

The Irreplaceable Nature of Capital and Fiduciary Duties of Financial Advisors

Adrian M. Baumann

The only unforgivable sin

Unprecedented is a term that we have grown tired of hearing. There were aspects of the market that may have arguably been unprecedented, though from an economic stand point it would be difficult to make that case. The financial pain, however, has been remarkably severe and millions of jobs were lost around the world.

We believe that blaming unprecedented markets is a cheap excuse from bankers, fund managers and other financial professionals alike that failed miserably in preserving their clients' capital. The wealth destruction – the question remains, if there has been real wealth creation in the first place – was so “unprecedented” that the financial pundits are all trying to dissociate themselves from their own failure instead of taking the blame and crying “mea culpa”! The idea of personal responsibility for ruining the lives of others is no longer relevant.

In fact, would we not say that the preservation and enhancement of capital is the very essence of our profession? It is the only job we have to do and it is a sin to fail since it is the only sin we must not commit. Everyone who failed in this mission should change profession or go out of business. Agreed? It is like the tailor who claims the reason the suit does not fit or has only one sleeve is that the fabric was of poor quality or there was too little available. Our guess is that the tailor would soon be without customers.



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The malfunctioning investment industry

The industry must simply jettison the novel rubbish of the recent past and reclaim old and plain virtues to make the banking world a better place!

Industrialised approach to investment management vs. customised and personal advisory service

The concept of benchmarking (relative vs. absolute performance measurement) and the number of client relations (often in excess of 100 per advisor) have turned investment management into an industrialised assembly line through the use of centralised portfolio management. Yet the credibility of investment management is violated if the bits and pieces of personalised

counselling (consideration of individual requirements, trust of personal engagement, etc.) are neglected and sacrificed at the altar of automation and economies of scale. In that respect 2008 most probably brought about a complete demystification of what a client can reasonably expect from his banker: Preserving and enhancing their capital was evidently not at top of the list, but rather personal enrichment by selling the client what ultimately turned out to be useless products.

Product distributors vs. independent financial advisors

Traditional private banking has mutated into a product distribution business. Success is not measured by achieving the clients' objectives but by turnover. Is it possible then for you to reasonably expect independent, faire and impartial advice?

Harmful incentive structures vs. long-term objectives

The wrong incentives favoured a system of greed and imprudence disguised under concepts like financial innovation and cleverness, as short-term thinking and the primacy of the quick buck irrevocably harmed the trusting partnership with the client and the success of the chosen investment strategy. It is important to never lose sight that rendering a service is an honour that comes with inherent responsibilities.

Information asymmetry vs. trust

The specific knowledge and information of financial advisors may be

greater than the client's. This disparity places the client in a vulnerable position of trust. The advisor in these situations is responsible for ensuring that the client's long-term objectives and expectations for custody account performance are both realistic and suitable for the client's circumstances, that the risks involved are fully understood and appropriate, and that the goals of the advisor in no way conflict with the best interests of the client.

Conflict of interest vs. transparency and alignment of interest

Bankers act in a fiduciary manner and the duty required of a fiduciary exceeds acceptable behaviour in many other business relationships due to their position of trust. Fiduciaries owe their undivided loyalty to the clients and are bound to place client interests before their own. Full disclosure of all actual and potential conflicts of interest is required to protect clients. Transparency is the only means of properly assessing whether the interests of all parties are in full alignment.

Hidden fees vs. compensation by clients

Banking has essentially become a dishonest business of product distribution powered by (for the client) non-transparent referral fee schemes. Clients must be aware of the nature and estimated value of any consideration (whether in cash, in soft dollars, or in kind) received or delivered to others for the recommendation of any services. Such disclosure helps the client evaluate any partiality contained in a recommendation of services and evaluate the full cost of the services. The best and proper solution however is to avoid hidden fees altogether and be compensated exclusively by the client.

Megalomania, high-handedness, incompetence and dishonesty vs. credibility, common sense and intellectual excellence

Far too many bankers are intellectually poor, exhibit no independent

reasoning, fail to challenge mainstream thinking and put too much faith in consensus when in fact humility, instinct, reticence and responsibility would be more appropriate. Someone who thinks he is smarter than the rest of the world is due for a shock ("pride before the fall" as the proverb says in the vernacular). Indeed, knowledge and skills have become much more important as no one trusts a banker or an investment manager who claims to be an expert in all fields and trades in an instrument or asset class that lies outside his or her core expertise. At any rate, a client is not primarily looking for a superstar, but for pedigree, good references, a decent track record, honesty and availability. The client much prefers someone at the helm of a well-run ship than to placing a bet on the Titanic.

Lessons to be learned or just repetition of trivial wisdom

Every now and then it is wise to be reminded of some trivial lessons that should guide us through the world of investment management. These are true for the individual investor, but even more so for every financial advisor managing client money. The financial industry is like a candy store that permanently tries to seduce you, whereas circumstances more often dictate courage to just say no!

- If you cannot understand it, do not buy it.
- If you cannot price it, stay away from it.
- Searching for yield can be dangerous.
- Cut losses short, let profits run.
- Do not borrow to leverage your returns.
- The business of (investment) banks is making money.
- Marvellous financial innovations often come with significant downside risks.
- Focus your attention on the risk side of the equation first.
- Big is not necessarily better; very big companies can be very poorly managed.

- Never underestimate the capacity of governments to enact terrible legislation.
- With big catastrophes come big opportunities.
- Be wary of crowds at extremes.
- Study history, do not repeat mistakes.

Investment strategy for the future

First, advisors should separate between alpha and beta in portfolio construction, i.e. between actively vs. passively managed assets if advisors correctly apply their individual core competences and are therefore able to seize above-average investment opportunities. The dispersion of returns among actively managed strategies across all asset classes has become very large. The result is, unless you are absolutely confident of your active management choices, it is better to go passive. The cause of this greater dispersion is that markets are more volatile. The hurdle for active management has been raised a number of feet and you have to be sure you are actually getting something for your money.

Allocation of capital is not something that can be taught, it is part of a larger structure of intuition. Advisors must define three individually different sub-portfolios in terms of size and composition based on the personal situation for each client by actually breaking down allocation to the individual client level, instead of allocating assets homogeneously among clients with the same risk preference/tolerance:

- Safety portfolio: securing the client's material existence and standard of living
- Alpha portfolio: applying the advisor's individual core competences and profound know-how in one or more particular market segments, and allocating a substantial part of the assets to these segments
- Beta portfolio: residual portfolio considering mainly passive and therefore cost efficient investments

Second, distinguish between two

sets of risk if by applying a prudent risk management, i.e. understanding and avoiding the risk of loss, you automatically expose yourself to potentially outsized positive returns:

- **External (can be delegated):** Consider the history of risk mitigation for each manager and investment vehicle instead of just looking at the return potential for the manager and investment vehicle
- **Internal:** Look at the risk characteristics of the portfolio as a whole, and make sure they are consistent with rapidly changing correlations and herd behaviour among investors and fund managers. In addition, protect the portfolio against particularly disastrous scenarios and forego some returns if cheap insurance is available.

Diversification as a risk reduction measure is also employed but not in the conventional sense. We neither seek nor avoid diversification for its own sake. We see it in the manner of an art collector who, having stumbled across something desirable, contemplates its purchase: If it fits the collection and the price seems reasonable, the collector buys it.

Finally, on currency considerations (not applicable to the safety portfolio), be aware that there is no money in the world today that has any intrinsic value. There is no way to exchange your savings with a certainty that the purchasing power will be preserved. Therefore, over time, it makes no difference what the (reference) currency of your portfolio is as long as the investment policy is sound. The results of a decent, first-class and long-term portfolio in any currency would be fine in any other currency.

Act as “owners” of capital

For more than a century, the investment actions of fiduciaries have been subject to the test of the prudent man rule. The rule holds that a fiduciary shall exercise the judgment and care, under the circumstances then prevailing, which

men of prudence, character and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

Over time, with the introduction of modern portfolio theory – though most of its findings are questionable – the prudent man rule evolved into the prudent investor rule, because the narrow directive to preserve capital and avoid risk constrained an investment manager’s ability to outpace inflation. Simply stated, the rules are:

- Adhere to duties of loyalty, impartiality, and prudence;
- Maintain overall portfolio risk at a reasonable level (i.e. avoid the risk of loss);
- Provide for the reasonable diversification of client assets (i.e. “collector approach”);
- Act with prudence in deciding whether and how to delegate authority to experts;
- Incur only costs that are reasonable in amount and appropriate to the investment responsibilities and
- Exercise diligence and thoroughness in making investment recommendations or in taking investment actions.

Anybody listening? Does anyone comply with these rules today? By looking at the current state of our industry and the misery which was brought about by the financial wizards, we would suggest the answer is NO! In this process, a few have enriched themselves beyond description while the fate of most is one of continued impoverishment. This is not a failure of capitalism but the result of the intellectual and moral poverty that grips our world.

Predicting the future, unknowable as it is, would be rather foolish. How much more useful can predictions be if understanding the events of today is quite difficult in itself? Accordingly, we are not even in the least concerned with making money, but are instead

focused primarily on avoiding serious errors in judgement. As fiduciaries, we must act as “owners” of capital with a sense of personal responsibility for both the means and the result, and not as “speculators” of other people’s money. ■

About CAYROS capital AG

CAYROS capital is a low profile, rock solid independent Swiss investment management company aiming primarily for the preservation of capital in inflation adjusted terms. The key question for our clients and us is not about how to become rich, but how to remain rich. We try to avoid errors by sticking to our investment standards, making fewer decisions and having well defined objectives. We are not paid to produce great numbers. In the short term, the financial markets will often make us look really smart and other times rather foolish. Our mandate demands an approach that is quite unconcerned with comparative analysis. What others do is of zero concern to us. We view investment results in absolute terms and not compared to indices or other benchmarks. Our goal is for a relationship that is well suited to the development of a strong and permanent intellectual trust.

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