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Wall Street *Transparency*…Clear as Mud

As America re-regulates its financial system we hear plenty about conflicts-of-interest, disclosure, and the regulatory differences between investment advice deemed "suitable" for clients and, alternatively, offered in clients' "very best interests." At Hamilton Point we believe the debate should be less about disclosure and more about aligning incentives, and think our fee-only business model with the highest fiduciary responsibility is the standard to which all investment advisors should be held. However, we doubt the government will implement needed changes when it is they that financially back-stop those organizations that need the most reform and fight changes every step of the way.

WHEN MORE IS LESS— We recently walked down memory lane with our friend, Alex McMillan, who had an illustrious career as a five-term Congressman from North Carolina's Ninth district. Mr. McMillan shared a fascinating eight-page research report on **Lowe's Companies, Inc**. he had written in 1965 (before entering politics) as an investment research analyst with R.S. Dickson and Company. Lowe's, the venerable home-retailer, as he predicted forty-five years ago, has been a tremendous long term investment. In reading his report it struck us that it was incredibly well written (no surprise with Alex as author) but also contained discussion about the quality of management—an area too often overlooked these days by traditional Wall Street research departments.

Noticeable as well was the relative dearth of disclosure at the end of this report from the 1960's. Specifically—and in just fifty words of classic "boilerplate"—it concluded that 1) nothing was guaranteed, 2) the sources of the data were believed to be accurate and 3) his firm may broker shares of the company or be long or short at different times. For curiosity's sake, we reviewed a Wall Street firm's latest research report on Lowe's which coincidentally, was eight pages as well. It included only four pages of analysis (nothing on management, of course) and four pages of the disclosure in itty-bitty print. The modern-day research report had less substance but around *3,500* more words of disclosure at the end—fully seventy times those in the 1960's version.

HIDE AND SEEK— If our use of the word "mud" in the title of this newsletter is too strong, perhaps translucent is better to describe Wall Street disclosure since it means that, "light passes through something without clarity." The New York Times recently wrote on this subject and quoted Nobel-Prize winning economist Herbert Simon who warned, "*Information consumes the attention of its recipients. Hence a wealth of information creates a poverty of attention.*"[1] It appears that government regulators of all stripes believe that the "buyer beware" principle is sufficient as long as everything known to man is fully disclosed in the, ahem, fine print (see our disclosure that follows, courtesy of our regulators).

So what should an investor do if obfuscation is the weapon of choice among so many financiers? Before offering our advice, let's review the two distinct regulatory bodies governing the investment world currently:

1. "Full Disclosure: Most Risks Hide in Plain Sight." New York Times 24 April 2010.

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Brokerage Firms Regulated by FINRA— Commission-based and so-called *fee-based* brokers that are registered representatives for firms like Merrill Lynch or Morgan Stanley Smith Barney are self-regulated by the Financial Industry Regulatory Authority who makes sure that any security promoted or sold is *suitable* for the client's needs and that all facts about the product (like conflicts, high fees and penalties) are fully disclosed.

Registered Investment Advisors Regulated by the SEC— Advisors like Hamilton Point are registered with and regulated by the Securities and Exchange Commission or state regulatory agencies who assure that advisors not just offer a suitable product but first act in a client's best interests in what is also known as fulfilling a "fiduciary" role.

There is a huge difference between the two standards cited above. Registered Investment Advisors, who are typically fee-only rather than commission based, have a compensation structure aligned with clients' interests, so attention can be focused on finding what the advisor believes are the best investment opportunities, given a client's profile. In the brokerage world, commissions and "payout" structures do not always align broker incentives with client interests. Further, brokerage firms often have in-house financial products they want brokers to sell to clients, thus generating more revenue (and potential conflicts) for the firm. As far as FINRA is concerned, the broker is acting responsibly as long as the offered investment program is technically "suitable"—again, not *best* but *suitable*—and conflicts, risks and expenses are fully "disclosed" somewhere in the small print.

We recommend that investors get a second opinion from someone who knows how to calculate all investment expenses when evaluating their investment manager, and we hope that Washington focuses on aligning incentives between clients and their advisors rather than creating new regulatory regimes or disclosure requirements that would further overwhelm, rather than inform investors. When incentives are aligned, lengthy disclosures become arguably unnecessary because the advisor has already vowed to act in the client's interest regardless of the fine print.

HOUSE ARREST— We honestly wonder if some of our largest competitors could *afford* to act in the best interest of their clients. Improved legislation could save clients money, but would come at the cost of our nation's largest brokerages—an impact Washington dare not impose on some of its capital-starved "affiliated" debtors. Rest assured, most stockbrokers know of these legislative headwinds, and many have recently formed or joined independent companies like Hamilton Point. Sadly though, many taxpayer supported brokerages ultimately used their capital to make huge "retention" payments to brokers, structured as multi-year loans that are forgiven if the broker does not "jump ship" to join or start independent outfits during that time.[2] How can legislators and regulators defend a system where many brokers have effectively been bribed to stay with a certain institution, regardless of whether they think they could do better for their clients elsewhere—now or even several years down the road?

Though many brokers (well-intentioned as many may be) have been handcuffed by the usual Wall Street shenanigans, and we have no faith in Congress to act, at least clients do have the opportunity to vote with their feet and seek out truly independent, fiduciary advisors. At Hamilton Point, we are proud to offer an escape from the translucent—at times muddy—world of Wall Street for a truly transparent world where the client comes first – always.

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Hamilton Point Investment Advisors is an independent and independent-minded, boutique investment advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

2. Lucchetti, Aaron and Brett Philbin."Bonus Blowback Bypasses Brokers." *The Wall Street Journal* 25 Feb. 2010.

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