have their financial savings locked up in retirement accounts that offer them only one choice: to keep adding money every year to the the plan some sponsor, employer, advisor, or broker has set up for them. And, unfortunately from the market top of 2000 through 2006, most conventional mutual fund averages have underperformed both conventional index funds and ETFs. As outlined in Chapter 2 some mutual funds have barely broken even over that period. I can't tell you how many times some acquaintances have said, "Well, my account is finally back to the previous high after five years."

As noted in *Financial Services Review*, Summer 2006 edition by John Haslem, H. Kent Baker, and David M. Smith, "The bulk of the evidence, however, suggests that actively managed funds, on average, underperform benchmark portfolios with equivalent risk by a statistically and economically significant margin [Jensen, 1968; Malkiel, 1995; Gruber, 1996; Carhart, 1997]. That is, after accounting for expenses and transactions costs, active managers typically destroy value." A sobering thought.

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HOW THE INVESTMENT BUSINESS CHANGED

How did the lack of investment choice get this way? In May 1975 the U.S. Congress ended the NYSE's fixed-commission schedule that Wall Street firms charged and the era of discount commissions was introduced. Most retail brokers didn't think much of the change since it primarily affected institutional business, at least initially. So brokers continued to charge relatively high retail commissions until Charles Schwab & Co., which entered the markets around the same time, really started to gain traction with retail investors in the early 1980s. Schwab was joined by others and by the mid- to late 1980s there were several well-established discount firms dealing with both institutional and retail investors.

Most brokers scoffed at the upstart discounters. In fact, many major Wall Street firms told their landlords that if they rented to one of those firms, they would terminate their lease for cause. I did my share of scoffing, too; I was living off those high commissions myself. As a matter of fact, I prided myself on being ahead of industry trends then since I was one of the first brokers in the firm to make a living by gathering client assets for outside money managers. Managers paid me commissions from the accounts at the full retail rate, thank you very much, and both the client and I were seemingly content.

Then sometime in 1987, the firm I was then associated with, Shearson Lehman Bros., presented a tape from Fidelity Investments that its high-end brokers were asked to watch. Both firms had exchanged tapes regarding their respective vision of the financial services future. [We didn't get to see our firm's tape, which with hindsight would've been as, or more, interesting.] At that time Fidelity was the leading sponsor of mutual funds and had started a complementary discount brokerage firm. The CEO of Fidelity made a convincing case that the discount commission and mutual fund business were going to continue to grow due to expanding retirement accounts and favorable Baby Boomer demographics challenging the conventional Wall Street models—including mine!

After initially dismissing these themes out of pride, I started to notice a short time later that the money managers hired for my clients were starting to agitate for lower commission rates. Excuse me? Every broker in this position would naturally resist at first. But the money manager stated it was his fiduciary duty to seek the best transaction prices and his peers were doing the same. You certainly can't go to your clients and complain that you want to make more of their money when better executions were available. So, you went along. Commissions started to drop in short order from an average of 1 percent per transaction to just pennies.

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What to do? Since most FAs were paying nearly 60 percent of what was left of the commission revenue to their firm, perhaps it would be better to alter that relationship by starting my own firm. I rented some cheap office space, went through the expensive and exhausting registration and licensing requirements, and after all was done changed the split, increasing our take before expenses to 85 percent. We also registered with the Securities and Exchange Commission [SEC] as investment advisors so that we could share some of the managers fee income the money manager was charging. This was an awkward period since the money manager also wasn't interested in sharing but eventually saw my worth as a member of the team. Now we were on the same side working in the client's best interests.

But our commission revenues suffered as customers who didn't qualify for privately managed accounts, or who wanted to do their own thing, including some of our best trading oriented clients, started to take a portion of their business to places like Schwab. A good client who might usually buy 1,000 shares of stock from us was suddenly just buying a few hundred shares and taking the balance to the discount firm. And that's if we were lucky!

It got worse. Our in-house research analyst wrote a report recommending a stock. I mailed the report to a client who called to chat about it subsequently. He placed no order. Then about a year later the analyst put out a sell recommendation on the stock. The stock dropped and I received a call from the client who seemed interested as to what happened to the stock. The client was upset that the stock had dropped and became even more furious when told that we had put a sell recommendation on it previously. Believing that the client hadn't bought the stock, or so we thought, he hadn't received the sell recommendation. No, he obviously had purchased it from a discount firm. So he was taking our research that we were paying a high cost analyst to research and prepare a report only to take his business to a discount firm. This is something that happens every day now, and is a big part of the reason that investment banks have cut back on their research efforts.

Needless to say, we had to find a way to compete and raise a lot more money. One way was to hire more brokers and grow the company. So we proceeded to grow following that path over the next 10 years. But in a highly regulated environment where the largest firms dominate and have more influence over the rules, they can make things rough for the smaller firms. After all, they have the economies of scale to deal with all the regulatory requirements including filings, audits, examinations, additional registrations, reporting requirements, and endless red tape. You start a small broker/dealer and investment advisory firm to manage your clients' investments, and end up spending more time on regulatory matters, benefiting the big firms by driving smaller competitors out of business. Anyway, I did something about it and sold the company.

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Now I'm back to doing what I value most, studying the markets and writing about it them our newsletter, but that's another story.

THE AGE OF THE DIY INVESTOR

Many retail investors don't realize they can pursue other alternatives on their own without complicating their lives too much. If you have a computer, an Internet connection, and enough money—and it doesn't have to be a huge amount, although more is always better—you can do everything yourself.

The success of the discount brokerage firms has made investing online a low cost and convenient way to deal with investments for those willing to take the time to do so.

During the 1990s when the bull market was roaring day trading became a popular activity even for the most unsophisticated investor. Armed with

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"Online Trading Makes Broker Obsolete."

Source: Courtesy Pritchett Cartoons.

high-speed computers and handheld quote devices, individuals were having a great time. Some quit their jobs and started trading full-time for a living. Small unlicensed shops sprang up sponsored obliquely by newbie online firms where individuals could open accounts and learn rudimentary trading skills. It all worked well until the bear market arrived in 2000. By the time it was all over in early 2003, most of these boutiques were closed and the full-time traders were back looking for conventional employment.

As we learn in Chapter 2 online investing reached a peak in 2000, fell substantially with the bear market, but is now back to the heights of 2000. Many online brokers consolidated during the bear market as day traders and others left the scene for greener pastures or more stable forms of investing. After all, the quick money crowd who were day trading later found flipping real estate a new and more lucrative activity at least until that, too, ended in late 2005.

As firms consolidated, their services expanded to include more online investing help while at the same time a commission price war ensued. Of course all this accrued to the benefit of customers. Commissions for transactions have been reduced to single digits for most online firms. In late 2006, Zecco.com, a new online brokerage firm, introduced the "zero commission" structure. That's right "zero." That action was quickly matched by Bank of America Securities for accounts with $25,000 minimum balances. And in February 2007, Wells Fargo also introduced a zero commission structure for 100 transactions per year for accounts also with $25,000 minimum balances. The services aren't as free as they look, though. These accounts pay very low interest rates, and some have questioned execution quality. No doubt, however, this commission model will pressure the traditional online brokers, much as the online brokers in their day pressured traditional brokers' revenues.

New services offered by online firms allow you to more easily monitor your portfolio checking on performance, asset allocation, dividends, and taxes with an open architecture to make further customization constrained only by your own imagination. Low cost and even free IRA accounts are standard fare as are many other services online investors would expect only from conventional wire-house firms.

The big wire-houses have fought with the "wrap" account concept that offered free trading, with some limits [200 trades a year at Merrill Lynch], all-inclusive fee for high net worth clients. The fee charges are on a sliding scale with lower fees maybe less than 1 percent per annum for balances greater than $1 million. The initiative goes some way toward meeting the challenge, but has run into regulatory problems as some firms moved large, but largely inactive accounts, into this structure, essentially charging customers huge sums for what are basically custodial services.

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Customers with other managed assets, such as hedge funds and privatized partnerships, can be "stuck" if they don't want to deal with the complexity of different accounts at different institutions, but the writing is on the wall for this business. After all 1 percent on $1 million is $10,000. That's a foolish amount for investors to pay and eventually they'll get hip to it.

Younger investors who are starting to earn and save funds in their retirement accounts are more likely to want to do their own thing online in the most contemporary manner but they'll want more help and tools. Further they will gravitate toward ETFs since they are easy to use with many different issues and sectors to choose from.

DIY investors will find many resources to help them structure and employ various strategies including guidance with some handholding from online investment newsletters and other conventional news sources. Younger investors may find most current FAs to be a little too old school for their tastes. Further all the scandals over the past decade that have rocked the mutual fund and brokerage community have been off-putting.

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IF YOU CAN'T BEAT 'EM, JOIN 'EM

Just as when I first saw that Fidelity tape, for the contemporary advisor things are beginning to change again. And the changes are coming fast and furious—more quickly than can be written about. The ETF boom taking off in earnest in early 2004 has overwhelmed the financial markets with a wide array of low-cost products and choices. Their popularity is challenging conventional business models for FAs as retail investors want to participate in the most contemporary investment models and schemes.

Today's modern broker is not the same skilled and educated financial expert common several decades ago. When just a teenager in Chicago, I asked my father what all the men did for work who were walking home from the train station early in the afternoon while everyone else was working later hours. He said they were probably working at the commodity exchanges downtown. I was intrigued by them and their profession. They toted their ubiquitous *Wall Street Journal* [WSJ] under their arm, had an enigmatic aura about them and what they did for a living. I tried to read the *WSJ* once back then, but I may as well have been reading a detailed medical journal. I wanted to learn more since this looked like an intriguing profession. Besides, from a youthful perspective, these guys got off work early!

But seriously, when first entering the business I worked for a "wire-house," which is an old expression that defined firms headquartered in New York that had remote offices scattered about the country connected by a teletype or wire. These firms pushed product just like firms today do mutual

funds and other managed money products. The difference was that back in the mid-1970s firms pushed stocks and bonds primarily. Perhaps they took down positions of stock in inventory, marked them up, and dispatched them over the wire to the brokers to pitch to their clients with a detailed story. A broker in those days needed to know a lot about stocks and bonds beyond the scripted story. Many experienced brokerage clients and prospects would have good questions and you had to have good answers.

Since I started in the business as a bond salesman if I wanted to expand my business to stocks it was better to find others more knowledgeable about the subject than me to do it. That's how I gravitated to the now popular "managed-money" format.

Not meant as a putdown but today's FA just carries the *WSJ* around for show. That doesn't mean they're unskilled but they don't know as much about stocks, bonds, or other complex financial instruments as did their predecessors. They don't come to the business educated in finance and accounting. Studying and understanding corporate financial reports including balance sheets, earnings statements, and strategy are skills of a former age. Today's FAs are trained to pass the various licensing tests, taught asset gathering techniques, and provided computer generated financial plans designed to sell products. The latter advisors allocate assets to a range of high-fee mutual funds or even individual money managers, getting you to fund them and to continue doing so with perhaps occasional reallocations.

Changing from a commission to a fee-based business model was the major brokerage firm's strategy to compete with the discount firms. Most wire-house firms liked the idea of gathering assets or building "evergreen income" [industry jargon for developing recurring fee income structures] approaches for many reasons. First, it was easy to supply the brokers with product like mutual funds. Second, many believed there would be less compliance issues from trading abuses of ["churning" primarily] common stocks, options, and commodity trading—but as we shall see later they were mistaken on that count.

For clients with small accounts the FA's fee business tools of choice were mutual funds. Firms made deals with mutual fund families, provided FAs with computer driven financial plans that spit out canned presentations for clients with certain profiles including risk tolerance, age, goals and objectives, and so forth. The broker/FA would enter the data and out would pop a series of recommendations. The FA would then present the preferred models to the client and let them make choices.

Clients with larger assets would be offered an SMA [separately managed account]. This would consist of the obligatory computer driven financial plan but in lieu of mutual funds would incorporate firm approved outside money managers to allocate the assets as if they were mutual funds.

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It all sounds convenient and compelling for all parties involved. Naturally there were flaws. Many computer driven financial plans are based on previous performance data that may contain 5 to 10 years of data. If the previous study period benefited a certain style over another it doesn't necessarily follow that the future period will replicate the past. It's a major "garbage in, garbage out" pitfall for most computer driven models. And since most modern FAs have more of this kind of experience and knowledge than from basic investing skills, trouble can often be the result.

For SMA accounts the FA's firm locates suitable money managers through their own internal due diligence process and cuts marketing deals with them. It doesn't necessarily follow that firms on the approved list are the best money managers in each style category since the best probably don't need to share fee revenue with anyone. Naturally, this is a significant conflict of interest that needs more disclosure than the industry currently provides. It's logical to assume that firms sometimes feature only money managers who are the most fee lucrative to them versus the best for the client. This is a conflict simmering beneath the surface and not often discussed.

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BAD APPLES AND UNETHICAL PRACTICES

As in any other profession there are some bad apples. Before the industry changed from a commission to a fee-based model most of the abuses revolved around "churning" where brokers whipped their client's portfolio assets around more for the commissions than for the client's well-being. The practice was the subject of many complaints and litigation.

Broker and FA abuses typically involve mutual fund switching, purposeful multiple allocations to avoid commission breakpoints, and other nondisclosure issues.

Many mutual funds are offered in four series: A, B, C, and H shares. Series A shares are termed front-end loaded, generating the highest *initial* sales commission that may exceed 5 percent of assets, meaning less money at work for you. Series B are back-end loaded and spread a lower fee out many years with a penalty if you wish to redeem before a certain date. Series C are level-load funds where a lower fee is charged every year without redemption penalties. H shares are no-load offerings that allow FAs the ability to add a recurring management fee of their own on top of existing management fees charged by the fund.

A common unethical practice is having clients switch frequently from one high front-end loaded Class A series fund to another to earn excessive commissions, also considered churning.

Breakpoints are threshold levels where sales loads or broker commissions are reduced. When breakpoints are used, commissions can be reduced

from around 5 percent to maybe 2 percent or less making them cheaper to own over the long term, although FAs just receive that commission once. Some abuses occur when sales are made just beneath the breakpoint. Further, most mutual funds are sponsored by firms that offer a ''family of funds'' with perhaps similar or very different objectives. Another serious abusive practice is for the FA to recommend several different A funds from different fund families depriving you of cost-saving breakpoint opportunities from within a fund family.

It's the FA's duty to inform you of alternative opportunities and to wisely recommend distribution of your assets in a cost-effective manner. Further, it is their supervisor's duty to monitor the FA's activities since they personally initial and inspect every transaction ticket.

Class B, or 12b-1 funds have become the most popular offerings for career FAs. They like them because B shares provide them with a potentially higher recurring income over the long term from annual fee splits with the mutual fund company than if they sold the initially more costly Class A share series. Selfishly or nefariously FAs also like them because sometimes costly redemption fees keep investors captive to the fund since clients are less likely to leave. As noted previously, within the business model this is known in the trade as building ''evergreen income'' for the FA. It is their primary career focus.

It is in this latter area where more unchallenged abuses occur. My friend who wanted to alter her accounts found the redemption fee an undisclosed surprise. Many FAs don't really explain this negative feature to their clients upfront or clients don't understand that the financial plan, based on old historical assumptions, won't work. Only then do they discover or remember the redemption fee drawback. If the mutual fund performs poorly and the investor wants to make a change, they still must pay the redemption fee on top of enduring poor results.

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FAs also like investment plans that require you to add more funds every year, [IRAs and other contribution plans] because even if these plans make no money, the FAs can continue to collect their fees.

Based on fines levied by regulators, management at the top of each firm has also been complicit in unethical and undisclosed conflicts of interest. In the recent past management had created selling agreements favoring one mutual fund family versus another not owing to anything other than more lucrative agreements with the fund. For example, mutual funds might request brokerage firms to grant them special ''shelf space'' [like merchandise at the supermarket] in exchange for certain favors. Such have included brokerage transaction kickbacks created by the fund that benefit the brokerage firm. Management might also create and implement sales contests and other promotional schemes to promote certain funds, which had been another

undisclosed conflict of interest. Further abuses include offering incentives such as special bonuses, sports and theater tickets, golf outings, expensive trips, and other benefits.

According to a February 19, 2007 article from *Investment News*, "Many brokerage firms are disclosing the existence of 'shelf space' agreements but are not disclosing the details of those agreements." So severe are some conditions that the article notes:

> *Smith Barney and UBS Financial Services Inc. of New York and Morgan Stanley say that funds that don't pay to be in their top tier of providers aren't allowed to send wholesalers to their branch offices. In its own disclosure documents, Merrill Lynch & Co. Inc. of New York says funds that do 'not enter into [shelf-space] arrangements ... are generally not offered to clients.'" And in a concluding comment from an anonymous Smith Barney broker the article continues, "I'm not sure [Smith Barney] is really searching for the best funds or it's just a matter of who's paying."*

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These types of schemes aren't just confined to typical Wall Street wire-house firms. MetLife Inc. was sued in January 2007 for allegedly providing secret incentives to its advisors to meet quotas for sales of its proprietary mutual funds and life policies. As noted in a March 5, 2007 article also from *Investment News*, "Advisers often wind up selling the proprietary products, because they flock like moths to a flame to products paying greater compensation," noted attorney Andrew Stoltmann a securities attorney and partner with Stoltmann Law Offices PC in Chicago.

HIGH PRESSURE ENVIRONMENT

Working as an FA isn't all peaches and cream. There's a lot of pressure on FAs to perform and meet production mandates. This pressure can often tempt FAs to make poor or unethical judgments. For the underachievers, and you know who you are, things can get pretty ugly.

In an October 16, 2006 *Investment News* article it was noted that James Gorman, President, Global Wealth Management Group, Morgan Stanley called for "brutal treatment of the lower half of the brokerage force, because—like it or not—a company is defined by its bottom half." In the same article it was noted that Gorman was also chairman of the Securities Industry Association [which has since merged with the Bond Market Asssociation to form the Securities Industry & Financial Markets

Association]. "I'm sure what he said wasn't cleared by SIA, but when the chairman of an organization makes a statement, it's difficult for the organization to back away from it, especially at a function where he's the keynote [speaker]," noted Ross Albert, partner with Morris Manning & Martin LLP of Atlanta.

And lastly, within the same article, Steve Winks, principal of SR Consultant.com of Richmond, Virginia, states, "Nobody wants to acknowledge the reality of the brokerage industry, which is that most novice brokers receive cursory training and then spend five years working phone books in an attempt to survive."

No, it can become an ugly picture and only reinforces my previous more negative description of the modern FA.

THE REGULATORS CRACKDOWN

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The frenetic growth of both mutual funds and the brokers selling them could only mean there would probably be trouble ahead. Pushing more lucrative commission laden mutual funds at the expense of others and receiving commission kickbacks started to give the industry a black eye and hurt them in the wallet.

- In 2003 Morgan Stanley was fined $50 million for pushing their own and other more costly mutual funds at the expense of more cost-effective offerings.
- In late December 2004 Edward D. Jones was fined $75 million for failing to disclose conflicts of interest with certain mutual funds. According to the National Association of Securities Dealers [NASD] December 22 NASD order, "Edward Jones told the public and its clients that it was promoting the sale of the Preferred Families [the name the firm gave to mutual funds it preferred its brokers to sell] mutual funds because of the fund's long-term investment objectives and performance. At the same time, Edward Jones failed to disclose that it received tens of millions of dollars from the Preferred Families each year, on top of commission and other fees, for selling their mutual funds. Edward Jones also failed to disclose that such payments were a material factor, among others, in becoming and remaining an Edward Jones Preferred Family member."
- In January 2005, the NASD fined American Funds Distributors for $100 million in undisclosed commission kickbacks to 50 different brokerage firms selling or pushing their products.
- In February 2005 the NASD fined Quick & Reilly [now a part of Bank of America Securities] and Piper Jaffrey nearly $1 million for directed commissions back to firms promoting their mutual funds.

- In the spring of 2005 the NASD leveled $21 million in fines against American Express Financial Advisors, Chase Investment Services, and Smith Barney for pushing mutual funds that carry higher fees such as Class B funds without telling customers that Class A funds would be cheaper over the long term and could be purchased at a discount [breakpoints].
- June 2005, 14 different brokerage firms involved with AIG mutual funds were fined $34 million for pushing higher cost funds without offering competing funds that were more cost-effective.

The litany of fines continues to this day. In February 2007, the NASD fined Fidelity Investments $3.75 million for among other reasons poor record and that Fidelity Distributors, the chief underwriter for Fidelity Mutual Funds, failed to "supervise certain registered individuals for compliance with Fidelity's ethics and conflicts of interest policies." The latter finding revolved around gifts to Justin Timberlake and Christina Aguilera concerts, chartered flights, tickets and lodging at expensive hotels, and "twenty bottles of wine." So, the beat goes on and one must wonder, "What is it about the rules they don't get?"

The previous is just a portion of the fines levied against both brokerage firms and mutual fund companies. These fines expose the level of corruption that can occur within the industry at all levels. And this doesn't include abuses and fines from the so-called "mutual fund timing scandal," which thus far has netted an additional $2 billion in fines and counting, discussed in the next section.

The compliance and legal benefits imagined by the bigwigs running wire-house switching from high commissions to a fee-based business didn't exactly pan out as planned. This was because the fee business came with its own set of compliance issues that were largely ignored in the rush to cash in on the stock boom.

At the extreme, and without naming names [you know who they are], what can you say about some firms who set up FAs in claptrap one person offices, put them through a crash license testing course, arm them with the most high cost mutual funds, and have them out on the street in rapid fire succession schlepping mutual funds door-to-door like encyclopedia salespeople? Without a proper education and training what kind of ethical behavior can you expect?

We all know about how many real estate salespersons suddenly appear with licenses when that market is hot. Or suddenly everyone you know is a mortgage broker. The same thing occurred with the proliferation of new stockbrokers as financial markets experienced a bull market from the 1980s until the bubble burst in 2000. And new mutual fund families stepped in

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to grow with them aided by demographics from the new investor class, the Baby Boomers, and the advent of IRAs and other tax deferred savings vehicles. Funds grew from around 1,000 in 1982 to more than 8,600 by the end of 2006 and according to the Investment Company Institute [ICI] assets grew to nearly $10 trillion.

Not to be left out were banks and insurance companies. When the Glass-Steagall Act, which prohibited banks from owning brokerage firms, was allowed to meet its demise in the mid-1990s, banks quickly stepped in to establish mutual fund sales desks within each branch. Trust officers and even bank tellers were getting licensed to push new mutual fund products. Some large CPA firms got themselves licensed as broker/dealers along with some of their accountants. The thinking was, Who was in a better position than your accountant to make investment recommendations? In short, everyone wanted to cash in on the boom times. Now some of these firms are abandoning their brokerage operations given their obvious conflicts of interest with clients.

Now seriously, what can all these folks suddenly know about the investment world in such short order? Not much. So when I say the average FA is not the *WSJ* toting financial expert of decades ago, you can easily grasp the point. That's why the industry suffered so many abuses caused by an uneducated sales force and management just there to "make hay while the sun shines" if you'll pardon the old proverb.

Don't get me wrong; mutual funds have their place and we'll explore in later chapters what should be a more contemporary use of them.

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THE MOTHER OF ALL MUTUAL FUND SCANDALS

> *One thing is clear: The mutual fund industry operates on a double standard. Certain companies and individuals have been given the opportunity to manipulate the system. They make illegal after-hours trades and improperly exploit market swings in ways that harm long-term investors.*
>
> —New York Attorney General Eliot Spitzer, September 3, 2003

Aside from the litany of abuses already listed, the most publicized scandal was the so-called "market timing" affair that rocked the mutual fund industry further from 2002 to 2005. As was mentioned previously the consequences have been more than $2 billion in fines meted out to a variety of well-known brokerage firms, mutual funds, and hedge funds.

Not many people realize that using mutual funds for "market-timing" strategies had been a long-standing practice among a small group of specialized asset managers, and a larger group of registered investment advisors handling client accounts. The constant skirmishing between these traders and mutual funds was a major contributing factor in the emergence of now well-known companies like Rydex and ProFunds who developed special derivatives-based mutual funds that were intended to offer daily liquidity. The ProFunds affiliate, ProShares, brought these products to the ETF market in mid-2006.

What was different about the latest market-timing scandal was the scale of corruption uncovered. It started small with the initial disclosure that hedge fund Canary Capital Partners had entered into schemes with a variety of mutual funds and brokers that included Bank of America, Bank One, and both Janus and Strong funds. It was just the tip of the iceberg for as the investigation continued, more and more similar circumstances of abuse surfaced: "Every time we turn over a rock in the mutual fund business, we find vermin crawling beneath it," Spitzer said.

There were two elements to the scandal: Late Trading and Market Timing.

1. In the instance of Late Trading, net asset values [NAV] are established for mutual funds at 4 P.M. or the close of trading each day. Orders placed before are given that NAV valuation and execution price. Any orders placed thereafter are given the next day's closing NAV. With late trading, some funds allowed firms like Canary to take post 4 P.M. market moving news and receive transactions based on that day's closing NAV. Canary and others' purchases diluted the holding of long-term investors in the fund when buying the shares and then flipping them out a day or two later.
2. Market Timing on the other hand is not illegal as long as the rules of the mutual fund company permit it. In some cases, however, the fund's prospectus noted that firms who engaged in active buying and selling of funds would be barred from further transactions. However, some funds looked the other way and didn't prohibit the activity, instead agreeing to allow the trading in return for so-called "sticky" assets placed in other funds. In other cases, hedge funds evaded the funds' "timing police" by opening multiple accounts and otherwise working the system for their own benefit. The creativity was, in some ways, admirable: One hedge fund offered its employees dinner at the most expensive restaurants in New York in return for undergoing health checks for variable annuity insurance policies; the manager then used those polices to make the the market-timing trades.

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The scandal took down some of the biggest names in the business. Richard Strong, founder of the Strong mutual fund family, was banned from the business, along with the Pilgrim Baxter founders. Dozens of executives lost their jobs in the fallout, which involved congressional hearings and SEC investigation that continues four years later and provided further evidence that money mnagers don't always have their clients best interests in mind.

BUT WAIT, THERE'S MORE POTENTIAL SCANDAL AHEAD

Are Wall Street trading scandals a thing of the past? Not a chance. With so much information and money changing hands every day there's bound to be abuse. It's naive to think otherwise. In fact, according to a February 2007 report from *Fortune* magazine, "the SEC is investigating whether major brokerage firms were tipping off hedge funds to the trades brokers handle for big clients like mutual funds." This activity is called front-running and is illegal since it relies on inside information to succeed. As Doug Atkin, the former CEO of Instinet who now runs the research boutique Majestic Research says, "Privileged information is the real currency that runs Wall Street." Amen.

Scandals like this usually start with a few drips and end with a torrent of fines, more black eyes for firms, and a continual shattering of the ethic of fair dealings.

Doesn't it make sense then that individual investors want more not less control over their investments?

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CLIENT RUMBLINGS AND GRUMBLINGS

All this cumulative malfeasance coupled with the bear markets of 2000 to 2003 wasn't lost on many individual investors. They wanted change but again were locked in by costly redemption fees and uncooperative FAs.

Indeed, according to a survey conducted by Charles Schwab in their Advisor Outlook Study reported in *Investment News*, March 12, 2007, "Accounts that clients transfer from wirehouse brokers have investment guideline statements that consistently are misaligned with client financial goals. Fully 75% of these accounts arrive with poorly structured portfolios, according to 1,400 registered investment advisers—managing a combined $347 billion in assets."

Most whiz-bang financial plans offered to investors don't include ETFs since they're set up to deliver returns directly to the investor, not to provide recurring fee income to advisors. This is because ETFs are tied to established

indexes where management skills are less [they just have to hold the same assets in the same proportion as the linked index] and they don't have special share classes that pay commissions, making for lower costs. It's understandable that the purveyors of high cost mutual funds would fight this trend since their income is under assault. FAs and conventional mutual funds have been busy putting down ETFs for one reason or another. Mutual fund research firms like Morningstar have made their living on that industry and are trying to add ETF research, but they seem stuck in the mode of offering criticism for criticism's sake, overlooking the benefits to individual investors of entirely new investment offerings. Gold's a good example of a place where investors can now make their investment decisions without having to worry about having a futures trading account, or trying to guess which mutual fund offering with some mix of mining stocks and the commodity has a better handle on what's going on. And, of course, with huge volumes of fee ETF-related information available on the Internet, Morningstar and its kind can't make the same kind of money as they did in mutual funds promoting the sector.

At the same time, many retail investors are intrigued by the enormous growth in hedge funds [which we describe and discuss in Chapter 3]. They and ETFs are the subject of cocktail party conversation whenever investing and the stock market become the topic. If you tell your friends you are a hedge fund investor, they would be more than a little impressed. But your FA doesn't offer these funds to you unless you have at least $1 million to invest and then their firm might insist you have several different funds for diversification. That is a steep threshold for the average retail client.

One of the main attractions of hedge funds is their fee structure may be better for investors: Fund managers collect lucrative fees if the fund actually makes money for all parties versus adding money to losing mutual funds and paying fees for the privilege.

So it's not hard to see why so many are losing confidence in following their FA's plan. They tell their clients that they have very few investment choices and retail investors are being led to believe that they have little ability to take action when needed.

Over the years, individuals have been clinging to what appear as outmoded schemes laden with conflicts of interest that primarily benefit the FA and their firm, while placing them in a deceptively limited, even debilitated, position.

I STILL WANT SOMEONE ELSE TO DO IT

Like my professional friend many people are too busy to take the time to deal with their personal finances directly. They want a professional to help

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them and to take care of things on a daily basis. But just remember one thing: just as we don't have many "full serve" gas stations anymore, the quality of investment advice has diminished making it more necessary to take greater interest in your investments. As opposed to the go-go days of the 1990s, you will more than ever need to be an active steward over your assets. There's just no getting away from it.

While we discuss this more in later chapters it's important to note that recent studies completed by our friends at Tiburon Strategic Advisors point out that after the bear market of 2000 to 2003 investors who previously were or thought they wanted to be DIY investors no longer want to go it alone. But their research also reveals something even more important: Individuals want more control over their investments, but they also want some help.

This might include using a FA to implement various strategies that you jointly develop and clearly understand. The FA you choose should not be based on family or social connections. Rather you should find an individual FA who is learned and skilled in contemporary investment themes and portfolio structure. Stay away from the "product pushers" with the dated computer based financial plans filled with antiquated high cost funds.

That FA may be independent or, if not, use soundly based strategies and themes that may even be unique from what the FA's firm pushes. This can be tricky since you must discover if the FA is knowledgeable, has done their homework, is ethical, and puts your interests above just moving product out the door.

But if you want to invest like the superrich and still have an FA represent you, taking the time for some thorough due diligence will be a critical component for your success.

Finally, if you're just lazy, you can't be complaining about poor performance results later because you'll have only yourself to blame.

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REPORTS OF MY DEATH HAVE BEEN GREATLY EXAGGERATED

After the bear market and later revealed scandals the mutual fund and large Wall Street firms along with their associated FAs are still going strong. To count them out would be foolish. *Never underestimate the marketing power of these combined forces.*

The central idea as indicated previously was to convert the commission business to a fee-based mode. That meant converting the business style and methods of current FAs from someone who schlepped stocks and bonds for a living to one now offering financial planning solutions for

a fee. Some more ambitious and thoughtful FAs also became Certified Financial Planners [CFPs] in addition to carrying the normal licensing and registrations. Doing so greatly expanded their professional capabilities, knowledge, and credibility.

In fact, according to a 2006 poll by National Financial [a part of Fidelity Investments] of registered representatives, 23 percent of broker sentiment index would prefer to be paid based exclusively on asset based fees.

Their firms started to package mutual fund "wrap account" products combined with computer driven financial plans and models. This initially became the overriding marketing thrust of wire-house firms. When dealing with clients with more assets the separately managed account was packaged with approved outside money managers splitting recurring management fees with the firm and the FAs.

It wasn't much different from what I was doing previously in a slightly different way. The major difference is that their firms were behind them 100 percent and were much better organized to find and deliver product than someone on their own.

Brokerage firms created the financial plans and computer programs, signed marketing and fee-sharing relationships with mutual fund families, and left it to FAs to "just add money" from their clients and prospects. Sounds simple enough and with a bull market providing wind to the FAs' backs it only got easier. The only rub was that so many others were getting into the act. But with the rapidly expanding wealth of the Baby Boomers in the 1980s through today, the supply of clients seemed endless.

Also let's not forget the expansion of all manner of retirement account assets whether they were from smaller IRAs, 401[k] plans to large pools of corporate pension plans, wire-house firms had plans and products to suit most clients.

The mutual fund industry is huge with more than $10 trillion in assets by the end of 2006. According to Tiburon Strategic Advisors,

> *19.5% of all US consumers financial assets were invested in mutual funds. [And away from wire-house firms] "independent FAs primarily utilize mutual funds, with fee-only financial advisors having 61% of client assets invested in no-load mutual funds inside fee-accounts, and independent reps having 39% of client assets invested in commissionable mutual funds and another 16% invested in no-load mutual funds inside fee-accounts.*

And firms have been successful at incorporating this format. In 2006 per the Investment Company Institute, mutual fund assets average recurring fees paid to FAs firms was nearly $2 billion.

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The other area enjoying great growth continues to be separately managed accounts [SMAs] for investors with larger accounts with assets in excess of $250,000 to $500,000. For these investors firms developed "approved lists" of outside money managers who FAs and clients could choose to manage their money. Fee income was shared by the manager and the firm with the FA getting a cut. Clients liked the customized service and prestige of having their own outside manager versus mutual funds. These had some snob appeal but their performance wasn't necessarily superior to accounts featuring mutual funds only. Independent money managers with either modest or short track records needed the marketing leverage that larger firms provided and were all too willing to share fees. It makes sense that money managers with outstanding performance records didn't need to share their fees as money would find them like a heat seeking missile. Further the best managers would more likely gravitate to becoming hedge fund managers where fees are even higher and fee-sharing is not a subject for discussion. While wire-houses dominate separately managed accounts with more $1.5 trillion in assets, also included are bank trust accounts with assets now more than $1 trillion and of course money managers. See RIA p. 23. $.5 trillion marketing directly to clients. Therefore, according to Morningstar this is now a $3 trillion business.

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FUTURE AREA OF GROWTH: UNIFIED ACCOUNTS

The unified account is coming to a brokerage office near you soon—in fact some are already appearing at a variety of firms.

Simply stated a unified account features multimanager and sector strategy where different client assets are housed in one account. This makes sense for both firms and clients. Currently with separately managed accounts brokerage statements to clients were scattered and not consolidated. The unified account puts multi-manager accounts into statements clients can read and understand.

One of the biggest areas of client complaint beyond portfolio performance continues to be hard to read and understand brokerage statements. Clients have been complaining about this for decades. They would say, "Why is it so difficult to just tell me what I own, what it cost, and what its worth?" "Why can't you put all these disparate assets together in a simple snapshot?" "Why do you overwhelm us with so much useless mail?" And so forth.

Consolidating and providing clients with meaningful and easy to understand statements was the biggest challenge I had when using multiasset class investments for clients in the 1980s and 1990s. It was made worse since we

had a penchant for incorporating alternative investments with clients who were willing to use them. Why worse? Futures and commodity accounts were overseen or regulated by entirely different organizations: the Commodity Futures Trading Corporation [CFTC] and National Futures Association [NFA]. These were the facsimile organizations to futures and commodities as the SEC and NASD were to securities. But because they were different they required a completely different set of account documentation and client reports.

Clients always wanted and demanded to know how their "entire" portfolio was doing rather than viewing it piecemeal. What to do? We took the risk and made the investment of crafting our own consolidated statements. Why risk? Because many abuses and criminal activity were associated with FAs creating their own phony client reports to either mislead investors and/or steal from them. So with great scrutiny we started to create complicated statements while I was still at Shearson Lehman Bros. in the early 1980s.

I remember buying the first PC that was in the office and hiring with my own funds an accounting student from the local university to perform the research and produce reports. I created a draft of how a client report should appear and we set about our task. This was easier said than done. First, we were all new to operating PCs and at the time, we used Lotus since Excel wasn't even available. Everything had to be done by hand and our university student struggled with all manner of issues from first just learning how to use the computer to dealing with complex industry standard rate of return formulas. Other brokers milled about our office wondering what we were doing and why. Since it was a proving ground operation so to speak we didn't say much until it was complete and approved by the powers that be in Albany.

After many months of effort we rolled out the first statement and sent it off for compliance approval. That approval never arrived since even New York legal and compliance officials couldn't figure out what to do with our efforts and results. This was another reason to strike out on my own since the reports were costly to produce [remember in 1982 PCs were expensive not to mention the help] but their production was much needed.

But essentially what we were doing is what's being done now for unified accounts: providing clients with a comprehensive analysis of how their total portfolio is doing including its disparate elements.

Around that time there was also a movement to start pension consulting practices within wire-house firms. An acquaintance had pioneered one in Honolulu and he was doing what we were doing except that he was dealing with large unions, foundations, corporations, and government. His services were valued by trustees and investment committees who had fiduciary

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responsibilities over large sums. They needed a consultant to provide cover for their oversight. He did an excellent job of sensing their needs intuitively and started crafting reports similar to what we were trying. In those days it was common practice for consultants such as these to be paid via commission business from the accounts. The investment committees liked it since they didn't have to pay a consulting fee out of assets thinking, "We have to pay the commissions to someone anyway." The consultant would bring the committee a group of money managers including several from each style sector and allow the committee to vote or select the managers they wanted. Further they allocated amounts to different sectors and styles per a plan crafted by the consultant and approved by the committee.

However, it didn't take long for committees to realize that there were potential conflicts of interest since the consultant might bring managers only to the group that was willing to pay the consultant commissions or those willing to pay the highest commissions.

Even though commissions were falling during this period, when you're dealing with $100 million accounts even reduced commissions would add up to substantial sums. Eventually committee trustees became aware of the potential for conflicts to arise. Committee members felt that by paying a flat consulting fee and no commission from the account, the potential for abuse would fall and only the best managers would be brought to their attention. However abuses could and would still occur as managers could pay a stream of commissions to the consultant from other accounts, which were an undisclosed activity. When discovered many trustees sought to eliminate the potential by requiring third party money managers not to pay any commissions to the broker from any source. And so it went.

The important thing is that these consultants were able to craft their own unified account structures that are now making their way to brokerage firms.

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THE FUTURE FOR FINANCIAL ADVISORS NEVER BRIGHTER—MAYBE

The savings rate in the United States has never been lower at a mere .2 percent of income. But Baby Boomers pending retirement will cause investment assets for them to rise since pension and 401[k] monies will be rolled over into IRA accounts. In fact, according to Tiburon research, "investable assets will rise from approximately $17 trillion to almost $30 trillion by 2010, creating a tremendous opportunity for financial advisors."

FAs who are successful at raising funds are living a good life today. It's been reported that the "average" production for industry leader

Merrill Lynch FAs was $750,000 in 2005. With their take at around 40 percent that means they're making a tidy $300,000 per year. Not bad, is it?

However, there is an important caveat. Many third party managers and some considered "in-house" are cutting fees. Some are cutting fees completely to FAs and their firms. For example, on January 29, 2007 Eaton Vance with $133 billion in assets announced it is no longer paying brokers at Merrill Lynch [ML]. Merrill Lynch also in early 2007 announced a sharp reduction in the fees it charges for fixed-income investment management meaning the FA's share would be reduced proportionately. So despite all the future potential, FAs will have to work harder collecting more assets for each dollar they earn. And ML is moving to a portfolio-based package for their SMA accounts where money-managers' fees might be drastically reduced by 40 percent according to *Investment News*, February 6, 2006.

In fact, according to an *Investment News* article of October 16, 2006, wealth managers are also being forced to restructure fees. "The most pressing concerns in the rarified circles of firms catering to high and ultrahigh-net-worth clients are fee transparency and the sustainability of percentage of assets under management as the industry's pre-eminent prices model." That's a pretty shocking admission. From the same article CEO Chris Snyder, Private Client Resources LLC said: "Pricing is hugely in turmoil. Banks are reasonably frightened, and it seems clear that the pricing paradigm needs to change."

Companies like Fidelity are rolling out interactive tools that allow DIY investors to create their own retirement plans that circumvent brokers and advisors. These tools allow willing investors the help they need to go it alone more easily.

These types of pressures will continue whether driven by customers from the bottom up or from the top down. FAs can count on being under growing fee pressure from all quarters for a long time.

These types of pressures may force many current FAs to reconsider their current FA status with a major firm and move to become an independent registered investment advisor [RIA]. In fact from the previously mentioned National Financial poll, fully 60 percent of current FAs would leave their firm to better control their ability to determine how they are paid.

The drive to compete and create more efficient cost structures move from one delivery cost to the next. First commissions and now fees. As we learn later ETFs are also a force in driving down product fees.

TWO BODY BLOWS TO WALL STREET FEES

Financial planners have long chafed at the notion that brokers not registered as investment advisors could charge a fee. The planner's organization alleged

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that brokers couldn't have it both ways and should either be charging a commission as brokers or register as investment advisors. And in a major court decision by the U.S. Court of Appeals for the District of Columbia Circuit, on March 30, 2007 the court agreed overturning the controversial broker–dealer rule. The SEC has elected not to appeal the decision.

Naturally, this decision has created chaos within existing product structures for major Wall Street firms. The consequence is that assets in fee-based brokerage accounts must be moved to either an advisory account or a traditional commission account. This will be no easy feat since it's estimated that there exists some $300 billion in roughly one million fee-based accounts.

The SEC has asked the courts for a four month extension and the sentiment is that it will be granted to allow the firms to transition accounts. In the meantime many firms are not accepting new accounts' popular existing products. Morgan Stanley stopped offering its fee-based Choice account to new clients on May 19, 2007. The same is true for other industry firms from Merrill Lynch to Smith Barney. According to *Investment News*, Merrill Lynch, Morgan Stanley, UBS, Smith Barney, and Charles Schwab together account for 75 percent of fee-based brokerage accounts. They are rapidly putting together "alternative advisory accounts." By the time you read this, these accounts should be available.

But the financial planners aren't done yet. They're also complaining that the planning tools used by Wall Street firms to allocate assets to portfolios are also a violation of rules that encroach on their legal turf. They may make this a litigious issue as well.

The next body blow may be that according to industry sources, the SEC is considering a ban on B or 12b-1 shares. These are the funds that possess costly redemption fees that serve to trap investors. The elimination of these products would hurt the evergreen income strategies enjoyed by many brokers where recurring fees are their bread and butter.

In all this it's important to remember that Wall Street is a powerful political force. They won't sit idly by while their business is threatened. Accommodations will be made but the game is changing hopefully to the benefit of individual investors. The bottom line is that by 2008 the structure and variety of product offerings from many firms will change.

CONCLUSION

While most individuals are not able to invest in hedge funds due to high minimum account sizes, ETFs are soon going to make individually constructed hedge funds possible. There are new types of ETFs that have

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been issued over the past year and more entering the registration process. These new securities will allow retail investors with $50,000 to $100,000 portfolios to take market positions just as easily as hedge fund investors. With proper online brokerage accounts or teamed with knowledgeable FAs small investors will be willing to step up to contemporary account structures and cutting-edge portfolio strategies and management.

DIY investors and forward-thinking FAs can take control and exercise much more choice. With the many structural changes taking place on Wall Street investors and FAs will find new tools and freedom to follow the best investment path. If they do a little research and consult unconflicted sources of portfolio advice, like unaffiliated newsletters, they will find that a broad range of low-cost investment alternatives are within their reach—such as ETFs, index funds, and, eventually, an ability to create their own individual hedge fund. Investing in the market does not have to be like a visit to Hobson's stable.

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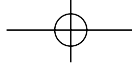
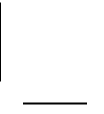
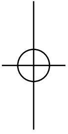
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