



Is Investment Management a Profession?

Early in September, Eliot Spitzer, New York's attorney general, filed a complaint on behalf of the state against certain hedge funds and their managing principal, alleging that the hedge funds engaged in various fraudulent schemes with three mutual fund companies and a provider of trust administrative services to retirement plans. The hedge funds, working with the other organizations, entered mutual fund trades after the market close based on post-close news, described by Spitzer as "betting today on yesterday's horse races." The hedge funds also engaged in market timing in contravention of policies disclosed in the mutual fund prospectuses.

It is helpful to put Wall Street morality plays in the context of an opera buffa, with villains, heroes and the innocents.

You may not have heard about Spitzer's complaint. If you have, it was probably through reporting that lumps the incident together with Enron, Worldcom and the compensation of the New York Stock Exchange chairman to further the image of the investment industry as a bunch of crooks. The facts and issues alleged in the complaint are complex, but we believe it is important for investors to have a more clear understanding of the situation.

The principals of Sigma have been in the investment business a long time. Our reading of the activities described in the Spitzer complaint led us to recognize character types and activities that, despite recent twists, have always been present in our industry. Our views are: (1) while corruption exists on Wall Street, everyone on Wall Street is not corrupt, regardless of media stereotypes; (2) if people believe that the investment business is a con game, they will not make the appropriate investments they need to provide for their retirement or other life goals; (3) when people are willing to engage in dishonest practices, they will do so regardless of the particular investment vehicle involved – there is nothing inherently evil or subject to fraud in mutual funds; and (4) investors should determine if their investment adviser is primarily driven by investment matters, thinking as a professional, or marketing matters, trying to appeal to new prospects.

While in no way minimizing the bad behavior alleged in the complaint, we find it helpful to place Wall Street morality plays in the context of a comic opera buffa, with four primary stock characters (pun intended): (1) the Snidely Whiplash type of villain, seeking to do evil and to encourage others to do evil; (2) the Tempted, with an angel on one shoulder and a devil on the other engaged in heated debate, the devil usually winning; (3) the shallow Unreflective Strivers, determined at all costs to make their sales quota or profit objective; and (4) the Thoughtful Professionals who realize they are fiduciaries for their clients. These characters are not unique to the

industry. Unfortunately, the Thoughtful Professional character does not make an appearance in Spitzer's complaint.

It is clear that the hedge fund operator is the evil Snidely Whiplash character, masterminding schemes to profit at the expense of mutual fund shareholders and convincing others to help him. He approached the fund companies and trust company and lured them into his wicked plots. The trust company wrote up its deal with the hedge funds, agreeing to help them disguise late trades and market timing from the mutual funds in return for ten times their normal fee. The trust company is clearly a Tempted character – they did not have the original idea, but they were all too willing to join in. Charging ten times the normal fee suggests they knew they were doing something shady. The exhibits seem to indicate that they kept quiet about the whole affair until they were caught.

The hedge funds are the Snidely Whiplash villain, while the trust company was one of the Tempted.

The hedge fund approaches to the mutual fund families were more subtle, playing on their desire for establishing relationships that would produce revenues for their collateral businesses.

As a *quid pro quo* for the ability to place late trades and market time, the hedge funds invested other assets on a more permanent basis in related mutual funds, invested seed money in new investment products sponsored by the mutual fund companies, borrowed money from banks affiliated with the mutual fund companies, and purchased derivative products created by mutual fund affiliates.

In many cases, representatives of the fund companies seemed to view this as just another business deal. They bragged to each other in memos and emails about using firm resources to enhance the new relationship with the hedge funds. It did not seem to occur to these people that there were any ethical or legal issues involved. These are the Unreflective Strivers in our story. People who know they are breaching fiduciary duties or violating the law do not typically boast about it in widely broadcast memos touting their achievements. Marketing and sales functions tend to be run on the basis of quantitative sales and profit objectives. It is almost impossible to overstate the pressure felt by participants to meet these objectives or quotas by the deadlines. This system is not always conducive to reflecting about potential ethical or fiduciary issues. The sales objectives are numerical, specific and soon, while ethical issues tend to be fuzzy, qualitative and distant.

For us, the most depressing aspect of the complaint is its portrait of large, marketing-driven organizations. The political philosopher Hannah Arendt used the phrase “banality of evil” in describing European totalitarianism in the twentieth century. It doesn't roll as trippingly off the tongue, but a certain banality of breaching fiduciary duty jumps out at us in the Spitzer complaint. There is an Orwellian aspect to the jargon and buzzwords these characters used in their internal communications. Violating stated policies against market timing is described as “capacity,” managers publicly give “accolades” to those involved in using the mutual fund firm's “resources” to further the timing or late trading schemes, and (as Dave Barry might

say, we are not making this up) a memorandum detailing prohibited actions is titled “Best Practices.”

The hedge fund activities ultimately came to the attention of people who realized that the other fund shareholders were being hurt. Some wrote memos to their bosses urging a halt to the schemes and were told to mind their own business and “waive” the requirements. Some reacted by demanding a sweeter deal from the hedge funds. In other words, certain of the Unreflective Strivers changed into the Tempted – it may not have occurred to them before that they were doing anything improper, but at this point, the train was rolling down the track too fast to stop. In none of the fact situations described in the Spitzer complaint, however, did anyone cease what they were doing simply because it was wrong.

Much bad behavior in the investment world stems from confusion over whether investment management is a business or a profession.

At play here is a fundamental question – is investment management a profession? Much of the bad behavior on Wall Street stems from confusion over this issue. Many financial service firms are run primarily from a marketing standpoint, where “the customer is always right.” In contrast, in professions, the customer is not always right. The surgeon is unlikely to listen to the patient’s advice on how to proceed in an upcoming surgery, nor the attorney to listen to a defendant’s advice on how to try a case. At Sigma, we view investment management as a profession. Substantial evidence and our own experience demonstrate that, in investing, the customer is almost invariably wrong at key market turning points. Almost everyone was optimistic at the market top a few years ago, while almost everyone was pessimistic at the historic low below Dow 800 in 1982. We view our job to be advisers, not enablers, and a key part of the value we add in a client relationship is occasionally talking a client out of doing something foolish. If this means turning down business, so be it – the doctor does not perform an unneeded appendectomy, and a reputable lawyer will not pursue a frivolous lawsuit. True investment professionals take fiduciary duty seriously.

It is clear that investors should only place money with the fourth character type (the Thoughtful Professional) and avoid the first three. It makes little sense to agonize over whether someone is a Snidely Whiplash, a Tempted or an Unreflective Striver – the potential harm is the same. The bad news is that there is not a bright line test to distinguish the Thoughtful Professional from the other three. If you had called any of the organizations mentioned in the Spitzer complaint and asked if they were engaged in fraudulent trading practices, they would have said no. A sociopath is likely to be more convincing than an honest person trying to do the right thing.

The good news is that the three bad characters do leave tracks, if you know where to look. The question to ask yourself is whether your investment adviser is run by investment people or marketing people. Good investment managers have a demonstrated competence, and they stick to that approach whatever the market cycle. Their marketing describes the reality of what they are, rather than leading them to

pretend they are something they are not. In contrast, marketing-driven firms generate product or tailor their advice to appeal to prospective investors. Did your firm launch a technology fund in the bubble years or your value-oriented manager start buying growth stocks as the mania progressed? Did your growth manager suddenly come out with a value product once the bubble burst? Is the fund operating expense ratio not commensurate with the fund's size?

Are your investments being managed by investment people or marketing people?

These signs, by themselves, do not mean that the people involved are villains, but they should be cause for concern and further investigation. The best professionals will make mistakes and have periods where their approach is not in style, but they will not distort their activities or expand beyond their area of competence to appeal to the latest herd of lemmings running towards the cliff. Their sales and marketing efforts will be the servants of their investment approach, rather than their investment approach being the servant of what will sell today.

In practice, however, the Thoughtful Professional is a commodity undervalued by many. When a prospect announces to us that a competitor has promised them 30 percent a year and asks if we can beat that (something that happens with depressing regularity), they are not placing a high value on fiduciary-type thinking. Marketing driven firms will always manufacture products to appeal to the numerous greedy prospects – usually with disastrous results for the “investors.”

It would be a shame if the Snidely Whiplash stereotype led investors to give up investing. If your reaction to fraud or bad behavior on Wall Street is to avoid investing, you will hurt your prospects for a comfortable retirement or meeting your financial goals. If your reaction is to avoid mutual funds, then what? Will you invest in hedge funds, with even less public disclosure? In brokerage accounts, where your helper is compensated by the number of transactions? In separate manager accounts, where undisclosed payments to the manager from brokers for “order flow” come out of your pocket? Corruption is corruption, regardless of the investment vehicle. Brilliant people will always try to game any system to their benefit. We will rarely be able to predict accurately how and where they will act – our only defense is to try to deal only with honest organizations driven by fiduciary-conscious investment people, not marketing. Potential conflicts of interest necessarily abound – the trick is to work with someone that realizes their presence and resists them.

Of course, we cast ourselves as Thoughtful Professionals. Our website, www.sigmainvestment.com, has archived our past newsletters. You can read what we think and make your own judgment about which role we play.