The Hidden Cost Of Speculation

Financial advisors should band together to fight against the marketing machines pitching derivative products to clients.

IN SPITE OF THE FINANCIAL CRISIS, the side bet business on Wall Street is still booming. The term "side bets" is a quaint euphemism for the vast unregulated derivatives market. How big is it?

Paul Wilmott, a Ph.D. Oxford-trained applied mathematics specialist and one of the world's leading derivatives experts, estimates the worldwide derivatives market at $1.2 quadrillion. That's 1,000 trillion! To put that number in perspective (if that's possible), $1.2 quadrillion is roughly 20 times the size of the entire world's annual gross domestic product.

It represents an almost inconceivably mammoth derivatives bubble, supported by a continuing, seemingly insatiable demand for speculative side bet products. You can bet Wall Street factories are not about to discontinue pumping out new versions to meet that demand.

Beyond a vague notion, few investors understand the derivatives market, much less the size, scope and precarious implications of the bets they make. Ominously, the reform bill recently passed by Congress does little to address either the abuses or the potential ramifications of the side bet bubble, which only grows larger by the day. Can the financial markets afford these side bets? Can the markets even survive this elevated level of speculation?

Derivatives were originally marketed as products designed to help protect investors against downside losses. These and other hedging strategies were ostensibly created to provide investors with a safety net, encouraging them to invest and helping boost our nation's economy. But derivatives quickly evolved into investments in their own right. At some point, the lab technicians on Wall Street over-innovated, crossing the line between prudent investment and wanton speculation, leaving us with a seemingly endless supply of derivative and hybrid products. In effect, they diverted Wall Street from its traditional capital market role to that of a casino.

These side bets are a distraction from productive investing and a tax on our economy. The capital markets, where companies go to find long-term funding, are languishing, and side bets are one of the principal reasons. If those who inhabit today's side bet world had to put their money to work in the real capital markets, the increased investment would benefit both investors and the companies they fund.

Over the past two hundred years, stocks, bonds and other basic investment products have seen little innovation, and have remained essentially the same entities. The early versions of packaged products and baskets-mutual funds, index funds and, more recently, ETFs-were similarly uncomplicated and functioned well. They were an easy, transparent way for investors to buy baskets of stocks providing portfolio diversity and making investing a bit less risky.

Somewhere along the line, however, hybridized and heavily optioned versions of these products, like leveraged ETFs (LETFs) and inverse ETFs (IETFs) materialized. They were cleverly marketed to sound like those simpler products with established reputations for safety while simultaneously promoting the promise of enhanced performance through leveraging.

The gambit was a marketing miracle. Leveraged ETFs and other option-drenched baskets and buckets sold like drugstore candy on Valentine's Day. The candy looked delicious and was beautifully packaged, so investors didn't look too closely at the contents. They should have. Top heavy with veiled fees and reliant on options and complicated derivative strategies for performance, many of these packaged products required a 3% to 4% annual return just for investors to break even.

Today, because I can find someone to take the other end of the side bet (the option contracts), I can access double the upside and downside of the S&P 500 compounding daily. If the S&P isn't to my liking, I can bet on any number of derivative indexes or industries. How long will it be before Wall Street announces that exchange-traded credit default swaps represent the next "must-have" product for retail investors? How much speculation is too much? How much danger is too much? These derivative bets contribute nothing to the much-needed and missing productivity of our country.

The Lure Of Leverage

Like any other products, investments are subject to the immutable law of supply and demand-even leveraged ETFs, optioned fund baskets and their fee-laden brethren. The appeal of these hybrids is contingent upon a credulous audience buying into the cloudy premise of enhanced performance and/or diversification. That's why they are marketed as "leveraged" and not "optioned" products. They would likely be much less popular if marketed to inVestors as what they are, day trading options, and less popular still when offered to retirees.

Their continued success, indeed their very existence, relies on investor demand fed by the improbable dream of making a killing. Those whose portfolios were eviscerated in the 2008 bloodbath seem particularly susceptible to the promise of recouping their losses through double- or triple-leveraged voodoo. If investors understood the cryptic strategies and bloated fees underpinning these products, their sales would soon diminish.

But who will educate investors to the dangers of these speculative packaged products? Certainly not the Wall Street product manufacturers, their marketing allies in the major wirehouses or the advertising-dependent mass media. The regulatory bodies could provide some clarification and protection for investors against the precarious practices of speculative products, but they are evidently too busy wrestling with the subtleties of those "onerous" 12b-1 fees.

Advisor Duty

Leveraged and inverse ETFs represent just a tiny fraction of the larger derivatives market and its host of packaged, optioned and leveraged products. The responsibility for protecting investors against the dangers of these speculative time bombs lies mainly with advisors, since the building blocks of the speculation cult are individuals. Changing the culture of speculation among registered representatives and their clients removes the fuel for further economic combustion by these products.

This entails overcoming the marketing sophistication and advertising budgets of Wall Street product manufacturers. While that may seem daunting, I believe it is a battle worth fighting. I also believe that en masse, advisors have the clout to challenge the SEC and get results.

The roughly 100,000 top brokers and financial advisors that represent the core of financial management in the U.S. have enormous power as a group. Advisors are the core income engines for the entire industry. They have the bully pulpit with their clients, an influential position that can wield enormous power. Advisors have the opportunity to apply their values to help guide their clients away from speculation and back to fundamental investing.

Back to Basics

That means satisfactory portfolio performance with sufficient downside protection can be achieved for most investors with a dIversified asset allocation, an appropriate mix of stocks, bonds, cash equivalents and non-leveraged ETFs.

This strategy may lack the excitement of triple-leveraged fund baskets or the thrill of being on the right side of a derivative trade, but it can give clients the safety net they seek, contribute to the productive use of investment capital and hopefully save investors from the inherent perils of speculative derivatives.

I do not suggest that this will be an easily won victory. At the very heart of the challenge is convincing individual investors to ignore the forcefully persuasive marketing messages they are subjected to daily. Getting some clients to resist the urge to plunge into the Wall' Street casino and take a flyer on a triple-leveraged roulette bet may be difficult, but as advisors, we have an obligation to do our best to change this mind-set.

Some advisors may contend that entrusting investment management to the array of derivative products frees them up to spend more time building their practice. But the perception of our advice as relevant is imperiled when we rely on side-bet products with black box strategies, leveraged risk and veiled fees. And even if we were free to spend more time on our practice, our client relationships would inevitably be strained if the loyalty shifted from advisor to product.

Finally, as an industry, we must challenge regulatory bodies to fo.cus on consequential issues. As a nation and an industry, we need to find a macroeconomic balance between the value of speculation and the value of investment. liIB

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