You Get the Clients You Deserve

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Clients do not want special treatment; they simply want to be treated the same way their investment managers would want to be treated if they were the clients. At the most basic level, a business decision cannot be ethical unless a firm asks not only how something benefits the firm but also how it benefits its clients. If a firm acts only in its own best interests, it will eventually and inevitably act against its clients' best interests.

In the investment management industry, firms seem to believe that they should put their clients on a pedestal, and in fact, I think they do. The typical client on a pedestal, however, bears a striking resemblance to a painting by Antonio Pollaiuolo, circa 1475, called the *Martyrdom of St. Sebastian*. In this painting, St. Sebastian has been carefully placed on a pedestal. In fact, he cannot get off it. The painting depicts this early Christian who was shot full of arrows by Roman soldiers until he resembled a human pincushion.

But in my view, St. Sebastian is also a modern metaphor for the typical investor, the typical client. The painting shows an arrow sticking into St. Sebastian's upper left chest, close to his heart; this arrow might stand for the agony of enormous management fees. Or maybe it represents years of underperforming the market by a margin even wider than the fees themselves—the piercing pain of negative alpha. Perhaps the arrow that is almost completely buried in his belly symbolizes the brutal tax bills generated by excessive portfolio turnover, and the one in the middle of his back might represent an investment management firm that hyped the hot performance of a fund at the exact moment when it was most likely to regress to the mean. The arrow that is sticking in his buttocks probably represents a fund that took in so much cash so fast that it destroyed its own performance, leaving the vast majority of its investors sitting on painfully sharp losses. Finally, the arrow in his right arm might symbolize the way his fund company treats him like an intellectual weakling, bombarding him with boorish marketing materials and inadequate discussions of risk, and the one in his left arm might represent the way his fund company itself behaves like an intellectual weakling, mindlessly herding its way into homogenized portfolios that maximize the firm's own fee income but minimize the chance for active management to live up to its potential.

The painting depicts even more arrows about to hit St. Sebastian. One might be the temptation of day trading, which is often executed by the very same investment firms that keep preaching about investing for the long term. Another might be the notion that getting rich quick is achievable or even desirable. And at least one of the Romans firing arrows into St. Sebastian must be a member of the media; the ethics of my own so-called profession leave much to be desired.

The point is that clients do not want to be put on a pedestal. They simply want to be treated the same way their investment managers would want to be treated if they were the clients.

Ethical Issues

The investment management industry must face four key ethical issues: tax efficiency (or the lack thereof), benchmarking returns, fee explosion, and promoting fund performance.

Tax Efficiency. Fund managers continually claim that they are reluctant to make tax efficiency an explicit objective for their funds. They claim that their goal is to maximize total return and that taxes are secondary. But when these managers invest their own money—when they are the clients—do they seek to maximize their total return pretax or after tax?

Benchmarking Returns. "Style purity," "minimizing tracking error," and "sticking to our discipline" have become articles of faith when money managers sell their services. Yet when they invest their own money—when they are the clients—do they ever pick stocks with the explicit intent of minimizing tracking error? Or are they, instead, trying to earn the best returns they can—with no regard for the benchmark?

Fee Explosion. Investment managers have no qualms about charging more than 1 percent a year to run portfolios that underperform a blindfolded chimpanzee. But when they invest their own money—when they are the clients—would they ever willingly pay more than 1 percent in annual expenses for below-average performance? And would they like to pay the same fees regardless of whether their portfolios perform well or poorly?

The earliest known fund prospectus is for the Foreign and Colonial Government Trust, which is a U.K. fund that was launched in 1868. At that time, expenses were capped at £2,500, which amounted to between 36 and 42 basis points (bps) on the fund's assets for its first five years. This investment trust is still around and performing solidly, and last I checked, its annual expenses were around 47 bps. In well over a century, this fund's expenses have barely budged, but the expenses of U.S. funds have shot up 50 percent in the past four decades, with no end in sight.

It is remarkable that funds advertise their market-beating performance, whenever they have any, and yet they do not charge accordingly. The U.S. SEC allows performance incentive fees, enabling a fund to charge higher fees when it beats a benchmark—so long as it is willing to charge less when it fails to beat it. Nearly every fund sells itself to the public on the grounds that it can or will beat the market, but how many are willing to put their own money on the line and take the other side of the bet they are foisting on the public? According to data from Lipper, the managers of only 158 out of more than 7,700 stock funds (i.e., only 2 percent) are willing to put their own money where their mouths are, and yet they are perfectly happy to encourage their clients to do so. Instead of thinking like clients, the managers are doing the exact opposite.

What is even more offensive is that some fund companies not only ignore their obligation to lower their fees but also believe they have a God-given right to raise them. For example, in 1994, the "independent" trustees of the Putnam High Yield Advantage Fund approved a 27 percent effective hike in management fees for the fund, on which Putnam was already earning a 41 percent net profit margin. Shareholders who voted "no" received an extraordinary letter that stated the following:

> According to our records, you elected to vote against the proposed changes in the management contract. We would like to be sure that you are fully aware of the implications of this decision. The proposal requires approval by 67 percent of the shares voted. If that percentage is not achieved, the meeting will be adjourned until a larger number of shareholders vote their proxies, which, in turn, may end up costing the fund more money for further mailings.

In other words, Putnam was saying that it would continue to charge clients more and more money until they agreed to allow Putnam to charge more and more money. Putnam later apologized for mailing the letter, but its original action made a complete mockery of the term "mutual fund." Would anyone at Putnam ever buy a high-yield bond from a company that treated its creditors this way? Were Putnam's managers treating clients the way they would like to be treated? The questions answer themselves.

Promoting Fund Performance. Mutual funds most heavily promote their performance to the public when performance is at a peak. Mutual fund ads shout "We're number one!" louder than sophomores at a college football game. Yet when fund managers invest their own money—when they are the clients—do they seek out the stocks with the highest past returns, or are they trying to own stocks that will have high returns in the future? No one denies that regression to the mean is the most basic law of financial physics. So, why do funds market to the public as if regression to the mean were nonexistent?

The following example shows what can happen to clients when a fund markets its performance at its peak. Parnassus Investments advertised that it had the number one growth fund in America. When I looked at data from Lipper to see how the fund performed in subsequent periods, I found that America's number one growth fund over the succeeding five quarters turned out no longer to be America's number one growth fund. The people who already owned America's number one growth fund enjoyed good returns, at least for a while, but the people who bought it on the basis of its number one performance got the 874th growth fund or the 881st growth fund.

The Great Divide

Those four ethical issues all stem from the artificial divide the investment management industry has erected between advisors and clients. To be blunt, business decisions cannot be ethical unless a firm asks not only how something benefits the firm but also how it benefits its clients. If a firm acts only in its own best interests, it will eventually and inevitably act against its clients' best interests.

In fact, to define "ethics" in any other way than acting in the best interests of others is to define the term into meaninglessness. As John Stuart Mill wrote in *Utilitarianism* in 1861:[1]

> The interest of mankind collectively, or at least of mankind indiscriminately, must be in the mind of the agent when conscientiously deciding on the morality of the act. . . . we ought to shape our conduct by a rule which all rational beings might adopt *with benefit to their collective interest*. (p. 49)

The term is "mutual fund," not "fund."

One of Wall Street's wisest sayings is, "You get the clients you deserve." If firms do not acknowledge at the outset, and in every day and at every hour, that everything they do must serve their clients' best interests as well as their own, then firms are doomed to deserve the kinds of clients no one wants. To deserve the clients firms would like to have, they must treat clients as they would expect to be treated if they were clients. More basically still, they need to act more like clients.

Now more than ever, acting like a client is not only an ethical imperative but also a business imperative. In today's Internet world, if firms do not serve their clients well, clients will serve themselves. The illusion of free investing on the Internet, and the high visibility of "the big score," is becoming irresistible. Try telling someone whose "dot com" stocks are up 173 percent in the past eight months that he is just lucky and could really benefit from professional stock-picking ability. It does not matter that the only thing this person knows about his stocks is their ticker symbols, or even that he owns QXT when he meant to buy QZT. From his point of view, he is a genius who is getting rich quick, which is fun and free; why on earth should he pay someone outlandish fees to lag the S&P 500 Index every year?

If this bull market lasts for several more years, individual investors may get to the point where they no longer add any money to mutual funds, except in their 401(k)s. If the stock market stays strong, I am gravely concerned that the mutual fund industry—aside from its sheltered position as the default choice for retirement plans—will end up squandering its natural role as the greatest contribution to financial democracy ever devised. Instead, it will become a quaint artifact. Fund companies will only be able to win back clients once they suffer a severe bear market—a marketing task about as easy as being chief recruiter for the Linda Tripp Fan Club. Even when day trading is finally recognized as the low-rent Las Vegas that it really is, guess what fund companies will still have to contend with: the index fund monster, which is going to loom over the landscape no matter what happens, continuing to make funds look bad in all but their best years and relentlessly draining off their institutional clients.

The Good Old Days

The investment management industry all too easily underestimates the anger of the investing public. A recent Securities Industry Association press release boasted that a mere 42 percent of the investing public believes the securities industry is "motivated by greed." The release proudly pointed out that that figure was "down from 49 percent in 1998 and 55 percent in 1997." This optimism is like looking at a glass that is half empty and declaring that it is completely full—and what it is full of is not drinkable either.

I get several dozen e-mails a week from retail investors, and they are fed up with the way this industry treats them. The main (although far from the only) reason the public is so disgusted is because of poor relative performance. The narrowness of the market in recent years accounts for much of that performance issue, and firms are right to explain it to their clients. But the situation is getting worse. The people who say that portfolio managers' jobs will get easy (like the good old days) just as soon as the market broadens again are wrong.

The good old days are gone forever, and here is the reason why. In the past, the investor who got the earliest grasp on the best information earned the highest return. The classic example is Nathan Rothschild and his flock of carrier pigeons, which almost 200 years ago gave him the finest early warning system in Europe and enabled him to dominate the foreign currency and bond markets for decades. In that kind of environment, the commodity that could be arbitraged most profitably was time itself.

But today, virtually every bit and byte of market information is transmitted instantaneously to every investor everywhere on earth. A great deal of information, in fact, is old before it even exists. Once upon a time buy-side analysts spent weeks painstakingly calculating their own earnings estimates; today, what counts is "whisper numbers" and even "prewhispers." Weeks in advance of any actual earnings release, the future has already been decided, and these numbers, which used to be an institutional commodity, now hit the Internet in a flash, for the whole world to see.

Meanwhile, fund performance—which used to be measured annually, then quarterly, then monthly—is now measured daily. In 1959, the typical fund owned its stocks for six years, on average. In 1999, the average holding period of stock funds will probably drop

[1] John Stuart Mill, "Utilitarianism," in *Utilitarianism, On Liberty, and Considerations on Representative Government* (London: J.M. Dent & Sons, 1977). Italics in the original.

below 12 months—the lowest, I believe, that it has ever fallen. Millions of investors, retail and professional alike, track stocks in real time, tick by tick, and soon they will be trading 24 hours a day. A recent article in the *Journal of Financial Economics* found that day trading is most profitable for holding periods of 80 seconds or less.[2]

Thus, the long term has shrunk down to anything longer than 1.5 minutes. Time is no longer arbitrageable. The velocity of learning has hit warp speed, and the informational efficiency of the stock market has never been higher. Professional money managers have lost the exclusive and powerful advantage that time arbitrage once gave them; scarier still, they have become the victims of it.

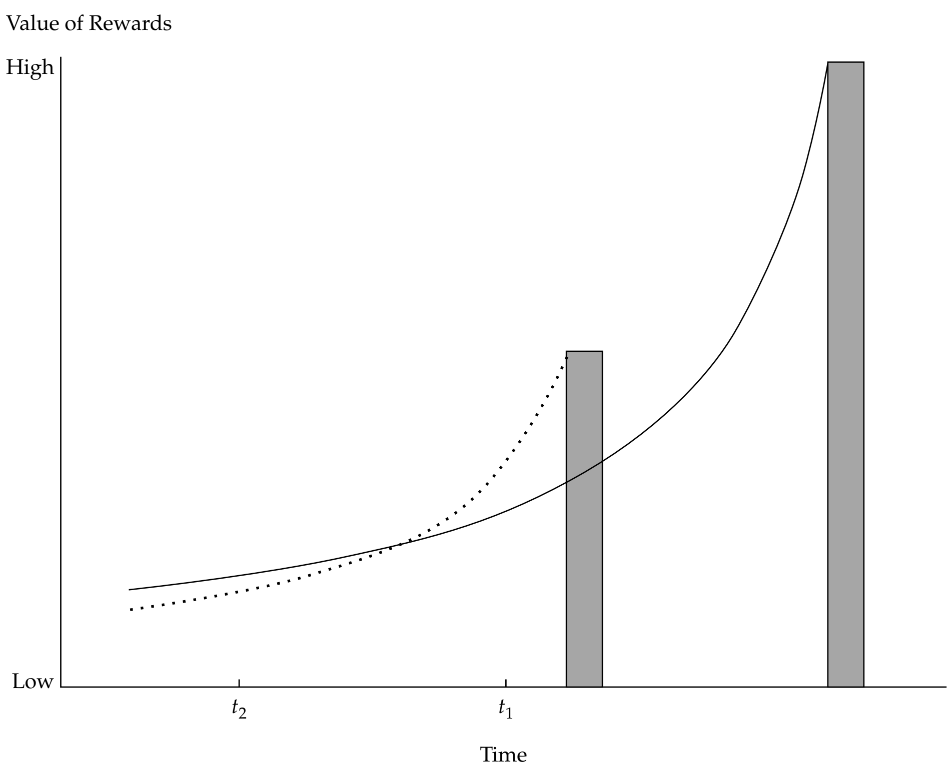
Research shows that the value of a reward is related to the length of time remaining until the reward can be obtained. The curves in **Figure 1**—which are based on experiments conducted on many species, ranging from rodents to birds to insects to humans—plot how the perceived or subjective value of each reward changes as time passes. This figure shows that when the time to receive a reward is in the distant future (in the region of t_2 on the figure), the larger, more remote reward is more attractive (i.e., has a higher value). But when the time to receive a reward is shorter (in the region of t_1), then the smaller, closer payoff becomes far more preferable. Where the lines cross is what psychologists call "preference reversal."

Think of the situation this way: When you are hungry, would you rather eat a large meal several hours from now or a small meal right now? The answer is obvious: When time is compressed, short-term, partial gratification becomes more satisfying than long-term, fuller gratification. This finding makes the pursuit of any long-horizon strategy—such as, say, a deep-value approach—psychologically painful, both for the firm and its clients. Clients want to eat now, not later, and so do firms. And as the Internet and CNBC and information saturation become universal, any investment strategy that does not pay off for years becomes almost unendurably difficult to promote.

Besides the acceleration of time, the power of the bull market is adding to this pressure. In an up market, what is a loss? The answer is not "losing money"

[2]Jeffrey H. Harris and Paul H. Schultz, "The Trading Profits of SOES Bandits," *Journal of Financial Economics* (October 1998):39–62.

Figure 1. Hyperbolic Model Plotting Value of Rewards over Time



Source: Leonard Green and Joel Myerson, "Exponential versus Hyperbolic Discounting of Delayed Outcomes: Risk and Waiting Time," *American Zoologist* (September 1996):496–505.

but "making a little less." And when investors see risk not as a true loss but merely as a foregone gain, they have an easy time dumping investments. Instead of kicking themselves, they can kick the portfolio managers—right out the door. Thus, for clients, firing a manager is not a damaging admission of their own fallibility; after all, they made some money instead of losing it. So, they are playing with the house money, which makes firing the manager easier than ever. Forget the old days, when fund investors used to need a signature guarantee before they could even write a letter to the transfer agent requesting a redemption, which took seven business days to settle. These days, three mouse clicks and they are gone.

In light of this changing investor sentiment, avoiding tracking error has become the prime directive, and relative performance has assumed absolute importance.

Retaining Clients

Because clients are so willing and able to leave firms, excellence in investment management no longer depends on getting the best information first, or hiring the smartest people, or building the best software. It depends, more than it ever has before, on a firm's ability to retain its clients—not to *obtain* them but to *retain* them.

Thus, how a firm chooses to market its investments is not just a vital business decision but an ethical decision as well, which surprises a lot of people. Most investment managers think ethics means establishing and living by fair rules of investing conduct, but in today's marketplace, how a manager invests funds and markets funds have become inseparable. Let me illustrate the point with examples.

Example One. From mid-1992 through the end of 1995, a leading small-cap mutual fund more than doubled in value, with little to no impact on the amount of assets under management. Monthly cash inflows during the period ranged from zero to less than zero to slightly more than zero. But then it became number one for capital appreciation over the trailing 3, 5, and 10 years, and its managers yodeled that number one ranking at the top of their lungs in advertisements far and wide. Advertising this number one ranking was like rubbing raw meat across a lion's nose. The public did not just invest in this fund; it attacked it. At the end of 1992, the fund had total net assets of just $3 million. In the first six months of 1996, it took in $2.5 billion.

And then small caps corrected, the fund's returns tumbled, the manager had to panic-sell into a dropping market, and the public yanked out its money. Because the manager's actions aided and abetted the public's own worst behavior, the public investors in this fund suffered dramatically. Although this fund had beaten the market by nearly two to one and nearly tripled in value from 1992–1997 with a time-weighted return of 27.68 percent, it earned an average of only 3.63 percent on an asset-weighted basis, or less than half the return of a certificate of deposit. Today, the fund's assets, which peaked at $6 billion in the height of the public feeding frenzy, languish below $3 billion. And its returns went from the top of the heap to the bottom.

By heavily promoting its performance when it was hottest—exactly when regression to the mean had the highest potential to destroy investors' wealth—this fund's managers treated clients like strangers rather than partners. Managers who think like clients would never behave this way. Poetically enough, in the end, these managers ended up not only devastating their clients but nearly destroying their own business. When I say that you get the clients you deserve, I am not kidding.

The lesson here is unavoidable. The cash flow from clients now rivals the investment process itself as the main determinant of total return. Asset elephantiasis can pulverize returns even worse than a market crash can. Unlike the profitability of their stock picks, firms *can* control the rate at which cash flows into their funds, and the decision to control cash flow is an ethical choice. I would argue, in fact, that it is one of the most important ethical choices any investment firm will ever face.

Example Two. Several years ago, a small-cap manager with a distinguished long-term record went to his firm's management committee asking that his fund be closed to new investors. As he told me:

> We'd gone from maybe $40,000 a day in net cash flow to $6 or $8 million a day, and I could no longer put the money to work in stocks I was comfortable with. When I asked [the management committee] to cap the fund, they said, "We can't close it. It's the only thing we've got that's selling." I saw myself being diluted into mediocrity, so I quit.

The thousands of shareholders who bought this fund because they wanted their money managed specifically by this man were out of luck. Even worse, the fund manager was forced to quit his job precisely because he was thinking like a client, precisely because of his belief that his firm had to consider the best interests of its clients in addition to its own.

Example Three. Here is another case of a manager—in this case a bond manager—putting himself in his clients' shoes only to find that one of the firm's directors was showing complete contempt for the firm's clients. Here is his chilling story:

> At a board meeting at my former firm, an independent director said to me, "You should stop focusing on long-term returns—don't you know that short-term performance is the name of the game for gathering assets these days?" I couldn't believe my ears. I asked him if he meant short-term, like monthly returns. The director said, "That's right." And that is why I left to work at another firm.

Example Four. A couple of years ago, I saw a bright, customized greeting card, festooned with colored streamers, that a rapidly growing fund company had sent to its existing shareholders asking them to "Join us in celebrating the reopening of [the fund]." These shareholders had nothing to celebrate and everything to mourn. The firm they had entrusted with their hard-earned money was not only acting against their best interests but also treating them as if they were too stupid to know the difference.

Summary. One of the odd things about being a journalist is that people are always willing to tell me the truth—but only if I agree not to print it. I have met portfolio managers who would deny on the record that rapid and massive asset growth is bad for their existing shareholders. But I have never yet met a fund manager who denied it off the record. The faster the fund gets bigger, the higher the transaction costs, the harder it becomes to find stocks the manager likes, the more stocks the manager is forced to own, and the less the manager knows about any of them. The truth is that the indiscriminate addition of new clients is bad for existing clients. The pursuit of rapid asset growth for its own sake, for a firm's own sake, cannot be defended on ethical grounds because it is directly against the clients' best interests.

Redefining Goals

What, then, should firms be doing? The traditional definition of high achievement for an investment management firm is to outperform a benchmark. I would like to propose a complete and radical redefinition: The highest ethical role of an investment management firm is not to earn the greatest possible return but to do everything in its power to ensure that *each of its clients* earns the greatest possible return. A firm's ethical imperative is to reduce the gap between the time-weighted returns of its portfolios and the dollar-weighted returns of its clients—to do its best to help every one of its clients earn the maximum possible proportion of the returns that the firm generates over time.

When a firm hypes a portfolio at the point of maximum performance, clients suffer for several reasons. First, the firm raises the odds that regression to the mean will have agonizing consequences for its newest clients. Second, the firm all but ensures that its results will regress to the mean, as the weighty force of cash flow crushes returns. Third, firms are committing a peculiar kind of performance suicide, in which their investors die and their management fees live on. Although a firm's time-weighted returns will often seem respectable, its average client will earn a miserable return. This tragedy will go unreported and unnoticed, because no one publishes dollar-weighted returns, but the cover of darkness is no defense.

In a recent issue of *The Ambachtsheer Letter*, Keith Ambachtsheer asked:[3]

> Should an explicit AIMR goal be to reduce the informational asymmetry between the sellers and buyers of investment management and research services? If the answer is "yes," what strategies would be most effective? (p. 3)

In my view, reducing the informational asymmetry between those who sell investments and those who buy them must be an explicit AIMR goal. By doing so, firms can narrow the shameful gap between the time-weighted returns of their portfolios and the dollar-weighted returns of their clients. As André Perold and Bob Salomon brilliantly wrote:[4] "Rather than rate of return, the goal should be the maximization of the total dollar return—the total wealth the investment process is capable of creating" (p. 31).

I like to tell the following little parable about the bus I ride to work each morning to illustrate my point about redefining goals. One day I asked the bus driver, "How many people ride your bus all the way from the first stop to the last?" "Nobody does that," he said. "Matter of fact, nobody ever *has* done that." A portfolio is just like a bus. The only person who rides it for the whole trip, and earns the full measure of the wealth it can generate, is the driver. The passengers all get on and off far too quickly; most of them never even get near where they want to go. But a mutual fund is worse than a bus in one respect: The bus driver never eggs the passengers on to the bus at the worst possible time, nor does the driver throw them off just when they would be best advised to stay. I submit that the portfolio manager's job is to do everything in his or her power to keep as many passengers as possible riding the bus for as long as

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[3] Keith P. Ambachtsheer, "Is AIMR Too 'Sell-Side'?" *The Ambachtsheer Letter*, no. 166 (K.P.A. Advisory Services Limited: Toronto, Canada, October 29, 1999).

[4] André Perold and Robert S. Salomon, Jr., "The Right Amount of Assets Under Management," *Financial Analysts Journal* (May/June 1991):31–39.

possible. Get them on the bus, keep them on the bus, and ride right alongside them: That is the essence of ethical behavior for an investment manager.

Communication

One simple way to achieve this goal of "riding alongside clients" is to use better communication. I am often asked how active management can fight back in the battle against indexing. The easy answer—"Just beat the market, pal"—is the wrong answer. Instead, what I advise active managers to do is something that a bloodless, faceless index fund can never do: Build a community.

The people at Southeastern Asset Management, who run the Longleaf funds, work on building a community. On the very first text page of its prospectuses, Southeastern Asset Management states what it stands for:

> We will treat your investment in Longleaf as if it were our own. . . . We will remain significant investors with you in Longleaf. . . . We will invest for the long term. . . . We will consider closing the Funds to new investors. . . . We will discourage short-term speculators. . . . We will communicate with our investment partners as candidly as possible.

In themselves, such statements have no value. The firm has to believe them, it has to mean them, and it has to show its clients that it means them. Each May, Longleaf holds a shareholder meeting in Memphis, Tennessee. The advisor, not the fund, pays for this event, and in 1999, more than 400 people came. One couple comes all the way from San Diego, California, every year; another man rides a motorcycle down from Allentown, Pennsylvania. The fund managers—and the independent directors—do not just give formal speeches; they let individual clients come right up to them, face to face, like equals talking to equals, just as the fund managers would like to be treated if they were clients. And, of course, they are clients; the people who run Longleaf have more than $200 million of their own money in their own funds. Maybe that is where some of the sincerity in the prospectus comes from.

Another example of treating clients right comes from an ad for a Warburg Pincus fund. The ad discloses that the fund actually underperformed the S&P 500, and it warns of an upcoming tax distribution. This is intelligent and fair risk disclosure.

One tiny fund company is using the Internet wisely and well. Robert Loest, CFA, who runs the IPS Millennium Fund, has tackled the problem of teaching people about risk. When people go to the IPS Millennium Web site (www.ipsmillennium.com) and click on the link for information about the IPS Millennium Fund, they can choose between reading "Risk Disclosure: Human Language" or "Risk Disclosure: Legal Boilerplate." The "Human Language" is charming, funny, and highly effective. Following is an excerpt:

> While the long-term bias in stock prices is upward, stocks enter a bear market with amazing regularity, about every 3–4 years. It goes with the territory. Expect it. Live with it. If you can't do that, go bury your money in a jar or put it in the bank and don't bother us about why your investment goes south sometimes or why water runs downhill. It's physics, man.

Not only does a prospective client get an entertaining discussion of risk but also a real sense of what the person who runs this fund is like and how he thinks, which is the first step in building a community.

Ten-Step Program

What are the best ways that as an investment manager you can get clients on the bus, keep them on the bus, and ride alongside them? In the spirit of a good personal-finance journalist, let me offer 10 great ways you can do better.

One. Ask yourself a basic question: Are you better off voluntarily reducing your fund's expenses now, when you can afford it, or waiting until the markets fall, when your high fees will stick out like a sore thumb? I submit to you that if you wait, you face only two choices: cut your fees at the bottom of the market or lose shareholders to the firms that already have cut them.

Two. Require, across the entire firm, that all bonus compensation and all retirement plan assets be reinvested in your own funds. Then disclose this policy, and disclose, in percentage terms if you prefer, how much of each fund the firm's executives, employees, and directors own. There is simply no better way to align your interests with those of your shareholders than by investing alongside them as partners. Acting in your clients' best interests is far easier once you are among your own largest clients.

Three. Ask whether an optimal asset size exists beyond which each portfolio should not be allowed to grow. (Once the firm's own staff has its own money substantially on the line, this question will be a lot easier to answer.) Then tell your clients in advance that you have set a ceiling for asset growth, and tell them why. That disclosure will teach them something about investing and something about the character of your firm.

Four. Define what you do much more clearly. If some clients demand minimal tracking error, then give it to them. But segregate that money where it cannot infect the rest of your accounts with its lack of ambition. Live up to the meaning of the word "firm"; stand firm, and do not get caught up in a race to the bottom. Likewise, if the 401(k) market is important to you, then add an index fund to your lineup; let that fund be the main receptacle for the 401(k) cash flow so that it cannot swamp the success of your other accounts. And if some of your funds are managed with little or no regard for tax consequences, then say so; tell your clients where you are tax efficient and where you are not. Your job is to disclose; a client's job is not to try to figure out.

Five. Call a complete halt to performance advertising. "We're number one!" works in the short run. But you know how regression to the mean works. Do not inflict mean-regressing returns on other people; it is just not right. What is more, acting in such a manner gets you what you deserve. The shareholders who buy your funds when they are momentarily ranked number one or temporarily emblazoned with five stars will always be LIFO (last in, first out) shareholders. When performance turns, they will desert you at the drop of a hat.

Six. Reward your shareholders for good behavior. People have grown to expect frequent flyer miles as the natural reward for loyalty to an airline or special prices at the grocery store when they use their savings club card. Why not pay your loyal long-term shareholders a small year-end bonus—say, 10 bps of their account value, automatically reinvested in new shares? The new exchange fund in Hong Kong is doing exactly this, issuing bonus shares for loyal investors who hang on for the long term, which, of course, in Hong Kong is one year or more.

Seven. Emphasize the human touch. Besides Longleaf, a few other fund groups hold annual meetings for their clients. For a few thousand dollars, the advisor gives hundreds of shareholders the opportunity to build an emotional bond with the fund and its managers. Loyalty is a two-way street. If you train your clients to think of your funds merely as mechanical generators of raw return, rather than as a community of people with mutual interests, their loyalty will always be as perishable as your performance. I am baffled that the industry uses the term "fund family" with no sense of embarrassment. What kind of family is made up of people who have never even met each other and are actively prevented from doing so by the master of the household? Simply by letting clients meet their portfolio manager and shake his or her hand, these few innovative firms are encouraging their clients to be loyal for years to come, and they are enabling active management to live up to its potential. These managers are teaching their clients, face to face, the power and value of long-term investing. The fund industry sees with its own eyes that Warren Buffett can fill a stadium at his annual meeting, but most fund managers yawn and look the other way. A few rare firms, however, have begun building a powerful emotional bond with their clients, and when the great bear market finally comes, these firms will retain a far higher share of their clients than the ones that have not established such a bond.

Eight. Use the Internet imaginatively and often to grab clients with short attention spans but intense interest. Set up live question and answer sessions for your portfolio managers once a month. Do as the IPS Millennium Fund did, and teach your clients about risk in a way that is fun and unforgettable. Tackle the problem of the wildly inflated expectations for future returns; tell your clients what you really think. Nobody reads a prospectus, but everybody is getting online. Good risk disclosure no longer has to be boring, which is a huge breakthrough and is ethically important. Do not let the opportunity pass you by!

Nine. The system of mutual fund independent directors needs a lot of toughening up. Too many independent directors, like the one I mentioned earlier, think that their job is to make the investment advisor rich. They sometimes forget about the client altogether. Chris Tobe, a CFA charterholder in the Kentucky State Auditor's Office, has proposed that AIMR encourage the establishment of a pool of unaffiliated CFA charterholders who would serve as independent fund directors, with the specific responsibility of reporting on the fairness of fees and other ethical issues. It is a proposal worth thinking about. I would suggest an even simpler alternative: Ask yourself whether your portfolios are run under the same strict standards of corporate governance that you expect from the companies you invest in. A double standard is no standard at all. If your own corporate governance falls short by this test, then go out and recruit the toughest, most combative business leader you can find and put him or her on your board. Tell him or her to defend your clients' best interests whenever you forget to.

Ten. Use performance fees. Stop asking your clients to take a bet that you are refusing! If you think they should bet their money on your ability to beat the market, then you darn well should bet your own money too. I am shocked that some fund companies pay portfolio managers bonuses based on the size of assets and the volume of positive cash flow into their funds, while out of the other side of their mouths they lead their clients to believe that beating the benchmark is the name of the game. The best way to cure this conflict is with contingent performance fees. As Max Bazerman and James Gillespie recently wrote in the *Harvard Business Review*, "Using a contingent contract to share risk often has an important additional benefit: It creates enormous goodwill . . . [and] tends to enhance the trust between the parties."[5] By showing your clients you are putting your own money where your mouth is, you send them a powerful signal that you are on their side.

[5]Max H. Bazerman and James J. Gillespie, "Betting on the Future: The Virtues of Contingent Contracts," *Harvard Business Review* (September–October 1999):3–8.

Conclusion

Ultimately, ethics in investment management is about serving clients' best interests, and for firms to do so, they have to think like their clients. To think like their clients, they need to *be* clients. Putting clients' best interests first does not mean putting a firm's own interests last. It simply means aligning the firm's own best interests with clients'. In the end, both the firm and the clients will be better served, and I venture to say both sides will even make at least as much money in the long run.

One final thought: St. Sebastian was not killed by all the arrows that the soldiers fired into his body. He lived on, to fight again. In the long run, firms will get the clients they deserve. I hope firms will try as hard as they can to deserve only the very best clients.

Question and Answer Session

Jason Zweig

Question: Why is the issue of ethics important?

Zweig: The issue is important for the very reason that we have securities regulations. If ethics did not matter, we would not have securities laws. To put ethics on the back burner is understandable in a bull market. But I would argue that during markets like these, ethics is more important than it normally is because when the market does ultimately come apart, we will find out where all the problems were. I had an aunt who used to say that it is not until the rinse cycle that you can see how dirty the laundry really was. I think that is what we're going to find when the bear market does finally come, whenever that is.

Maintaining the investment public's confidence in the securities markets is the single most important issue that any investment firm faces. You can't divorce that basic goal from a devotion to higher ethics.

Question: What is the problem with focusing on tracking error?

Zweig: Clients may sometimes demand things that make you uncomfortable, and if I were an active manager, I don't think I would really appreciate being told that my prime directive was to minimize tracking error, because I would think my prime directive would be to maximize return. It is not purely an ethical issue but also a matter of business judgment.

I think the proper response is to define yourself more clearly, as I mentioned. If you have clients, especially institutional ones, who insist on minimizing tracking error, then you can give them that service. But you might want to keep that money separate so that you can show elsewhere what you really can do.

Question: What do you recommend for improving the governance of mutual funds?

Zweig: I think that Chris Tobe's idea of some sort of ombudsman role might go some ways toward improving mutual fund governance, but it is a very difficult problem. The system of independent mutual fund directors is probably the single worst flaw in the Investment Company Act of 1940. Independent mutual fund directors have a great deal of difficulty acting in a way that most of us would recognize as independent. Because these people are appointed by someone, they believe that person to be their boss, when, of course, he or she is not. Under law, that person is not the boss, but what is true *de jure* is not true *de facto*. This person appointed these directors, they get paid pretty well, and they get to go golfing in a lot of nice places. Generally, they are going to do what they are told, which is a difficult problem and not an easy one to resolve.

My point was that the best way to get people to think like clients is not by telling them to think like clients but by requiring them to be clients. If you look at proxies, you will see that mutual fund directors generally have lower ownership stakes in mutual funds than corporate directors do in the companies whose boards they serve on, which is partly because mutual fund directors tend to have overlapping directorships. The problem could be changed with better bylaws, simply requiring within the firm that a director must invest a minimum of *x* in the company's fund shares.

Question: What's your reaction to the plain English initiative for prospectuses?

Zweig: Like a lot of regulatory initiatives, it has been overtaken by the real world marketplace. Just as the SEC tried to come up with a mathematical formula that would work as a form of risk disclosure, its efforts were eclipsed by better risk disclosures by mutual funds. The plain English initiative is a good idea, and fund companies are finally getting the point, as evidenced by such documents as those from the IPS Millennium Fund. The SEC is now getting out of the way and letting capitalism work, allowing intelligent people to come up with better ways to approach an audience.

Question: Do you foresee a decline in the demand for active management?

Zweig: So long as the bull market lasts, yes. But the flip side is that I don't think you should be too complacent. Although the conventional wisdom is that when the market finally goes down, active management will redeem itself, I think that is being too optimistic. History tells me that active management, despite all our intuitions to the contrary, does not work any better in a bear market or a flat market than it does in an up market.

What will change in a bear market is that the people who are flipping mutual funds and stocks on their own will learn that they do not have any special security-picking ability. But active managers are going to have a hard time winning those people back because they will be disgusted with equity investments in general. They're not going to view active managers with any special regard just because they themselves made a mistake. What we learned in the 1970s is that when people lost massive amounts of money, they often didn't get back in the market for a decade. And the reason wasn't because active management was doing poorly; it was because they had been burnt.

Winning investors back will be very difficult, which is why it is so important while the market is still strong to keep the shareholders you have, your clients, and to put loyalty measures in place before it is too late. Once clients go out the door, you will have a terrible time getting them back.

Question: Is something happening among the investing public that is an inevitable wave of change?

Zweig: My hunch, based on history, is that when the bull market finally does stop—and we will all know when it happens because suddenly people will be talking about risk again—the idea will go away that getting rich quick is a legitimate and sensible investment goal. People will care again about preserving capital.

What can firms do about it in the meantime? They can build client loyalty now before it's too late. For a very small firm, bringing in new clients may be vitally important, but large firms should focus far more on client retention at this point than getting new clients, because once clients go away, getting them back will be incredibly difficult. In the 1970s, a period when the market was fairly dormant, one-third of all funds in existence disappeared, but more importantly, one-third to one-half of all the shareholders disappeared.

