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Conflicts of Interest

A successful relationship with your financial advisor is grounded in trust. In fact, the most important asset you invest with an advisor is your trust. Conflicts of interest are caused by misaligned incentives that subvert motives eroding trust, and thereby damaging the advisor-client relationship. Warren Buffet's long time partner, Charlie Munger, captured it well in 1995 during a talk at the Harvard Business School called "The Psychology of Human Misjudgment" when he suggested one only needs to look at people's incentives to predict how they will behave. Many wealth management firms and private banks claim they are conflict-free despite structures and incentives that often are designed for the firm's best interest and not the client. Unfortunately, these conflicts are not always clear.

Partly in response to the revelation of several high-profile financial scandals as well as the 2008-2009 market collapse, President Obama recently signed sweeping financial-reform legislation knows as the Dodd-Frank Act. One of its many initiatives requires the SEC to evaluate the gaps in oversight among investment advisors, specifically, the lack of a fiduciary standard for broker dealers and their registered representatives. Since the fiduciary standard requires an investment advisor to act in the client's best interest, advocates claim that imposing this standard on all advisors who render investment related advice will add further protection for investors.

While it remains unclear how or even if the SEC will develop rules following their six month study, it seems unlikely that the rules will address all or even most of the blatant conflicts of interest that exist within the wealth management industry. Moreover, some of the conflicts pose a difficult dilemma in that disclosure often does not eliminate the problem or place the investor in any better position to make an informed judgment about the advice they are receiving.

The purpose of this paper is to identify several conflicts of interest that exist in the wealth management industry so that investors are better positioned to weigh the objectivity of the financial advice they receive from their advisors.

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Types of Conflicts of Interest

Firm Business Structure

Suppose that your local hospital is owned by one of the large pharmaceutical companies. While the delivery of medical services may be exceptional, questions may arise whether any of the doctor's specific recommendations are influenced by the drugs that are developed or sold by the corporate parent. The same is true in the financial services industry. Additional conflicts:

- *Firms that utilize proprietary trading desks and/or operate internal, employee-owned investment funds that engage in trading strategies that differ from those offered to the firm's clients.* When a firm is managing money for its employees or using its own capital to trade in products or strategies that differ (or are not even offered) to its clients, inevitably there are situations when the firm is providing advice to its clients that varies from their internal actions. The recent settlement by a prominent Wall Street investment bank regarding its disclosures relating to the formation of the vehicle that John Paulson utilized to bet against the subprime bubble is one example. In fact, during 2008 and 2009, there were a number of situations where clients were advised to purchase particular assets while the firm was actively selling the same assets from its own balance sheet when it knew, but did not disclose, that these assets were rapidly losing value (e.g., auction rate securities, sub-prime mortgages, etc).

- *Wealth management firms with other business lines (e.g., investment banking).* Consider when a research analyst in a large financial services firm suggests investing in a particular company while the firm is simultaneously serving in an investment banking advisory relationship with that company. Or, the recent news stories uncovering situations where internal emails about stock recommendations conflicted with what these firms publicly published, causing them to pay significant fines and to change the way they are organized. While these procedures may be helpful in controlling the flow of information and create the appearance of greater independence, these prophylactic protections do not wholly resolve the apparent bias in the investment information offered to the client.

- *Firms dealing as a principal for their own account while simultaneously managing client portfolios.* As noted above, when a firm is selling or buying assets from its own account to wealth management clients, there is the potential for harm. This is particularly challenging in areas like municipal bonds where no centralized trading market exists and large mark-ups can be charged to individuals. Some firms that provide wealth management services disclose a fee for advising based only on the equity portion of the portfolio yet charge a lucrative and often undisclosed fee as a

broker dealer on the bonds they are selling. The amount of the mark-ups on the bonds can also be difficult to ascertain, with total costs associated with this type of arrangement sometimes larger than what a client would otherwise pay for a typical AUM fixed income fee.

- *Firms with access to "limited" investment opportunities not equitably offered to all clients.* Sometimes an attractive investment or opportunity to invest with a hard to access manager becomes available with only limited capacity for new capital. Other times it occurs within the context of an allocation to an oversubscribed IPO. Firms have been reprimanded for providing these opportunities only to their "best" clients.

- *Firms deploying open architecture platforms that are not really "open."* Open architecture refers to an investment platform where the wealth advisor is able to offer investment strategies and products managed and created by other firms in addition to their own products. Ideally, an open architecture platform allows a firm to select the best investment strategies for their clients and provide greater transparency. However, this platform of "best strategies" may include managers who pay for the privilege of inclusion on the platform, regardless of whether their performance warrants inclusion.

Firm Fees and Advisor Compensation

Many wealth management firms charge fees to clients and/or utilize compensation programs that reward behavior that is not in a specific client's best interest. Examples include:

- C*harging different fees for advising on particular asset classes or securities while also providing asset allocation advice.* Some firms charge a higher fee for managing and/or advising on equities and a lower fee for fixed income investments. In such situations, if the firm is also providing clients with asset allocation advice, the firm, and possibly the advisor as well, has a financial incentive to encourage clients to invest more money in equities.

- *Charging commissions or a per transaction fee while providing advice related to asset allocation or purchases and sales of securities.* In these types of fee arrangements, the firm or advisor only makes money when the client is actively trading thereby creating an incentive to encourage transactions.

- *Incentivizing advisors to grow new assets under management rather than focusing on existing clients.* Some firms rely primarily on their advisors to generate new clients and often have incentives that place a premium on gathering new assets. While this does not itself create a conflict of interest, many advisors in these types of environments can become less focused on serving their existing clients in order to spend more time on business development activities.

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- *Using in-house (also known as "proprietary") asset management or proprietary products*. When firms use their own portfolio manager's products to invest client assets, a conflict exits even with an "open" architecture platform. While third-party rating systems for certain portfolio managers and mutual funds exist, the firm nonetheless has a financial incentive to use its own in-house products. Moreover, clients are often unaware that less expensive and/or better alternatives are available.

Summary

Conflicts of interest create misaligned incentives that subvert motives, undermine long-term performance and erode trust. Every wealth management firm has the option to structure their business to avoid potential conflicts and if they do occur, to reveal and deal with them in an open way with clients.

Often the conflicts that exist in the wealth management industry are difficult to identify, and yet can significantly impact investment returns and fees. As the industry has obfuscated the meaning of an "investment advisor" so as to include stock brokers and financial planners, investor clients are receiving investment related advice that is not governed under a universal standard of protection and fairness. Even with the recently enacted sweeping financial industry reform legislation, prudent investors should evaluate whether their advisor is acting in their best interest by examining whether they are really conflict free. In addition, investors should ask their wealth manager to put in writing that they will act as a fiduciary by putting the client's interests ahead of their own, and that they will fully disclose and fairly manage any other unavoidable conflicts in the client's favor. If they decline to do so, this should call into question the objectivity of the advice and services being provided.

Attached to this white paper are questions that can be used to engage your advisor about conflicts of interest.

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If your advisor tells you they are working with you pursuant to a fiduciary standard, will they put this in writing?

Does the advisor or firm have a documented, long-term performance track record demonstrating their clients' actual investment results, as opposed to pro-forma results or a list of currently recommended managers?

Does the advisor or firm receive compensation or have a financial incentive for:

- Recommending specific products?
- Recommending certain asset classes (e.g., they charge more for managing equities vs. fixed income)?
- Providing custody of assets?
- Managing "in-house" assets?
- Generating transactions and/or executing trades (commissions)?
- Bringing in new clients or assets and thus have a direct financial motive to seek new business?

Does the firm have other business lines, such as investment banking, that can potentially influence their wealth management advice?

How do they determine who is offered "limited" investment opportunities or capacity-constrained portfolio managers?

Does your advisor inquire as part of their diligence process whether the portfolio managers they use have significant percentages of their net worth invested in their strategies (which prevents the free option to take risks problem, an incentive for portfolio managers to make large, risky investments on which they get paid if profitable but do not share in the losses with their investors)?

Does your advisor have their own wealth significantly invested in the same strategies and portfolio managers they are suggesting you use (i.e., do they eat their own cooking)?

Does the firm have a proprietary trading desk and/or manage the firm's or employees' capital in investment strategies that are not offered to clients?