Why Investors are Frustrated with Wall Street

By Herb W. Morgan

Herb Morgan describes why investors must scrutinize hidden costs when making their investment decisions. It is not just a matter of reading carefully; it requires knowing where to look for costs that have been deliberately hidden by investment firms in their drive for greater profit.

If some of your client portfolios are stagnating or declining in value, the problem may not be the asset allocations decisions you have made but rather the way the investment product manufacturers deliver their wares, which is inherently flawed. The Wall Street businesses that create and deliver financial products are a part of the problem because their interests are often in conflict with your investor clients.

Part of the problem lies in how technical product information is communicated to investors. Often, the information in a sales brochure is technically correct but misleads the casual reader. For example, few mutual fund investors realize there are additional expenses not listed in the prospectus. These expenses are detailed in the Statement of Additional Information, but how many investors know to ask for a copy? These factors and others conspire to discourage investors and their advisors from gaining a clear and complete understanding of product offerings. This lack of knowledge keeps investors at a disadvantage, maneuvered into decisions that are less than fully informed and prevents them from acting in their own self-interest.

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Whose Success Are We Measuring?

Advisors and their clients might logically base the success of a product on its investment return, but Wall Street has a different measurement. They use the Effective Rate (ER), which measures the return they generate for themselves on your client's money. This is one reason for the disconnect between investment product manufacturers and your clients who invest with them.

Wall Street knows that uncertainty and the desire for greater return motivate investors; they design sales strategies to exploit this. They also know investors will ignore high cost structures under certain circumstances, for example, overpaying for mutual funds with high performance rankings the previous year. Despite historic evidence to the contrary, naïve investors continue to chase last year's winners, often ignoring their financial advisor's rational analysis for a rudimentary, haphazard scrutiny that extrapolates past events into the future. The result is consistently poor decisions. As long as this continues, Wall Street will churn out products destined for failure.

Mutual fund companies can be the biggest offenders. Consider a hypothetical example. Meltdown Mutual Fund Company sells three funds that invest in small cap stocks, each with a slightly different investment objective. Meltdown receives a $5,000,000 allocation of a hot Initial Public Offering (IPO) that

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soars 50 percent upon its debut. Look at the effect it could have on the firm's three funds:

Fund One:	$30 million in AUM	8.3%
Fund Two:	$100 million in AUM	2.5%
Fund Three:	$1 Billion in AUM	0.25%

Most fund companies will disproportionately allocate hot IPO shares to their smallest funds to boost performance records, which results in significant asset inflows. So the smallest fund, often the newest, gains the greatest benefit from the IPO allocation. Realizing this, fund managers funnel most or all of the IPO shares into the fund that will display the greatest percentage gain.

This is usually a one-trick-pony, however. The performance boost will likely attract many new investors, growing the small fund into a larger one. The company will now likely route the next hot IPO into a different fund, it's new smallest fund, because the fund that received the original allocation is now too large to benefit from the latest allocation.

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Mutual Fund Hidden Costs

The trading costs paid by some firms in the execution of buy and sell orders is another example of not acting in the best interest of investors. The expense ratio published in a mutual fund prospectus omits trading commissions paid by the fund; most investors are unaware of this. According to a University of Pennsylvania Wharton School study, the average mutual fund incurs .78 percent in trading expenses not disclosed in a product prospectus. So in addition to the other fund fees, investors pay an extra $780 in costs for each $100,000 invested each year they hold the investment.

The gains from securities sold within a mutual fund are taxable with short-term gains taxed at ordinary income rates. In recent years, as much as 30 percent of mutual fund gains have been short-term. While these gains can be offset by stocks sold for a loss, having more losses probably means the fund is down for the year, arguably a worse position than paying taxes on short-term gains. Either way, these tax issues contribute to poor performance when compared to other investments. Taxes on distributions add to the total cost of fund ownership, and damage the returns your clients should be receiving.

Capital gains and income taxes can have a negative effect on any taxable investment, but in the mutual fund universe there is an even greater risk for investors: the potential for losing money while still having to pay taxes. Mutual funds are required to distribute any net realized gains to investors at least annually. Any time investors buy a mutual fund they are saddled with the cost basis of the investments already in the fund. Advisors should never allow their clients to buy a mutual fund without first checking for embedded capital gains, a statistic readily available from data service providers.

The hardest hit investors are those who "hold" while their mutual fund stumbles. While other investors redeem their shares and the fund manager sells stocks to meet redemptions, the entire capital gains tax bill is dumped on the shareholders who remain with the fund during the distribution. To be fair, mutual funds experiencing strong net inflows provide capital gain dilution to their long-term holders.

Fund managers should maximize investor returns by seeking the best execution and lowest trading costs, but backroom deals relating to the distribution of financial products are commonplace in the industry. If a mutual fund company wants a brokerage firm to push its product, it may agree to place trades for the fund in exchange for favorable position with the broker's sales force. Of course, the costs are inflated, especially when compared with freely negotiated alternatives.

Further clouding the "best execution" equation is questionable research that ostensibly benefits the fund. Presumably acting in the best interest of its shareholders, funds pay lofty commissions to execute trades in payment for research. But the fund companies may never even read this research, despite using shareholder money to "buy" it. The cost of executing these trades is borne by the fund, not the fund company, which means the costs are passed directly to the investing consumer. It's a price investors pay so the mutual fund company can attract the attention of sales reps at a brokerage house, hardly a bargain.

Don't Rely on Wall Street Research

Two research companies recently released recommendations on the same stock: The first dropped the stock from Hold to Sell, the other moved it up from Neutral to Outperform. One might consider Neutral and Hold similar designations, but Sell and Outperform are about as opposite as you can get!

After a 5 percent drop that first day, due to the Sell rating stigma, within two months, the stock was trading at roughly the same dollar amount as the day before the contradictory announcements.

Investors relying on research from firms trying to sell them stocks can expect to encounter this kind of ambiguity. Firms do not simply make stock recommendations hoping investors can profit; they are trying to generate trading commissions, along with lucrative investment banking business from the companies whose stock they are touting. That's why stock research is inherently conflicted. Research published by any company involved with investment banking should be viewed with suspicion. This is true even if no investment banking relationship exists between the research firm and the company being covered.

When a company raises capital through a secondary stock offering, who does the CEO give the contract to, the brokerage house rating the firm a *Strong Buy* or one rating the firm a *Sell* or *Neutral*? It's obvious why Wall Street rarely issues a *Sell* recommendation.

Enron was rated investment grade by Nationally Recognized Statistical Rating Organizations (NSROs) just four days before filing for bankruptcy; A California utility company was rated "A-" two weeks before defaulting on debt obligations; WorldCom was rated investment grade 90 days before filing for bankruptcy; Global Crossing was rated investment grade in March 2002 and defaulted on loans that July; AT&T Canada was rated investment grade in February, 2002 and defaulted that September.

Wall Street searches for any reason to be positive on a stock and any reason not to be negative. A negative or *Sell* recommendation on a stock virtually assures the firm has no chance of obtaining lucrative investment banking business from that company. Recently, there has been a lot of interest in so-called *independent research* on stocks. While a better starting point for investors than overtly conflicted research publications, these independent research outfits often cite track records of their buy and sell decisions based on questionable price points. For example, suppose XYZ Company reports better than expected earnings after the market closes. A research shop could then put a buy recommendation on XYZ and cite today's closing price as their entry point. (The opposite is true of sell recommendations.) If the stock opens four points higher the next day, the recommendation is of no value to subscribers, but the research company succeeded in padding their track record, which likely leads to a subscription boost to their research publications.

Advisors and their client investors should ignore the buy/sell recommendations of any firm that is involved in any type of investment banking, and independent research should be thoroughly investigated as to the legitimacy of their track record claims.

TAMPS and Active Mutual Funds

Many advisors utilize third-party asset management programs (TAMP) for client portfolios. These are typically in the form of a bundled mutual fund product or "wrap" account. The problem with most TAMPs is the value does not justify the cost, and the cost hinders investors from achieving success. Mutual fund variable annuity wrap investors may pay 5 percent or more annually after the RIA fee is added to the fund costs. The concept behind a TAMP is sound. Asset allocation and regular rebalancing can significantly reduce risk and add value to a portfolio. However, product providers have gotten carried away with high-cost active mutual funds that consistently underperform their benchmark.

A recent study by Fulcrum Financial underscores the findings of many previous reports on actively managed mutual funds. The study reviewed ten years of mutual fund performance data and concluded that regardless of category, mutual funds fail to deliver, consistently underperforming their benchmark indexes by about 3 to 1. The study further stated that the additional costs imposed by funds, management fees, sales load/redemption fees, brokerage fees, trading and spread costs, are the primary culprit dragging down performance. Since investors can pull out at any time, mutual funds must keep some cash handy. As a result, they are generally not fully invested, leading to inefficiencies.

Occasionally, a study identifies mutual fund managers who beat the market or outperform their index.

Inevitably, these studies are based on gross performance, which fails to deduct any portfolio-related expenses. Include the fund's incurred expenses and their performance suddenly pales.

From 1992 though 2002, only 194 of 650 funds beat the S&P 500, and even this meager 29.7 percent is inflated because during that period, many poor performing funds were closed, and those shut down or merged away were not included in the analysis. Mutual funds that are doing well are unlikely to be shut down; the inference is that the ratio of funds beating the S&P 500 would have been even lower if all funds had been included.

The University of Chicago's Center for Research in Security Prices has done some work in this area and concluded that for the 10-year period ending in 2003, the difference in reported and actual average fund performance amounted to 1.6 percent. The study calculated an average annual gain of 8.8 percent for surviving stock funds, but that number dropped to 7.2 percent when discontinued or merged away funds were included.

The emergence of TAMP programs using exchange traded funds (ETF) provides a lower cost, tax-efficient alternative to traditional mutual fund and variable annuity wrap TAMPs.

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Fallacy of Chasing Performance

The mutual fund industry has something called "The Rule of Number One", which states that funds ranked number one in performance attract the greatest asset flows. Obviously, asset flows translate into revenue and profitability for the fund management company. This motivates fund managers to improperly abandon prudence in favor of aggressiveness.

The structure of the mutual fund business is such that it induces savvy companies to create numerous mutual funds in various asset classes, such as Small Cap Stocks or Investment Grade Bonds. Each of the funds invests in strategies that while different are similarly aggressive. The more funds a company offers in an asset class, the more likely it is to have a hot performing fund at any given time. This strategy enables fund companies to generate consistent revenue and earnings growth, year after year. The sales and marketing teams are quick to tout the hot performers, focusing their efforts on the performance of these attention-getting funds as long as they remain at the top of the charts.

The bad news for investors is that past performance almost never repeats itself. Studies of asset flows into mutual funds support the theory that the overwhelming majority of mutual fund shareholders enter and exit mutual funds at counterproductive times. This phenomenon is well known to mutual fund companies, who exuberantly hype performance to the detriment of investors who ignore history and their past mistakes by continually leaping back into "hot funds" and being disappointed...once again.

Long-term mutual fund investment success relies on careful examination of absolute performance and consistency. The analysis should include all costs and fees, along with an evaluation of the tenure and track record of the fund's manager, including any other funds managed.

ETF Alternative

A superior alternative for advisor clients is an exchange traded fund wrap account. EFT TAMPs have lower costs, often as much as 90 percent less than traditional mutual funds, and are a more tax efficient solution. ETFs also do not experience cash drag inefficiencies since they distribute holdings, rather than cash, to meet redemptions. They reduce expense and risk to investors while still allowing independent advisors the opportunity to earn a living. ETF TAMPs do not reduce the fees advisors charge their investor clients, but rather strip away much of the unnecessary and hidden costs of active funds, plus the capital gains distribution and costs of active manager failure.

Given the advantages, advisors should consider systematically replacing mutual fund wrap products with ETF wrap programs.