Packaged Products Threaten Client Relationships

By Edward K. Riley

The author discusses how marketing of investment products can erode the trust clients place in their financial advisors.

Over the years, the major players on Wall Street have demonstrated amazing resiliency. Every time a market plunge threatens to send investors to the sidelines in mass retreat, Wall Street's lab technicians emerge with an alluring new product. It attracts enough investor dollars to keep the financial factories humming, churning out the next group of packaged products and paying for Wall Street executive bonuses.

Sometimes, the products work as advertised, often they do not. When they do not work, they are dropped like a politician's campaign promises. When they do work, the products become modeling clay for analogous products—each one carving out a slightly more focused market niche with increasing complexity and fees to match.

When the "tech wreck" that happened in 2000 exposed the danger of sector saturation, Wall Street responded to cries for products promising diversity and downside protection. Its solution was to create new indexed funds, including exchange-traded funds (ETFs). These funds represented a sensible addition to advisors' asset allocation strategies. Many retirement portfolios benefited by investing in these funds, given their need for capital preservation and consistent income.

In 2000, investors learned the hard way that portfolio diversity was not defined as 50-percent Microsoft stock and 50-percent Dell stock. No doubt, most who were hit hard were doing their own stock picking. Those with managed retirement accounts were probably asking how their advisors could allow them to become so concentrated in a single sector. To be sure, there were clients who failed to follow the advice of their advisors. As an advisor, being right in retrospect rarely assuages angry investors who forgot you warned them they were playing with fire.

While the tech-wreck was an example of one investment sector bringing down other sectors, the Wall Street Crash in 2008 was a case of virtually every sector imploding simultaneously. If better diversity would have helped investors in 2000, it did little to rescue investors in 2008. Investors who owned baskets of funds and those who owned individual stocks both had equally large losses. The crash that happened in 2008 was something altogether different because virtually no one escaped unscathed. Retirees took a particularly hard battering due to their dependence on investment income.

Advisors and managers faced hard questions from investors. Why had they not provided better downside protection for their clients? Since virtually all investors took it on the chin, how valuable was the advice clients were getting from their advisors in the first place? Given the ongoing volatility, why not get out of the market and into cash until things stabilized? It was a time when a lot of advisors dreaded answering their phones.

Meanwhile, Wall Street had its own problems. Firms were shrinking in size and staff as a result of the crash. The Madoff investigation made things incrementally worse, as did a series of other Ponzi scheme investigations. Investors were becoming increasingly wary—dare I say distrustful?

Edward K. Riley is chairman and CEO of E.K. Riley Investments, LLC, a full-service independent brokerage and investment advisory firm. Headquartered in Seattle, Mr. Riley has offices in five western states. He can be reached at 206-832-1524 or *edward.riley@ekriley.com.*

The indexed funds and ETFs that had become a portfolio staple prior to 2008 had lost much of their appeal because they provided investors with little shelter during the crash. In addition, competition had rendered what was never a terribly profitable product even less so. Something had to be done. Wall Street responded to thinning returns by releasing a series of "packaged products" that were increasingly creative investments: inverse exchange traded funds (IETF) leveraged exchange traded funds (LETF) and leveraged inverse exchange traded funds (LIETF). Packaged products combine a basket of traditional investment products with investment services. The resulting "package" attempts to solve one or more investment challenges in exchange for a fee.

The selling point for the hybrid products was that they were just like ETFs, only more rewarding. The marketing message was: Smart money will "buy the dip," meaning buying during a market downturn, but truly sophisticated buyers will "buy the dip with leverage." Sample packaged products, and the challenges that may be solved, are listed below.

LETFs and other "baskets" and "buckets" of hedged and option-laden funds sold like George Forman grills. Wall Street may have promoted the items by saying they were diverse and transparent, but it seemed just the opposite. And too many investors failed to ask questions to educate themselves on the products.

Whether profit was Wall Street's solitary motive can be argued. In this author's opinion, there is no question that the manufacturers of these funds profit while providing investment vehicles of highly questionable value. Less costly to create, the funds are layered with enigmatic fees, provide profits for a host of behind-the-scenes players, minimize the need for advisors and portfolio managers, and now threaten to erode the relationships between advisors and their clients. Worst of all, like LETFs and their unfathomable counterparts created earlier in the decade, some of these products may be subject to implosion.

Investment or Speculation?

The rationale for the packaged products being offered to investors is based, principally, on the timeworn Efficient Market Hypothesis. Ironically, the role of providing needed portfolio diversity was reasonably well served by the original indexed funds. They were effective, but the "plain vanilla" index funds lacked marketing pizzazz, and were not particularly profitable for their issuers. LETFs and their kin were more profitable for their producers, but nudged investors another step back from the basics of investing.

Markets exist to accommodate transfers of capital so that investors with money to invest can provide it to companies or municipalities that need money to build and grow. This is fundamental investing—the seed that makes production, employment, profits, retirement and more investment possible.

Specific markets exist to meet specific needs. For example, the commodity markets were created to provide price discovery and cost consistency when trading agricultural items such as corn, wheat, soy, swine, poultry, etc. The market allows farmers to estimate what a crop will be worth in the future—at the end of its growing season when the item is actually ready to be sold at market. It helps farmers make decisions about what and how much to plant, thereby selling into a higher anticipated price. When the futures market was established, its relatively low margins reflected a belief that it should not support speculation. Indeed, preventative measures were put in place to discourage speculation. Unfortunately, some major loopholes were found in those regulations. Today, speculation in futures is rampant. Retirement portfolios can go long or short on gold, silver, pork bellies, or virtually any other commodity. Worse, double ("2x") or triple ("3x") leverage has become a common practice.

Much has been written by some of the smartest minds in our industry on the topic of investing versus speculation. Indeed, it is difficult to add anything of consequence to what has already been written. It continues to amaze me, however, that despite the many painful lessons of the past, from tulips to dotcoms to real estate to derivatives, the investing public continues to display a naively insatiable appetite for speculating.

Speculation was a topic about which John Maynard Keynes had some strong opinions. Keynes was an economist who advocated for governments regulating economies in the 1930s and 1940s—a revolutionary idea during that time. Today, however, many believe Keynes was the most influential economist of the 20th century. Keynes theorized that investing involved forecasting yield over the life of an asset, and that speculation involved forecasting market psychology.[1] Sad to say, more people in the financial industry have become rich by understanding investor psychology than understanding the markets.

In his 1938 classic, THE THEORY OF INVESTMENT VALUE,[2] economist John Burr Williams clarified the differences between speculation and investment when he wrote: "[s]eparate and distinct things not to be confused, as every thoughtful investor knows, are real worth and price." More than 70 years later, his argument loses none of its relevance or acumen.

Again, quoting Williams: "No buyer considers all securities equally attractive at their present market prices whatever these prices happen to be; on the contrary, he seeks 'the best at the price.' He picks and chooses among all the stocks and bonds in the market until he finds the cheapest issues. Even then he may not buy at all, for fear that everything is too high and nothing will give him his money's worth. If he does buy, and buy as an investor, he holds for income; if as a speculator, for profit. But speculators as a class can profit only by trading with investors, to whom they can sell only for income; therefore in the end all prices depend on someone's estimate of future income."

Williams also noted that "the longer a buyer holds a stock or bond, the more important are the dividends or coupons while he owns it and the less important is the price when he sells it ... For this reason, we shall define an investor as a buyer interested in dividends, or coupons and principal, and a speculator as a buyer interested in resale price."

Another discussion relating to speculation can be found in the book Security Analysis: Theory of Common Stock Investment.[3] The book was written by David Dodd while he was a professor at Columbia Business School. Dodd referred to the trend-of-earnings phenomenon leading up to the 1929 market crash as follows: "Considering the 1927–1929 period we observe that since the trend-of-earnings theory was at bottom only a pretext to excuse rank speculation under the guise of "investment," the profit-mad public was quite willing to accept the flimsiest evidence of the existence of a favorable trend."

For many, speculation has become not only tolerable but necessary, presumably to keep the markets stabilized. Without question, speculation has become incrementally easier. Many of the packaged products that have evolved from simpler, more useful versions tout diversification and an ability to allow investors to take advantage of specific price machinations. Packaged products are marketed as investments that help protect against downside risk but are speculative in nature. In order to fulfill their stated objectives, the creators have to utilize the options markets. Of course, the manufacturers do not call these products "optioned ETFs" or "optioned index funds." They use investor-friendly terminology like "leveraged funds" so retirees think they are getting diversity. In this author's opinion, what investors are actually getting is hyper-speculation built upon illusory marketing.

Products and Middlemen

At its core, the financial services industry exists on the principal that stocks and bonds deliver some value to investors and the country at large. When that is forgotten abuses can, and do, occur. Each manufacturer of a financial product claims to have a better mousetrap but each iteration moves further away from the core of investing, which is making a loan or buying a piece of a company. As the mousetraps gain complexity, they become more difficult to understand, not only for investors but also for advisors, analysts, and rating agencies. In some cases, even the manufacturers do not fully understand how their creations work, and more importantly, how they will behave in the market. Along the way, a series of middlemen join the enterprise: The original manufacturer, one or more fund companies, brokers, consultants, an entity making investment decisions, someone engaged to secure options, or whatever speculative component is necessary, and so on. It may be all but impossible for an advisor or investor to fathom just how many players exist.

There have always been middlemen involved with any investment product targeting retirement portfolios, depending on whether the portfolio is serviced through a brokerage or advisory account. The increasingly convoluted products emerging today, however, have so many layers of middlemen that the value of their presence (in relation to the value received by investors) must be questioned. As product complexity grows, advisors are further removed from a thorough understanding of what they are selling to their clients. In turn, the clients are drawn closer to speculation as they move further away from investing fundamentals.

Manufacturers of financial products may have created a recurring cycle of profitability. They introduce a relatively simple product in response to recent market movement. If the markets are doing well, enhanced versions of the product are subsequently launched. Each enhancement is more obscure and, of course, more profitable. Each distances itself a bit further from basic investment principles and is a bit more speculative. The longer the boom cycle lasts, the more convoluted and undistinguishable the latest version is from its ancestor. The final emanation, typically released just ahead of a major market correction, is a stratified, hybridized piece of financial architecture with an indecipherable fee structure.

Where ETFs Went Wrong

An ETF is perhaps a quintessential example of a useful financial product ultimately contaminated by tinkering. The original idea of the ETF was to provide a simple, relatively transparent product vehicle to help reduce portfolio risk. The product worked well for retirement accounts as it helped address the need to protect vital investment capital. Retirees and advisors came to regard ETFs as a reliable asset allocation tool. Sadly, the trust that retirees placed in the original, uncomplicated ETFs became one of the underpinnings for Wall Street's ability to lure them into increasingly exotic variations.

That is not to say that even plain-vanilla ETFs were without risk, of course. As sector-oriented baskets of funds, investors in ETFs risked sudden downturns in a given area and the temptation to chase hot sectors existed as well. Liquidity made trading easy and that presented another opportunity for increased risk. While expenses were generally low, brokerage commissions could deflate returns, especially for smaller portfolios and investors trading frequently.

Whatever the disadvantages of the plain-vanilla ETFs, those burdens were virtually negligible when compared with the specialized ETFs and LETFs that followed. While marketed as providing additional diversity, the hybridized versions did anything but. For instance, the hybridized funds tracked progressively more focused stock or fund baskets; they became inherently more volatile and subject to sharp sector swings. Like their forerunners, they were typically fully vested and the constant re-sizing boosted transaction costs. The "leverage" in LETFs was created by using options, swaps, and other derivatives in an effort to reduce exposure. Investors who made LETFs, inverse ETFs, and other stratified investment funds part of their retirement portfolio took on volatility and risk they did not anticipate—in addition to being charged for transaction costs, management fees, interest, and expenses.

If advisors had recommended that their retiree-clients buy options every day as a hedge against market movements, I doubt there would have been many takers. Yet, that is essentially what retirees who invested in LETFs were doing, often unwittingly. If packaged products had been presented to investors with transparency, their history would likely have been a short one. It seemed Wall Street took the financial equivalent of a Pontiac Aztec and somehow made it look like a reincarnated GTO.

The purported advantage of LETFs was the ability to use leverage (options) to increase returns of double ("2x") or triple ("3x") leverage or more. Writing on leveraged ETFs in the WALL STREET JOURNAL, Jonathan Burton offers a simple but telling example of how many investors fail to "understand the dramatic impact that daily compounding can have on returns over a long period of time. According to Burton, "[t]o understand the math, consider a hypothetical index that rises 10% one day and falls 10% the next. If you earned exactly the index return in an unleveraged fund, a $100 investment would grow to $110 and then drop to $99, for a cumulative $1 loss. Now take a 2x leveraged fund: A 20 percent advance would bring you $120; after a 20 percent drop, you would be left with $96. Over two days you have lost $4 instead of $1."[4]

In their paper, *The Case Against Leveraged ETFs*,[5] Yates and Kok note that, "A widely held misconception about these funds is that they will offer twice the return of the underlying index, which means that if the S&P 500 returns about 10 percent a year, then (these funds) should return 20 percent. But that's not true, because these funds only double the daily return, and there's a big difference between doubling the daily return and doubling the annual return."

The authors go on to explain that the fund assets increase or decrease in value in response to daily market movements. This throws off the leverage ratio because total assets are no longer equal to total debt. In order to maintain the target leverage ratio, a fund has to buy or sell millions of dollars worth of shares every day. Not only does this increase expenses, transaction costs, and short-term capital gains taxes, but it is a bad investment strategy. Whenever the fund must sell shares, it locks in losses and reduces its asset base, making it much harder to recover gains in the next market upturn. This is called the Constant Leverage Trap and is a well-known problem in financial modeling. Investment portfolios that try to maintain constant levels of leverage perform very poorly in bad market conditions because they sell off large percentages of their assets, similar to a margin maintenance call.

One of the more pervasive risks of using LETFs, IETFs and LIETFs in retirement accounts was that they were designed to achieve their performance objectives on a daily basis. That fact was not always made clear to retirees investing for the long term. Because they reset daily, their performance can differ greatly from the underlying index over time. In volatile markets, such as we have experienced in recent times, this impact can be devastating to retirement account investment principal.

Sadly, many investors were lured by the double and triple profit potentials touted by LETF marketers, but leverage is a two-way street. Even when the market moves up or down, as anticipated over an extended period, LETFs or inverse ETFs frequently lose money for their investors. Several dozen bull and bear ETFs from ProShare Advisors, LLC, are the only such funds with at least a three-year record and they all show negative returns over the period, whether the fund was long or short, according to Morningstar.[6]

A senior executive of one of the major product manufacturers penned an admittedly biased article in which he attempted to defend the use of LETFs, saying the product was " ... meant to be used as part of an active investment strategy, which sophisticated investors—from day traders to institutions—routinely employ. Just because [LETFs] serve a different purpose from traditional ETFs and mutual funds doesn't mean they're flawed: it means they occupy a different market niche."[7]

The executive continues: "That isn't to say that leveraged ETFs aren't suitable for investors who plan to hold them for more than a single day ... an advisor or investor might indeed decide to hold an ETF for periods longer than a single day, perhaps even for weeks or months, as part of a sophisticated, tactical investment strategy. If held for such periods, however, it is imperative that these positions be monitored very regularly, like daily. By and large, this isn't the mom-and-pop investment community. This is institutions, endowments, pensions, corporations, and other sophisticated investors that seek to take advantage of market volatility with actively managed portfolio strategies."[8]

This lofty rationale is not exactly how LETFs were presented to advisors who, in turn, unwittingly recommended the volatile hybrid securities to their retiree-clients. It brings to mind a customer walking into a car dealership to shop for a family sedan. The salesman sees the fellow glance at the racy sports car on display and says: "Yes, that's one of the fastest cars on the road and people who drive it are often mistaken for celebrities, but it's not a car for the faint of heart or frankly, for most family men like yourself. It's for the man who demands the ultimate driving experience and knows how to handle raw speed."

What the salesman is really saying is: "Not for you unless you're man enough to handle it." It is a sophisticated psychology that no doubt often works. Similarly, Wall Street producers of LETFs claim innocence because the product was never intended for long-term investment. What of the marketing messages touting double or triple investment returns to investors who saw 40 or 50 percent of their retirement portfolios disappear? The severe restrictions and/or eventual banning of LETFs (and some related products) by Edward Jones, Ameriprise, LPL Financial, UBS AG, and other financial giants is testament to the ill-conceived promotion of these products for long-term investment purposes.

> As product complexity grows, advisors are further removed from a thorough understanding of what they are selling to their clients.

Unsuitable from Day One

Not all of the "sophisticated" offerings with onerous fees are the result of Wall Street embellishing a basic product. Sometimes, the manufacturers create products that are overburdened with fees and complexities right from their genesis. A few examples are discussed below.

Long/Short Funds

The long/short fund gained popularity in the second half of the decade as investors scampered for refuge from the volatile markets. From 2003–2008, these funds enjoyed their greatest growth and the average long/short fund earned an annual return of 2.38 percent. During this same period, a balanced index fund (following a more traditional method of hedging one's stock risk by allocating 60 percent to the total stock market and 40 percent to the total bond market) earned an annual return of 3.45 percent in that same period, according to Nathan Hale, writing in Moneywatch.[9]

In addition to lackluster performance, the average long/short fund saddled investors with a 2.16 percent expense ratio, more than 50 percent higher than the average equity fund, according to Moneywatch. Hale points out in his article that "[t]he 2.38 percent return does not include the records of the dozens of long/short funds that disappeared during that period. Including them would knock about one percent off of that annual return, bringing it to 1.4 percent—or just 40 percent of the balanced index fund's return. The investors in those funds fared even worse, earning an annual return of just 0.13 percent, according to Morningstar." He concludes that "[i]f you're comfortable forgoing a bit of sophistication in your portfolio, the record thus far is clear that you're likely to be far better off passing over these complicated funds in favor of more traditional, simpler, and less expensive alternatives."

Auction Rate Securities

The list of people and entities that had losses because of auction rate securities (ARS) is a long one, including investors, advisors, revenue-starved municipalities, mutual funds, corporations, and even student loan organizations. These securities were marketed as inherently safe, fixed-income alternatives. However, a group of Oppenheimer clients whose ARS were frozen for over two years (and then received a settlement of five cents on the dollar[10]) would argue otherwise.

In February of 2008, the ARS market plummeted, a situation that was ignored by some of the nation's largest banks and wirehouses. The securities became virtually illiquid overnight and investors were left with no viable option. Some firms ultimately agreed to buy back their ARS from retail investors and small businesses, but only under pressure from state regulators. Many institutional investors were less fortunate and litigation involving billions of dollars in ARS paper continues today.

An important nuance of the *Oppenheimer* lawsuit settlement was that it cited inappropriate sales practices, not underwriting. Thus, when the ARS market collapsed, the salespeople were held liable, not the people who broke the market.

Principal Protected Notes

A principal protected note (PPN) was a highly complex product that consisted of an unsecured bond that was "protected" only by the resources of Lehman Brothers. PPNs were introduced to an unsuspecting public under a variety of monikers; among them were "100 Percent Principal Protected Absolute Return Barrier Notes" and "100 Percent Principal Protected Notes." Despite the reassuring name, however, PPNs did not protect investors' principals—investors were stuck with billions in losses and worthless paper when Lehman Brothers went bankrupt.

The New York Times reported that "The Securities Litigation and Consulting Group, a financial economics consulting firm, analyzed 14 issues of principal-protected notes and found that more than half carried a yield of less than two percent. Meanwhile, broker commissions on the products averaged 1.7 percent. More than half the time, the analysis concluded "Investors would be better off investing in Treasury securities. Add these securities to the growing pile of Wall Street inventions that benefit ... wait for it, wait for it ... Wall Street."[11]

One only has to go back to late 2007 to learn how PPNs were being promoted to investors as being risk-free products. Here are a couple of excerpts from *The Zero-Downside Profit Report*.[12]

> (1) Principal protected notes, also referred to as "Bull Notes" are transforming the way people invest their growth portfolios these days. By design, these securities are for investors who want to participate in the potential gains that stocks offer, but who also desire total protection from losses. They're built to do two things:
>
> 1. Completely eliminate an investor's downside risk; and
>
> 2. Earn returns that are tied to the performance of a group of stocks.
>
> (2) Principal-protected notes are essentially bonds with returns linked to a stock or sector index. And, like bonds, these "bull notes" have a term, or maturity date. But no matter how poorly the index it tracks performs, the financial institution backing these notes guarantees you will NOT receive less than your initial investment at maturity.[13]

In early 2009, however, Morningstar reported that, "Broadly speaking we dislike PPNs in light of the risks and high cost. Most investors with long time horizons should stick with regular mutual funds or ETFs, which are generally less expensive and will more often than not come out ahead over the term of the note.

When it comes right down to it, a lot of our skepticism comes from the complexity of PPNs. In many cases these notes are marketed aggressively in oversimplified terms, while their actual offering documents are incredibly confusing. As recent lessons in asset-backed commercial paper and collateralized debt obligations have taught us, it can be very dangerous to invest in products that can't be easily explained over a cup of coffee."[14]

In the Spring of 2010, an online article questioned whether the discredited PPNs were innately tainted or whether they had merely been inappropriately marketed.[15] "The losses suffered by investors on [PPNs] have absolutely nothing to do with the notes being "convoluted" or unsuitable for unsophisticated investors. I'll make it really clear: Investors suffered losses on these notes because Lehman Brothers went bankrupt. That's it. It's not because of confusing derivatives, complex structures, or anything of the sort—it's because the notes were obligations of Lehman Brothers. Is it possible that the UBS brokers selling the product failed to explain this, and to stress that Lehman Brothers' credit was not quite as good as that of the U.S. Government? Absolutely. In fact, it's likely, but that's a very different issue from the complexity of the product."

Sometimes, the manufacturers create products that are overburdened with fees and complexities right from their genesis.

Whether investors were the victims of the Lehman Brothers collapse, or unscrupulous sales practices by brokers, the end result was the same: This was another instance of Wall Street inventing a complex investment (promising safety and liquidity) that eventually leaves investors holding worthless paper.

The investing public seem to have forgiven Wall Street's abuses. Witness a 2010 Reuters release:[16] "This year, Bank of America, Barclays, Citigroup, HSBC and JP Morgan Chase all have filed offering statements with U.S. securities regulators to sell principal-protected notes that guarantee investors the return of either 95 percent or 100 percent of their initial outlay, even if the underlying investment does not pay off. Research firm Greenwich Associates predicts investor demand for principal-protected notes and other structured products will rebound in 2010, after evaporating in Lehman's wake."

The Reuters article continues: "Most banks that issue and sell principal-protected notes declined to comment. But privately, banks pointed out that the prospectuses state that the guaranty is ultimately dependent on the creditworthiness of the issuer." Would that disclaimer refer to the creditworthiness of firms like Lehman Brothers? Apparently, yes.

The Reuters article also discusses a possible reemergence of PPNs: "One reason Wall Street is banking on a rebound for principal-protected notes is that these securities generate significant underwriting and sales fees. Principal-protected notes also serve as a cheap source of funding because the notes pay a return only if the underlying investment performs as anticipated." It seem that no matter how poorly the product performs, Wall Street will be paid, and handsomely so.

In this author's opinion, one fellow who has it right is Craig McCann, director of the Securities Litigation Consulting Group, a research group that works with attorneys representing investors. Says McCann: "Principal protected is pure marketing gloss and I think it is deceptive. They have added this label to something that essentially is unsecured."[17]

The Beat Goes on

Many packaged and structured products have proven to be something altogether different than initially purported. Only the public's short-term memory can account for Wall Street's continued success in marketing the products. In some cases, the gambit is to take a practical investment product and turn it into a security masquerading as an enhancement. In others, Wall Street generates a derivative-infused concoction that a math scholar could not decipher.

Clients who fall prey to these products hold their advisors responsible: "How could this happen? Why didn't you protect me?" If an advisor does not fully understand the complexities of an investment, how can what went wrong be explained to an investor? When the investor is a retiree, the problem is compounded because there is no time for the client to recover losses. His or her investment capital has been eroded and even conservative income projections are no longer valid. Battered retirees are faced with the equally unpalatable alternatives of going back to work (if they are physically able and if work is available in a 10-percent unemployment environment) or significantly reducing their expenses and lifestyle.

The wounds inflicted on investors by some of these stratified products did little to cause Wall Street to change its marketing strategies. LETFs are now being positioned as a day trading product for sophisticated investors who understand, and are willing to accept, the downside and liquidity risks. That is a dramatic departure from how LETFs were marketed in response to the 2008 market collapse. While they are rarely utilized for retirement accounts anymore, the amount of damage they brought about remains unanswered. We do know that advisors who used them experienced a deterioration of many client relationships.

Most financial firms have since banned the use LETFs from a risk management perspective. When they were being promoted as capable of delivering 2x or 3x upside potential, they were a persuasive temptation. While some advisors shunned the products from day one, those that sold the product discovered a striking difference between marketing promotion and market performance.

> Many packaged and structured products have proven to be something altogether different than initially purported.

LETFs, PPNs and other optioned fund baskets have joined a long parade of financial products that have failed on an epic scale. Their hedging strategies failed to guard against downside losses. As volatility ramped up, the need to continuously buy incrementally more expensive options deteriorated the way the products performed. While investors may readily be able to discern distribution, marketing, and sales charges from a fund's prospectus, any clearing costs and transaction fees may not be apparent.

Let us assume I manage a fund of funds. In addition to my management fee, there are fees for the various funds, transactions fees, options fees, and perhaps a few other cost layers. While major fund managers get impressive discounts, the amounts paid in commissions (compounded with the bid/ask market spread) were potentially enormous and not disclosed on my prospectus. What is shown is that the fund buys a net price but that price has an embedded commission, one my investors pay. The expenses and fees add up and are substantial. Pity retired investors paying those kinds of fees while blithely hoping to protect their investment principal, maintain a needed income stream, and maybe stay a step ahead of inflation.

Basic investment products—stocks, bonds, cash equivalents—have limitations and do not meet everyone's needs. They also tend to be unglamorous. Hence, new products are invented (or new versions of existing products) with the promise of meeting every possible investor need or contingency. Eventually, products become commodities that need to be resuscitated to rekindle investor enthusiasm. The existing product may be working just fine, but some think that investors should be "upgraded" into products that are easier to control, more cost efficient, more revenue consistent, and more complex. The rationale is that investors (and advisors) will be discouraged from trying to replicate the products via self investing.

It is now 2010 and, hopefully, prudent investment dictates that the financial community steer clear of packaged products like LETFs, PPNs and ARS in both brokerage and advisory accounts. But there are a host of other products being promoted to clients, as well. Are these products destined to take their investors down the same path as their tainted forerunners? The likelihood of additional product implosions represents an ongoing threat to the client relationships of advisors who respond to their siren call.

Preserving Client Relationships

Few advisors today recommend long-shorts, LETFs and other short-term strategies for retirement accounts. Some of the packaged products that have not yet failed rely on ambiguous strategies employing swaps, options, and other derivatives to achieve their investment directives.

Advisors who put their retirees into these products (as a means of seeking downside protection and diversity) inadvertently imperil relationships with their retiree-clients. Without a complete understanding of how the products work, they expose retiree portfolios to unrecoverable losses. And if losses happen, they put themselves in the position of not being able to explain what went wrong. How many advisors would recommend derivative products to a retiree whose primary concern is capital preservation and consistent income? Yet that is exactly what happens when retirement portfolios contain a fund of funds, hedge funds and other baskets of financial products. If retirees understood the esoteric strategies and derivatives hidden beneath the surface of these products, would they be comfortable tethering their retirement security to them? If they were aware of the myriad fees involved with these products, would they still want to buy them?

With investor priorities having turned from performance to safety in recent times, a return to investment fundamentals may be a prudent move for advisors. A diversified asset allocation composed of an appropriate mix of stocks, bonds, cash equivalents, and ordinary ETFs can provide a satisfactory foundation for almost any retirement account. Resolute research and analysis can produce satisfactory portfolio performance to meet the conservative requirements of retirement accounts.

Uncovering Value

In the equities area, there is value to be found exploring market inefficiencies among small—and mid-companies with solid fundamentals. In relation to investments producing fixed incomes (an arena few investors correlate with value) selective municipal bonds offer exceptionally high yields in the current environment when compared with Treasury bonds. The expectation of higher tax rates may serve to enhance municipal bond values. The Build America Bond program could contribute to a rebuilding surge, but care should be taken to avoid issues currently under regulatory scrutiny for mispricing.

Granted, the process of uncovering good products is time consuming. Not every advisor is willing to devote the time and effort needed to do the hard research. Not every advisor has the experience or acumen to perform critical analysis. That is not an indictment of those who prefer to cede management of their retiree portfolios to a passive indexing strategy or fund manager. But it does beg the question whether advisors see themselves as salesmen or managers. More to the point, how do their clients see them?

Preserving client relationships is contingent upon the clients believing that advisors bring value and consistency to the table. Relying on packaged products risks clients eventually questioning why they are paying higher fees for average performance—and what contribution their advisors are making—beyond handing off their money to others for management. Advisors seeking to establish value must be willing to earn their money. They must know the products they are recommending, inside and out, and constantly monitor performance.

I understand the rationale of some advisors who prefer to spend time trying to grow their practices rather than becoming an investment picker. It is certainly easier to outsource client assets into packaged products so they can spend more time prospecting for new business. There is substantial merit in the belief that they can fortify client loyalty by schmoozing more and spending less time talking about stocks. I have also heard the argument that if all advisors delegated management to indexed and packaged products, their clients would be better off. Even if that contention was valid, however, many client relationships would gradually collapse because client loyalty eventually shifts from the advisor to the product. Packaged products may create stickier clients for Wall Street manufacturers, but rarely for the advisors who recommend them.

If a retiree-client buys stocks based on an advisor's recommendations and one day the advisor moves, changes broker dealers, or goes independent, the client's loyalty remains with the advisor. If that client is invested in packaged products recommended by the advisor, and the advisor has spent a decade defending product performance and management of the client's assets, what justification would the client have for staying with the advisor? The client's loyalty may shift toward the brokerage firm and the packaged products. Even if his or her loyalty is evenly divided between the products and the advisor, the bond is weakened because the advisor has ceded at least partial control to an outside element. From the client's perspective, anyone who can provide the same product may be acceptable. The client may like the advisor personally, and appreciate the recommendation of the product, but the advisor will have to exhaust some portion of his emotional capital reinforcing the decision to buy the product. It becomes a matter of whether the client views the advisor or the product as more important.

If the product performs poorly, the advisor may lose a client's respect. The advisor may also lose the client because it was the advisor who brought it to the client's attention in the first place. This is not to say that stock picking is the only way for an advisor to justify his or her worth to a client; recommending a packaged product carries a responsibility to completely understand its structure, liquidity and potential downside.

Making a Choice

Wall Street firms will continue to manufacture an endless stream of new merchandise. The products will continue to make huge profits for the manufacturers and the brokerage houses. Retirees hoping to recoup past losses will continue to be enticed by the marketing hype.

The ramifications for advisory relationships are obvious. As an advisor, do you choose to sell investments or packaged products? You may have to protect your client relationships and your professional future with a strategy of investment fundamentals and a value approach or risk losing clients. If you choose to seek value among the stream of Wall Street packaged products, know that the more complex the product, the greater the scrutiny required. An advisor who sees packaged products as an opportunity to focus entirely on the customer without keeping an eye on the investment may find his or her clients questioning the advisor's value. This is especially true when clients get their fingers caught in the latest Wall Street contraption.

ENDNOTES

1 John Maynard Keynes, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (England: Macmillan Cambridge University Press, 1936).

2 John Burr Williams, THE THEORY OF INVESTMENT VALUE (England: Harvard University Press, 1938).

3 Benjamin Graham and David Dodd, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE (New York and London: McGraw-Hill Book Company, 1934).

4 Jonathan Burton, *Leveraging Your Bets*, THE WALL STREET JOURNAL June 7, 2010: C12.

5 Tristan Yates and Lye Kok, *The Case Against Leveraged ETFS*, May 17, 2007, available online at *http://www.seekingalpha.com*.

6 Jonathan Burton, *Leveraged ETFs Magnify Returns—and Risk*, June 11, 2010, *www.marketwatch.com*.

7 Andy O'Rourke, Senior VP, Direxionfunds, *Debunking the Myths of Leveraged ETFs*, INVESTMENT ADVISOR May 1, 2010.

8 *Id*,

9 Nathan Hale, *Long/Short Mutual Funds—More Style Than Substance*, Oct 26, 2009, available online at *www.moneywatch.com*.

10 May 13, 2010, available online at *www.auctionratepreferreds.org*.

11 Gretchen Morgenson, *100 percent Protected Isn't As Safe As It Sounds*, THE NEW YORK TIMES, May 21, 2010.

12 Excerpted from *The Zero-Downside Profit Report* on *www.investmentu.com*, December 19, 2007, Issue 744.

13 Dec 19, 2007, available online at *www.investmentu.com*.

14 Al Kellet, *The Skinny on PPNs*, Mar 20, 2009, available online at *www.morningstar.ca/globalhome/Industry/News.asp?Articleid=284329*.

15 May 26, 2010, available online at *www.seekingalpha.com*.

16 Matthew Goldstein, *Structured Notes Start to Overcome the Lehman Taint*, Reuters, March 29, 2010.

17 *Supra* note 15.