Ruminations© – December 2007

H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

Is Anyone Looking Out For You?

It is a financial disaster. The widespread issuance of mortgages to "subprime" borrowers – folks who didn't have any chance of paying their interest and principal obligations over even the short term, let alone the long term – has flooded the market with junky fixed-income investments, notably collateralized debt obligations. As everyone knows, these are going down the drain faster than ice cream melting in the August sun.

Many buyers of these complex, risky securities were supposedly sophisticated investors, but others weren't. And an important question has arisen from the mess: why did the investment bankers, who should have understood the nature of CDOs, sell such junk to unknowledgeable investors – or anyone, in fact?

The honest answer, critical as it may be, is: initial lack of understanding on their part and then pure pursuit of profit once they knew what they were peddling. The latter half of that answer is highlighted by the actions of Goldman Sachs – a firm highly respected in the financial community for its shrewdness, but now deserving of criticism by any objective observer. This year, while constructing and selling CDOs loaded with subprime mortgages, and thus offering enticing high yields to a variety of customers, at the same time Goldman was selling CDOs for its own account in the market in various ways, including short sales and through derivatives. This was a wager (which turned out to be correct) that the subprime market was headed for trouble.

The firm's huge selling programs, which drove down the prices of their customers' investments, netted Goldman a whopping $4 billion of profits. Those gains far more than offset the $1.5-$2.0 billion of mortgage-related losses incurred elsewhere in the firm, and they enabled Goldman to earn a record-breaking net profit for 2007 of $11.6 billion, a 22% increase from a year earlier. And that huge profit will result in a total paycheck for the CEO, Lloyd Blankfein, expected to reach $70 million – a staggering sum even in these days of excessive compensation.

Goldman was one of the major underwriters of CDOs and *The Wall Street Journal* has asked a natural question: "The firm's success at wringing profits out of the subprime fiasco (by all its selling)…raises questions about how the firm balances its responsibilities to its shareholders and to its clients?" The stark answer is that it doesn't provide any balance toward its clients, nor do most investment banks much of the time. From my long experience, these firms just develop offerings of various kinds of securities which look attractive on the surface and therefore are easy to sell – at big underwriting profits. But if the underlying fundamentals of the investments are weak, that's the buyers' tough luck. (Not all are weak, of course.)

Charles Schwab, a pretty responsible brokerage firm and not an investment banker, had a great advertisement on this subject a few years ago, during the tech stock boom. It showed a sales manager addressing a group of securities salesmen. As I recall his words, they were, "Hey, kids, here's today's magic stock. We've got big incentives on this one, so get on the phones… Let's put some lipstick on this pig."

So the problem is simple, and it has persisted for over a hundred years: lots of seemingly attractive investments, like the CDOs of recent vintage which had very high yields in a low-yield environment, get sold to investors for whom they are totally unsuitable.

And the solution is simple, too, for those smart enough to embrace it. Back in the early 1920s, three gentlemen named Scudder, Stevens and Clark established a new type of investment management organization: an investment counsel firm. Their idea was to work wholly in the interests of their clients – understanding the clients' investment needs and desires and buying for them only high-quality securities that conformed to those needs and desires.

Also, they came up with another innovation: they would not get paid by the traditional way of charging commissions on all the clients' purchases and sales (which tended to encourage expensive, counter-productive portfolio churning). Instead, they would charge a moderate percentage fee on the market value of their accounts. So if the clients' portfolios did well and rose in value, their fees would rise; and if the portfolios did poorly and declined, the fees would also drop.

The net result of these innovations was to align the interests of the investment manager and the client. Given all the abuses of investment bankers and brokers selling unsuitable, risky securities to investors back in the 1920s, and the unhappy experiences stemming from them, the idea of investment counsel caught on quickly. Sensible investors loved it, and many other investment counsel firms were soon established, including: Loomis Sayles & Co.; T. Rowe Price & Co.; Stein, Roe & Farnham; Dodge & Cox; David L. Babson & Co., etc.

Some of these firms have since merged into larger investment organizations, but all the many investment counsel firms of today adhere closely to the code of ethics of their professional association, the Investment Adviser Association. They do act always in the best interests of their clients, and I'm quite sure that there was no ready market for CDOs in recent years among these firms.

So in the turbulent financial markets of today, clients of investment counsel firms can be confident that the securities bought for their portfolios by their managers will be suitable for them. Chances are that not all of those securities will turn out to be profitable, because circumstances change unexpectedly and the future is not perfectly predictable – but certainly clients won't get stuck with any low-grade pigs that had been gussied up with lipstick.

Not all unsuitable investments come from greedy investment bankers and brokers. As John Bogle, founder of the Vanguard mutual fund group, has shown convincingly, over the years mutual fund management companies have become much more focused on building their assets under management to enhance their own profits than on offering the right kind of funds to small investors. So, often they sell what is appealing, not what's appropriate for most investors at the time.

A striking example of this came in the technology boom of the late 1990s. As that reached a fever pitch in 1999, with share prices soaring into the stratosphere, many new tech funds were formed, and sales efforts accelerated, to attract more gullible investors into the game. The net result was that nearly three-quarters of all the money flowing into tech funds in the entire multi-year boom came in during the last nine months of the frenzy, from July 1999 to the peak in March 2000, after tech stocks had reached dangerous, unsustainable highs.

My long-time mentor, David Babson, was an avid believer in investment counsel, and restraint in mutual fund sales. When some younger person in our firm would refer to it as a "business," Dave would quickly say, "We are not a business. We are a profession. We are always working solely to help our clients, to manage their investments well. It is not our goal to make a lot of money for ourselves and get rich. If we do a good job for our clients, they'll pay us remunerative fees, and we'll make a comfortable living. But our greatest reward should be that our clients have done well."

This sounds a lot like a sermon, but so be it. It's a worthwhile one; and certainly a much stronger dose of ethical behavior would be very helpful in the investment community right now after so many investors have lost their shirts due to self-interested behavior by those purporting to help them.

Meanwhile, caveat emptor (buyer beware) should be an important watchword for investors. And by all means, have a manager who is looking out for you.

Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2210
Boston, MA 02110
617-956-6710

www.marbleharboric.com