Investment Advice Is One Of The Greatest Scams Of Our Time

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Andrew Haigney is Managing Director of El CAP, a Registered Investment Advisor in the state of Vermont that provides investment-consulting services to individual investors, corporations, foundations, trustees, and endowments

David Swensen, Yale University's Chief Investment Officer, published on August 13, 2011 an op-ed in theNew York Times in which he shines a spotlight on one of the mutual fund industry's dirty little secrets – the punitive nature of investment management fees.

In the article, "The Mutual Fund Merry-Go-Round," Mr. Swensen, who oversees Yale's colossal $16 billion endowment, calls for improved investor education (particularly with respect to the benefits of low cost index funds) and calls for retail brokers to be held to a fiduciary standard.

We applaud Mr. Swensen for taking a stand on these important issues and we agree with most of his points.

However, we believe that the scope of the problem goes well beyond mutual funds, and more can be done to protect investors.

Scope of the Problem

The underlying problem is that investment advice has become a "product," and investment advisers steer prospective clients right into their own products.

Today's investors looking for investment advice end up seeking it directly from the point of sale of these products.

Beyond mutual fund companies, the point of sale runs the gamut, from large brokerage firms and registered investment advisers to hedge funds and bank trust departments.

A 2008 SEC study found that nearly 95 percent of investment advisory firms with individual clients also provide proprietary portfolio management services for individuals. These firms make their money through portfolio management services, not by dispensing investment advice. Many of these firms claim that they have no products to sell, instead they say that they provide a service – make no mistake, portfolio management services is a product.

How often at the end of a sales presentation do you think investment advisers (who are held to a fiduciary standard) sit back and tell a potential new client that they may be better off going to a larger firm with more experience or better resources? Or, as Mr. Swensen suggests, explain to a prospective lucrative client that their investment objectives can be better met by investing in a low cost index fund? They don't. With sales quotas to fill and fierce competition for new business, the name of the game in asset management is to get the money in the door and start generating fees.

Mr. Swensen argues in his article that actively managed mutual funds should be required to show prospective clients a side-by-side comparison of low cost index funds as an alternative to the actively managed fund being sold. We agree with Mr. Swensen, but we fail to see why this should be limited only to mutual funds. Why not also require registered investment advisers that offer proprietary portfolio management services to do the same thing?

Fiduciary Standard 101

We differ from Mr. Swensen with respect to his call for expanding the fiduciary standard. There is a common misperception that the fiduciary standard (which generally applies to mutual funds and registered investment advisers) provides a greater level of protection to investors than does the suitability standard (which applies to traditional brokers). In theory, the fiduciary standard offers investors a high level of protection, but in practice this is not always the case.

The fiduciary standard as applied to the investment industry is not uniformly defined by regulators, in fact the word "fiduciary" doesn't even appear in the Investment Advisers Act of 1940. It wasn't until a 1963 United States Supreme Court decision that investment advisers were deemed to be fiduciaries. The Court held that investment advisers were required to "…eliminate, or at least [to] expose, all conflicts of interest…"

In the financial services industry, investment managers are inextricably trapped in a fiduciary conflict between shepherding their clients' interests and marketing their products. The fiduciary standard has become an exercise of "disclosing" these conflicts of interest in the fine print, and as such the essence of fiduciary duty also gets disclosed away.

Many investment managers tout their fiduciary standing in marketing materials, as a kind of seal of approval. But the devil can still be found in the details – conflicts of interest are everywhere.

Notwithstanding the Dodd-Frank Act mandate that these disclosures should be expressed in plain, easy to understand English, the disclosure statements remain difficult for most investors to fully understand. Regulators routinely uncover serious deficiencies in disclosure statements that would be nearly impossible for the untrained eye to detect. Additionally, the fiduciary standard is subject to human failure, fraud and deception (remember Bernard Madoff had a fiduciary duty to his clients).

Expanding the fiduciary standard, absent a clear and uniform definition, will only further confuse investors. To better understand the practical side of fiduciary duty as it relates to the investment industry, see our in-depth report "Fiduciary Duty: What Does It Really Mean?" (available upon request).

What Can be Done?

Securities regulators need to take a page out of the Federal Employee Retirement Income and Security Act (ERISA) rulebook. Investors covered by ERISA rules (usually pension plans or other retirement programs) enjoy far greater protection than does the general public. Many of the investment vehicles commonly pushed on non-ERISA investors would be prohibited under ERISA rules as they'd be deemed to carry excessive, redundant or otherwise unnecessary fees. Under ERISA rules, investment advisers who provide investment advice to qualified plans are generally prohibited from receiving compensation tied to the investments the plan makes

Among many other things, ERISA rules assume that once someone has a product to sell, they can no longer be truly objective. With fewer and fewer workers getting traditional pension retirement benefits, shortfalls in 401k plans will come from individuals' non-ERISA protected investment accounts. Why aren't these assets entitled to the same protection?

The bottom line is that the investment advice business is perhaps one of the greatest consumer scams of our time. Rather than attempting to educate investors on the ills of Wall Street, regulators need to get serious about investor protection. Again, we applaud Mr. Swensen, who clearly has no dog in this fight, for bringing attention to these important issues. Investors should pay attention.