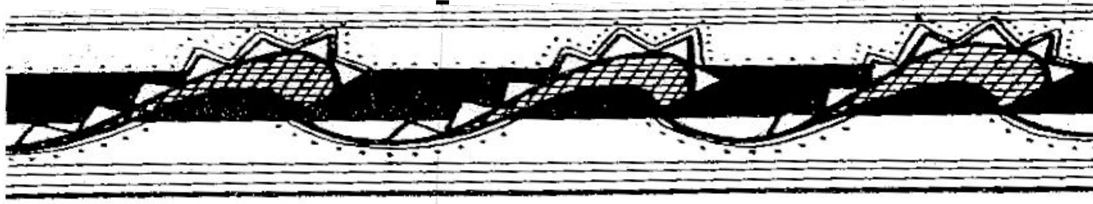
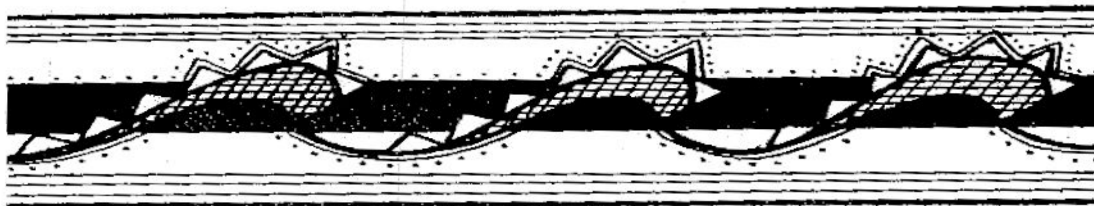


THE INVESTMENT INDUSTRY

What You Need to Know About The Players, Regulation, Fees & Other Pertinent Matters

by Gelvin Stevenson



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Introduction ...

This volume is one of a series of handbooks for Native American tribes that want to take control over their own financial resources and to manage them well. We introduce the series first, and then this book on ***The Investment Industry***. While this booklet is meant to be complete in itself, it is best read as part of the entire series. For example, many terms used in this booklet are defined in the booklet on ***Investment Principals***.

... To This Series

Something new has happened in Indian country. For the first time, a substantial number of Nations now have, or will soon have, money to invest. For many tribes, that money had been held in trust and managed by the Bureau of Indian Affairs, Division of Trust Management. Only now, after much hard work, are tribes winning the right to manage that money. In addition to the BIA Trust money, many tribes have received land claims settlements, or are earning money from tribal resources or gamin or other tribal enterprises. While the sources of this new money may vary, it needs to be managed, and managed well.

Since having money to invest is a new experience for most tribes and Native people, we often lack the experience and skills necessary to invest and manage it properly. Even people with formal education may know little about investing, and those tribal members who do understand investing may not be familiar with the world of institutional investing, which is populated by specialized laws, companies, concepts, practices and people. To manage a tribe's investment portfolio well requires knowledge not only of your tribe's needs, but also of the money management industry and its concepts and language.

This series was written to introduce tribes and tribal members to the world of institutional investing and money management. It includes three short books: ***Investment Principles***, ***The Investment Industry***, and ***Evaluating and Monitoring Investment Advisers***.

This series is intended for tribal treasurers, controllers, investment officers, chairmen, chiefs, council members, members of finance committees, trust committees, judgment fund committees, and all other interested tribal members.

This information is meant to teach and guide, to start you off in the right direction. It is not an encyclopedia. Nor is it a bible. It is a beginning.

Your money is important enough that, in most cases, you should hire professional help. We will discuss below what kind of help you might need and where to find that help.

This handbook was funded by the Northwest Area Foundation, as part of its ongoing efforts to build the capacity of tribes and other institutions in the northwestern U.S. The Foundation seeks "to contribute to the vitality of the region by promoting economic revitalization and improving the standards of living of the most vulnerable of its citizens." The Minnesota Chippewa Tribe received and administered the grant, through its Economic Development Division. The author thanks Karl Stauber and Terry Saario of the Northwest Area Foundation for their encouragement and support and Gary Frazer and Richard Robinson of the Minnesota Chippewa Tribe for their cooperation and assistance.

Thanks, too, for their careful reading and helpful comments on early drafts, to Mike Roberts and Bruce McKay, First Nations Development Institute; Lynn Giago, Piper Jaffray and First Nations Oweesta Advisory Committee; and Debra Powless and Raeann Skenendore, Oneida Trust and Enrollment Committee.

Any errors are my responsibility, and I would appreciate having them pointed out to me at 2160 Bolton St., Apt. 3B, Bronx, NY 10462, 718-863-4156.

The Foundation wants to make clear that their support of this series should not be read as an endorsement of the author in any way other than as the author of this work. In other words, the Foundation does not want to imply that it favors this author over any other professionals working in this area.

This handbook is the work of a particular person who has his own way of understanding and communicating. Like all information, it should be carefully evaluated by the reader. Part of that evaluation requires knowing something about the author.

My name is **Gelvin Stevenson**. I am Western Cherokee. I work as a Financial Consultant in New York City, have a Ph.D. degree in economics, have been a business and financial writer at *Business Week* and elsewhere, and worked as a stock broker for a brief interlude. A main interest of mine is Socially Responsible Investing. I currently serve as a Director of the First Nations Development Institute, the American Indian Community House in New York City, and the Environmental Research Foundation, and sit on the Council of the Nuyguli Keetoowah Society in New York City.

My political bias is toward the sovereignty of Native American Nations, and their well-being as they define it. I value the traditional ways, and feel that the best way to strengthen our traditions is with education and sophistication. In the area of money management, that means learning how other people and institutions manage money, and applying those insights and skills to managing our own money our own way for the goals that we define, thinking always of our children and all children to come.

... To This Volume

This book describes the investment industry — the players, the fees, and how it all works together. It is a huge industry, with more than $4 trillion in pension fund assets alone. There is even more under management in the mutual fund industry, and endowments (foundations, universities, museums, etc.) are also sizable. Yet in its current form, it is a relatively new industry.

The institutional investing industry came into existence because huge amounts of financial assets have accumulated in this country. Total pension fund assets have grown from $444 billion in 1975 to $3.6 trillion in 1991. Stock and bond mutual funds have ballooned from $46 billion to $807 billion in assets from 1976 to 1991. [Ellis, p. ix] There are also large financial assets in foundation endowments, family trusts, portfolios of individuals, insurance companies and elsewhere. A growing number of Indian Tribes are joining these ranks.

These institutional investors have come to rely on professional money managers because of the legal requirements of fiduciary responsibility, and the corollary need to protect

themselves from charges of being legally negligent. In addition, the growing use of mathematics and statistical theories in institutional investing, the increase in the amount and complexity of investment information, and the increasingly global marketplace for capital, have all combined to make money management more specialized and more professional.

The purpose of this booklet is to introduce responsible tribal officials to the world of institutional investing. Our overview will cover the investment industry and those parts of the securities industry you need to know to manage your tribe's investments. We will cover broker-dealers, brokers, and custodians. We will briefly discuss securities markets and market makers. (The Overview section below explains the distinction between the securities industry and the investment management industry.)

The investment industry is composed of several types of organizations. There are institutional investors, money management firms, consultants who help investors pick money management firms, custodians that actually hold the securities, the securities industry that manages securities markets and executes trades, and regulatory organizations that try to ensure that all this activity functions fairly and legally.

We begin this book with some recent history. Then I describe the industry's regulation, which comes in several layers and several types. We then move to the main types of institutional investors, along with consultants, Registered Investment Advisers, and custodians. Then I lay out the securities industry — broker-dealers, brokers, market makers, investment banks, and clearing firms. The last section is dedicated to fees — how and how much the various parts of the industry charge for their work.

One grammatical note: Throughout, I usually use the term "investment adviser" to refer to the person or company who is investing your money. The legal term is Registered Investment Adviser. On occasion, I substitute the formal name or use the term "money manager," which is commonly used by the industry.

1 The Investment Management Industry — History & Overview

History

Before the 1950s, money management was a staid and sleepy profession, composed only of a few financial professionals who guarded the money of the world's wealthy, often working out of bank trust departments. But during the second half of the 1950s, a new, more dynamic breed of money managers began investing more aggressively, particularly by buying stocks for their growth potential rather than for their current yield. Around the same time, labor union's collective bargaining agreements were emphasizing pension funds, and that created huge employee benefit plans that had to be professionally managed. Then the growth of mutual funds and the performance of a few stocks like Xerox and Polaroid created a demand for investment "performance," the ability to find or generate exceptionally high returns.

After an exciting start, money managers ran into rough going in the 1970s, as inflation increased at 8% a year, while stocks eked out a total return of only 6% and bonds managed only 4%. [Ellis, p. viii.] And then, throughout most of the 1980s, most money managers did worse than the market averages. In other words, from 1983 to 1990, an investor could have done better by investing in the S&P 500 (500 large stocks picked by the Standard & Poors Corp.) than by following a money manager's advice. (The main reason was that the stocks of large consumer products companies performed very well during that period — better than the "growth stocks," and the large companies pulled up the averages.) These findings, as troublesome as they were to money managers, were even more worrisome to institutional investors. To get their portfolios performing at least as well as the overall markets, institutional investors began investing in "index funds" and relying more on consultants to help them decide where to invest their money. The first strategy created a new industry — index funds. The second strategy gave a huge boost to a newly emerging industry — investment consultants.

Overview: Who's Who & Who Does What

It will simplify matters if we separate the **Securities Industry** from the **Investment Industry**. The securities industry is composed of all the components that create and market the securities, like stocks and bonds, that people invest in. The investment industry is composed of all the institutions and companies that are responsible for managing investment portfolios, as well as those that actually make the investments, evaluate them, and help plan them.

The securities industry is made up of:

- issuers of securities — the corporations, governments, hospitals, partnerships syndicates and others that sell or issue securities or "private placements;"
- investment banks, which help market or "underwrite" those securities;
- securities markets, where securities are bought and sold between investors after they have been issued, and the market makers keep trading fair and orderly;
- broker-dealers — the companies, regulated by the National Association of Securities Dealers, that handle securities trades and are charged with ensuring that the brokers who work for them obey securities laws;
- brokers — the people who interface with investment clients. They used to provide investment advice, but increasingly act as salesmen/women and guide clients to professional money managers;
- mutual funds — investment companies that invest in a portfolio of securities and are owned by their shareholders; and
- custodians — the banks or other companies that safeguard the investor's securities and provide information and reports to the investor.

The investment management industry incorporates the entire securities industry, and includes these parts:

- institutional investors — pension funds, foundations, universities, tribes and other institutions that invest capital;
- Registered Investment Advisers — the people or companies that actually manage the money; and
- consultants — the people or companies that help institutional investors select money managers, decide how to allocate their investments between cash, fixed income securities and equities, and do special studies.

This booklet will explain and discuss each of these components of the investment industry, plus most of the parts of the securities industry.

2 Regulation

Most of the laws governing the securities and investment industries in the U.S. were passed in the decade following the onset of the Great Depression, which was widely — but some say unfairly — blamed on fraudulent investment activities. There are seven important federal securities Acts. In addition, states have the right to regulate securities transactions, and some exercise that right with great vigor.

Federal Laws

The **Securities Act of 1933** seeks to ensure that companies selling stock to the public reveal complete and accurate financial information. Specifically, the law requires that companies selling stock to the public must file a comprehensive registration statement and prospectus with the Securities and Exchange Commission, the federal agency responsible for enforcing securities laws. The purpose is to ensure the "fair and full disclosure" of financial and other information about the security and the company, so that potential investors can make an informed decision about whether to purchase the security or not. This information is not meant to say whether or not the security is a good investment or not, but only to guarantee that the information is accurate and that all potential investors have equal access to it. In addition, there are restrictions against people trading on the basis of "insider information," which is information that is not available to the public at the same time.

A lot of securities and issuers are exempt from the Securities Act of 1933. These "exempt" securities and organizations include those that are regulated by other government agencies or not regulated at all. Exempted securities include: federal government securities, municipal securities, commercial paper, and bankers acceptances. Exempted organizations include domestic banks, Small Business Investment Companies, and religious, educational and charitable institutions (which often issue bonds).

The **Securities Exchange Act of 1934** regulates the national securities exchanges and broker-dealers, including business practices in the securities industry. It also supplements the information disclosure purpose of the 1933 Act by regulating in more detail public reporting done by publicly held companies.

The **Public Utility Holding Company Act of 1935** requires registration of electric utility and gas distribution companies, and the **Trust Indenture Act of 1939** regulates the issuance of debt securities over $1 million. In 1940, two other Acts were passed. The **Investment Company Act of 1940** regulated mutual funds and other investment companies, and the **Investment Advisers Act of 1940** regulates, as it says, Investment Advisers, or money managers. It also requires that Investment Advisers register with the Securities Exchange Commission, hence the term Registered Investment Advisers.

State Laws

The states are also allowed to regulate the securities and investment industries. These laws, usually called "blue sky" laws, regulate and require the registration of broker-dealers, investment advisers and agents. They also govern the registration of securities sold in their states and regulate their sale.

Most states (about 35) have adopted the Uniform Securities Act. Usually, state securities laws are more strict than federal laws. For example, while federal securities laws require only the full disclosure of relevant information about a company or a security, state laws may require that a particular security be approved for sale in that state. In California, for example, brokers can not buy stock for clients if those companies have weak balance sheets, i.e. have too much debt. Also, broker-dealers must be registered to conduct business within a state. So a broker-dealer registered in New York, for example, can sell securities to clients who are residents of New Mexico only if it is also registered in New Mexico.

In many states, the state's Banking Department will actually specify which securities can be purchased by savings banks and restricted trust funds, and some states extend such regulations to insurance companies and other fiduciaries. (Fiduciaries are people or

companies that have the legal authority to transact business on behalf of another person.) This "legal list" of securities is usually comprised of high quality, or "investment grade" bonds and equities. (Investment grade securities refers to securities that are rated in the top four rating categories by Moody's or Standard & Poors, two well known securities information and evaluation companies that are discussed in the ***Principles*** book.)

Self-Regulatory Organizations

Instead of regulating the entire investment industry directly, the SEC, under authority of the 1934 Act, allows large parts of the industry to regulate itself. The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) are both Self-Regulatory Organizations (SROs). Each regulates its own members. The NYSE regulates all broker-dealers that are members of the New York Stock Exchange (commonly referred to as the "Big Board," after the board that shows the prices of the most recent stock trades.). All broker-dealers are members of the NASD, which runs the Over-The-Counter (OTC) market, which is the stock market for smaller companies or large companies that prefer not to be listed on the American or New York Stock Exchanges. The NASD also oversees the examinations that have to be taken and passed to become certified to do certain kinds of securities work. Examinations are required to be a stock broker, a supervisor or principal in a broker-dealer, an options trader, and several others.

Regulatory Gaps & Omissions

In spite of all this regulation, there are wide regulatory gaps. Consultants are not regulated by any agency. And the custodian industry is regulated only through the institutional form of the custodian. In other words, bank custodians are regulated by bank regulatory agencies, and broker-dealer custodians are regulated by NASD.

3 Institutional Investors

Institutional investors are organizations that invest their own assets or those it holds in trust for others. They include pension funds, mutual funds and other investment companies, universities, foundations and religious institutions. Tribes with money to invest can be considered institutional investors.

The various types of institutional investors are often regulated by and operate under different laws. For example, foundations operate under state and federal tax law. There are several types of pension funds: Taft-Hartley pension funds, corporate pension funds, and government pension funds. The U.S. Department of Labor regulates Taft-Hartley pension funds. Government pension funds are implicitly regulated by that particular level of government. Corporate pension funds are regulated by the Department of Labor under authority of the Employment Retirement Insurance Security Act (ERISA) and the Pension Guarantee Benefit Corporation (PGBC).

4 Registered Investment Advisers

Registered Investment Adviser is the official name for the individuals or firms that actually manage investment portfolios. They are commonly known as money managers, portfolio managers, or investment advisers. Some Registered Investment Advisers are independent, some are trust departments of banks, some are subsidiaries of investment banks or brokerage firms, some are parts of insurance companies, and there may be other forms. But whatever type of company they are, they must all be registered as Registered Investment Advisers with the Securities and Exchange Commission (SEC).

Independent Registered Investment Advisers

Many Registered Investment Advisers are independent corporations. They can range in size from one person to several hundred employees. To become a Registered Investment Adviser, one only has to have some capital and to file and have approved an application with the SEC. The SEC requires disclosure, but does not concern itself with investment performance.

Registered Investment Advisers as Subsidiaries

Registered Investment Advisers can be subsidiaries of other corporations. For example, many Registered Investment Advisers are subsidiaries of broker-dealers, investment banks, commercial banks, insurance companies, mutual fund groups, and others.

For years, bank trust departments were the only investment management game in town. Many bank trust departments still operate as Registered Investment Advisers. A common view throughout the industry is that bank trust departments are very, very conservative in their investments — so conservative, in fact, that they achieve relatively low investment returns. Of course there are exceptions.

5 Mutual Funds

Mutual funds are one of the hottest investment activities going. There are now more mutual funds in the U.S. than there are companies listed on the New York Stock Exchange. Mutual funds can be purchased directly from the fund or, in the case of load funds (funds that charge a sales commission), through a broker.

Mutual funds are investment companies that own portfolios of securities and sell shares in that portfolio to the public. Essentially, owning shares in a mutual fund is like owning a percentage of that fund's portfolio. The mutual fund manager makes the investment decisions, and your holdings rise or fall with the value of the mutual fund's portfolio. There is an efficient market in mutual fund shares, so someone can buy or sell shares quickly and easily, usually at a value no lower than the "net asset value" (NAV) of that fund. The NAV is the total value of the fund's securities divided by the number of shares outstanding.

Mutual funds are very popular among individuals, but they are also widely used by institutional investors. In recent years, their popularity among institutional investors has been growing, in both defined contribution and defined benefit plans.[1] A 1992 survey found that 34% of all pension funds invest in mutual funds, up from 30% in 1991 and 24% in 1990. Corporate funds use them most, with 39% placing at least some of their money with mutual funds. Of those pension funds currently using mutual funds, 7% planned to begin using an additional fund within the next 12 months, and 3% of the non-users planned to begin using funds in the next year.[2]

Mutual funds provide all the services that institutional investors need. They provide professional money management, diversification of portfolios, liquidity and custodial

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[1] Reminder: With defined contribution plans, employers must contribute a specified amount to the pension plan, but is not responsible for how much is paid out upon retirement. In defined benefit plans, the employer is committed to paying a certain amount to the employee upon retirement.

[2] "Big Job Gets Bigger: Investment Management 1993." Greenwich Associates, Greenwich, CT.

services. You pay a management fee that covers most administrative costs and commissions. Some funds (called load funds) also impose sales charges. These loads are paid when a purchase is made (front end loads), when they are sold (back end load), or over the life of the fund (12.b.1 fees). These fees can almost always be negotiated for large purchases that an institutional investor might be making. If you purchase over a certain dollar amount of a fund, the fee drops. The dollar value at which it drops is called a breakpoint. In addition, there are many no-load funds that charge no sales fees. (Of course they still charge management and administrative fees.)

Invest in Mutual Funds or Hire an Investment Adviser?

The difference between a mutual fund and an Investment Adviser is that all investors in a mutual fund share in the same portfolio of securities. Investors who have their own Investment Adviser, on the other hand, have direct ownership of their portfolio. So with a mutual fund, you share in the community's pot. With an Investment Adviser, you have your own bowl.

Mutual funds and Registered Investment Advisers are regulated differently. Mutual funds are considered "Investment Companies", and are regulated under the Investment Company Act of 1940. According to that Act, an investment company is a corporation or trust in which investors pool their funds in order to obtain diversification and professional management. The Act stipulates the structure of the fund and the fees it can and can not charge.

Just as Registered Investment Advisers follow particular management styles, so do mutual funds. Mutual funds are characterized as growth funds, dividend funds, convertible funds (they invest in convertible stock and bonds), small cap funds, big cap funds, value funds and on and on. Similarly, there are sector funds — funds that invest in one or another sector of the economy. These include utility funds, biotechnology funds, international funds, telecommunications funds, media and entertainment funds and others.

Index Funds

Index funds are of particular interest to institutional investors. Index funds own a basket of stocks that is structured to move in line with a particular index. Some index funds, for example, mimic the S&P 500 or the Russell 2,000 index of small-cap stocks, for example. Therefore, if you decide, as part of your investment policy, that you want to earn returns equal to a particular index, then an easy way to achieve that return (or, more accurately, that return less the mutual fund's fees) is to invest in an appropriate index fund.

One advantage of index funds is that they are very cheap. Since they need very little active management, they generally charge very low fees — usually lower than investment advisers. For example, you can invest in a no-load S&P 500 Index Fund for 25 basis points. Remember, that includes all fees. Or stated more precisely, it saves you all other fees, i.e. management fees, trading commissions, and custodian fees.

Index funds are no-brainers. With an S&P 500 Index Fund, you are essentially "buying the market." It guarantees that you will not beat the S&P 500, but it also guarantees that you will always do about as well as it does.

Unfortunately, all index funds do not always do what they portend. That is, they do not always track an index well. Instead of purchasing shares of all 500 companies in the S&P 500, or all 2,000 in the Russell 2,000, some funds purchase shares in a sample of stocks that have historically moved with those indexes, or shares in companies that are heavily weighted in the index. So before you purchase a particular index fund, check that it has been successful in keeping up with the index it is based on.

Even if you purchase an index fund that does what it portends to do, it will not answer all your investing concerns. You still have to decide your asset allocation, i.e. how to divide your investments between stocks, bonds and cash. You also have to determine which indexes you want to invest in. Do you want indexes that mimic large capitalization stocks, small capitalization stocks, growth stocks, value stocks, international stocks, European stocks, Pacific Rim stocks, or what? (If you want to avoid making that kind of a decision for a while, you might want to consider the Vanguard Total Stock Market Index, which is supposed to track the entire universe of U.S. stocks. But check its overall record first. This mention is most emphatically *not* a recommendation.)

6 Consultants

Investment consultants attempt to provide sophisticated and objective advice to institutional investors. Consultants may be hired to help develop and write your investment policy, decide asset allocation, search for investment advisers, and to evaluate the performance of your investment advisers.

Since there is a great deal of specialized knowledge involved in managing large sums of money, consultants play an important role in the investing process. They have access to data and have the expertise to analyze and present that data in ways that are helpful to trustees or investment committee members. Most spend a great deal of time getting to know investment advisers and gather data about their performance. They range in size from one to several hundred employees. Some are highly specialized. There are consultants that specialize, for example, in selecting and evaluating custodians in asset allocation, or in real estate investments.

Consultants are not regulated by any organization. Therefore, it is important to check the qualifications and references of consultants you are considering hiring. Check their resumes and talk to some of their other clients. The best safeguard, however, is to always be sure you understand what they are telling you, and the reasons they are giving the advise they are giving. Your relationship should be comfortable and trusting. If not, find another consultant.

In fact, even if you are highly satisfied with your consultant, you should consider hiring other consultants for specialized tasks. Not only might those other consultants be better at those tasks, and maybe less expensive, but hiring another consultant will be an exercise in independence and empowerment (to show you are not overly dependent on any one outsider) and will send a signal to the first consultant that you are not to be taken for granted.

It is important to know the business relationships that your consultant might have with investment advisers that he or she recommends, custodians, and others involved in the

investment process. You must beware of potential conflicts of interest. The important issues involve how the consultant is paid and by whom. For example, does the consultant also own a broker-dealer, where the investment advisers do their trades? Conflicts of interest are so important that we have dedicated an entire section to them. See Chapter 10, below.

7 Custodians

Custodians are, as the name implies, the organizations that have custody of the stocks and bonds that investors own. It would be out of the question for any institutional investor to hold the actual paper securities that they own. It would be complex and cumbersome, and slow the trading processing. Every institutional investor keeps its securities with one or more custodians. If the investor has several investment advisers, it probably keeps all its securities with one custodian, called a Master Custodian. It may seem unusual that the securities do not have to be kept by the investment adviser that is actually deciding the trades, but in the securities industry, the trades are agreed to in one place (the markets), and the transfer of the securities from the previous owner to the current owner is accomplished separately.

Custodians can be national banks, trust companies, brokerage firms, or other qualified institutions. Some investors prefer banks to brokerage firms, because banks are better set up for reporting and other aspects of the job, especially when the portfolios are large. Custodians provide a variety of services. In addition to safekeeping, custodians may offer a variety of clerical functions including acting as transfer agent, registrar, or dividend disbursing agent. They often generate a variety of reports for investors.

Types of Reports Generated by Custodians

- monthly transactions
- asset and liability
- performance measurement
- daily cash and settlement transactions
- broker commissions
- pending trades
- fail reports
- securities lending

Increasingly, paper certificates — stock certificates or bonds — are being replaced by "book entry" systems, that are electronic records of ownership. Many Treasury Bills, Notes and Bonds are bought and sold as book entries. Custodians keep track of securities you own whether they are in paper or book entry form.

Here are some issues you will want to investigate before selecting a custodian.[3]

1 Are assets maintained separate from the bank? If not, there is a concern that they might be at risk if the bank runs into financial difficulty.
2 Is all money in your account that is not invested in securities automatically swept into a money market account? No money should ever be left idle. It should be earning interest for you. Even if you're going to invest it the very next day, you should earn interest on it overnight. That is exactly what "sweep accounts" do — they sweep all idle money into a money market account that pays interest.
3 What reports can the custodian prepare?

When shopping for custodians, as in shopping for all parts of your investment operation, be sure to ask lots of questions. Be skeptical. Are they trying to hide something? You can't be too cautious when hiring a custodian. And remember those old adages: If it looks too good to be true, it probably is. And: You get what you pay for.

Usually, you will want a Master Custodian, that will keep the securities for all your accounts and all your investment advisers. Also, having one custodian instead of several can save you money on the fees, which often decline for larger accounts. Be sure to get one that can take care of all your needs, including performance measures and periodic reports.

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[3] From material prepared by Raeann Skenandore for the Oneida Tribe of Indians of Wisconsin, 1993.

8 Broker-Dealers & Brokers

Broker-dealers are the companies that are licensed to sell securities to the public. Brokers are the salespeople who work for the broker-dealers. A broker can not work independently of a broker-dealer, but must be licensed with one. Broker-dealers are regulated by the National Association of Securities Dealers (NASD) and by the Securities and Exchange Commission (SEC). They are also responsible for regulating the activities of the brokers that are licensed with them. So the regulators regulate the broker-dealers, and the broker-dealers regulate the brokers.

There are thousands of broker-dealers, and a huge variety of sizes, styles and business niches. They range in size from one employee to thousands of employees. Some operate merely as adjuncts to other lines of business, such as financial planners, while others have offices around the globe, with modern and sophisticated communications systems, able to invest and sell securities in any major country in the world. There are also many regional brokerages, with offices in various cities within their region.

Broker-dealers also vary in the services they provide. Some offer only retail brokerage services, while others offer a wide range of products and services. Some discount brokerages trade securities at very low prices, and offer practically no other services. Others charge higher commissions on trades, and also provide research on investments, insurance, and other products. Many broker-dealers exist in combination with other investment companies. For example, the largest also do investment banking, provide custodian services, checking accounts, and credit cards.

Brokers, too, are highly varied in their work, their abilities and, sad to say, even their ethics. Some only sit and make "cold calls" to sell stock to prospective clients. Others sell a wide range or products, including life insurance, annuities, mutual funds, options, limited partnerships, and other investment products. Still other brokers provide a wide range of financial services, including financial planning, developing investment policy for individuals or institutions, estate planning, small business finance, investment adviser searches, and portfolio evaluations.

9 Fees: How Companies & Professionals Are Compensated

For some companies and professionals, the method of compensation is straightforward. Many brokers, for example, are paid commissions, and that's it. Some consultants are paid consulting fees, and nothing else. However, in many cases, it's not so simple. Some companies get paid in multiple ways — trading commissions, annual fees, and special fees. Sometimes, this can lead to confusion, and sometimes to conflicts of interest, which we discuss in the next section. This wide variation definitely means that shopping around, knowing what you are buying, and knowing how much you should pay are all critically important.

Comparing prices in the investment world is not easy. There is no publicly available, comprehensive data comparing prices from different firms. There is no Consumer Reports magazine of investment services. The only comparative data that might be available comes from consultants who have gathered it themselves, and it is not free.

Adding to the difficulty of comparison shopping is the fact of having to do business with several different kinds of companies — investment advisers, custodians, brokers and consultants (unless you have a wrap fee arrangement, discussed below, which has its own problems). With all these difficulties in mind, this section discusses methods of payment, and prices when available, for the institutions that constitute the investment industry.

Custodian Fees

There is a great deal of competition in the custodian industry now. This means that there are relatively low prices available, but you need to shop around for the lowest fee from a custodian that provides all the services you need at a high quality. As you shop, you should be wary of offers of "free custody." Some firms offer custody at no additional cost

as part of the services they provide if you have your accounts with them and run your trades through them. This is a cost that they absorb to get your other business. Other firms, however, may not charge directly for custodial services, but may charge higher fees for other services.

There are a lot of hidden fees in the custodian relationship, like for special reports and certain securities transfers. Indeed, the majority of master custodians' profits are made from the ancillary services they provide, outside of plain vanilla custody.

In general, you want to avoid all-inclusive fees and pay separately for each service, or each transaction. All-inclusive fees can hide a lot. For example, you are unable to see how much a particular service costs you. Also, if your fees are based on transactions and not assets, then they will not increase when your assets increase. But the advice to pay separately for each service is only a general rule. In this era of price competition, some all-inclusive fees might be so low that they do provide the best deal.

It could be that a mix of fees is what you will end up with: some asset based fees, some fees based on the number of investment advisers you have, a fee for different accounting requirements for different plans (e.g. your pension plan may be accounted for differently than your scholarship fund), fees based on the number and types of transactions that occur with your portfolios, the number of different countries represented in your portfolios, and other fees based on unique or unusual services.

To give an idea of how fees are stated, and the variety of ways in which fees are charged by custodians, here are six price quotes researched by one tribe in a recent search for a new custodian. They asked for one quote for assets of $2.5 million, and another quote for assets above that amount. Note that some of the price quotes are based mostly on assets, while others are based partly on assets and partly on services.

Consultant Fees

Consultants may charge an annual retainer, on a project basis, and on an hourly or daily basis. The retainer, similar to how lawyers charge, is a flat annual fee. Normally, the

Price Quotes from a Custodian Search October, 1994[4]

Custodian A: All inclusive fee of five basis points (which is 0.05%) of assets up to $2.5 million (which equals $1,250.00), dropping slightly as the amount of assets rises above $2.5 million.

Custodian B: Base rate of $3,751 for $2.5 million in assets, plus transaction costs, and fees for on-line access and the money market account. Over $2.5 million: $4,502 base rate plus manager fees of $6,502 (for four managers).

Custodian C: Base fee of $600 plus $25 per transaction, plus a minimum of $9,500 on assets held. The asset fee rises to a maximum of $10,500.

Custodian D: 10 basis points (which is 0.10% of the assets, or $2,500 for an account of $2.5 million) plus $250 per investment manager.

Custodian E: 10 basis points plus $1,000 per manager.

consultants charge against the retainer, meaning that they keep track of their actual time spent on a job. No additional payment is made if those hourly bills are less than the retainer. However, if those bills exceed the amount of the retainer, then the client must pay the additional amount. The hourly rates charged by some consultants can be high. Some lead or principal consultants in a consulting firm may charge an hourly rate of up to $300, while other employees may be billed for at $100/hour.

A retainer without the possibility of additional charges for additional hours can run $30,000 to $40,000 per year.

Some investors hire consultants for a flat fee just to perform one project. For example, an asset allocation study might cost $10,000. Similarly, a search for an investment adviser might run anywhere from $5,000 to $10,000 to $15,000.

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[4] From material prepared by Raeann Skenandore for the Oneida Tribe of Indians of Wisconsin, 1993.

One endowment fund with about $1 billion spends approximately $100,000 to $120,000 per year on consultants, including their travel, lodging and other expenses. That is about one one-hundredth of one percent. It would not be unusual for smaller funds to spend on consultants from $10,000 to $20,000 to even $30,000 in a busy year.

A growing number of institutional investors employ more than one consultant. For example, they may have their lead consultant on retainer and then hire another consultant for a particular project, such as managing a search for a new investment adviser, or doing an asset allocation study. The multiple-consultant strategy provides some checks and balances. It keeps consultants on their toes if they know that the client knows and uses other consultants.

Even though consultants are not regulated, many become Registered Investment Advisers or even broker-dealers. For the client, that means that ADVs (Advisor's disclosure forms) are available for those consultants registered as Registered Investment Advisers, and ADVs contain a great deal of information about the firms, including resumes of the principals in the firm and business arrangements with other companies.

You might want to ask your consultant if he or she is a Registered Investment Adviser, and, if so, ask for and read a copy of the ADV.

Expenses incurred by the consultant in the line of work are generally paid separately. Normal expenses may include travel to meetings, lodging and meals.

Some consultants are paid indirectly, through commissions. These are called "soft dollar" arrangements, and mean that trades are done by particular brokerage firms, either a broker that the consultant owns or one that the consultant has a special arrangement with. If a consultant is being paid, for example, $25,000, then commissions totaling more than that must be run through the broker-dealer that pays the soft dollars to the consultant.

How much more in commissions than the total due must be paid? Often, the amount of commissions paid in order to pay a bill can be as much as double the dollar size of the bill. So $2 in commissions must be paid to satisfy every $1 of a bill. But some soft dollar arrangements use lower ratios. There is one company that is paid for data processing

services in soft dollars at a rate of 1.2. That means that trades generating total commissions valued at 1.2 times the amount due must be run through that firm's broker-dealer, or through the broker-dealer it has an arrangement with. In this case, if the amount due is $25,000, then $30,000 in commissions must be paid (1.2 X $25,000 = $30,000).

In contrast, if you were paying that bill in "hard dollars," you would merely write a check for $25,000.

Investment Adviser Fees

The norm for investment advisers is to charge a percent of the amount of assets under management. It is also normal for that percent to decline as the assets increase. A typical fee structure for an equity investment advisers might be as follows:

Typical Investment Adviser Fees for a $25 Million Portfolio

Amount of Assets	Fee Rate	Fee Amount	
Under $1 million	1.50%	$15,000	(= 0.015 X $1 million)
Next $4 million (to $5 million)	1.00%	$40,000	(= 0.01 X $4 million)
Next $15 million (to $20 million)	0.75%	$112,500	(= 0.0075 X $15 million)
Over $20 million	0.50%	$25,000	(= 0.005 X $5 million)
TOTAL		$192,500	

Note that each percent is calculated not for the entire portfolio, but on the additional amount, or the amount above the previous cutoff. So 1.5% is charged on the first $1 million. The fee drops to 1% for the next $4 million (which brings the portfolio to $5 million). The fee drops again to 0.75% for the next $15 million (up to $20 million). Any amount over that is charged at 0.5%. The total fee for a portfolio of $25 million is $192,500, which is 0.77% of the total portfolio.

Equity managers charge more than fixed-income managers. It costs less to manage larger amounts of fixed-income securities, because less research is traditionally required, and the sizes of trades and positions tend to be larger. For example, one tribe pays its equity managers 1% each, and its fixed-income managers 0.5% and 0.45%.

Also, passive investment strategies cost much less than active managers. Index funds, for example, which are mutual funds that track certain financial indexes, such as the S&P 500, may charge as little as 40 basis points (0.4%) for all services — management, commissions and custodian services — compared to wrap fees of around 200 basis points (or 2%).

Some investment advisers charge fees based on their performance — the better they do for you, the more you pay them. For example, a performance based fee might be 20% of the gain, but zero if there is a loss. Or it could be 25% of the gain in excess of some benchmark, such as the S&P 500.

Brokers

Does anyone need a broker, once relationships are established with Registered Investment Advisers, custodians and consultants?

Brokers are salespeople. They may make the initial contact with the Institutional Investors, and even close the deal. But after that, they are not needed. Just think about what brokers do: they sell, and usually to individuals. But institutional investors have specialized organizations working for them that do everything that brokers do for individuals: manage money, consult on asset allocation, execute trades, and safeguard the securities,

Commissions on Securities Trading

There is a great deal of competition for the business of trading securities, and that competition has pushed prices way down. But it has also created wide variations in commis-

sions charged by different firms. It is important to seek out the best commissions on your trades, but it is also important to get the best execution, as discussed in the next section. Remember, too, that if you have money managers, they are directing your trades to some broker-dealer. They should be trying to get the best deal for you, including low commissions and good prices, because it will all show up in their performance numbers. In other words, if your money managers fail to get good deals for you, their performance might suffer and they might lose your account. However, they may have obligations to other parties that require them to execute their trades through certain traders, even though the commissions might be higher there.

Equity commissions. Today, for most institutional investors' sizes of purchases or sales of common stock, commissions should not exceed six or seven cents per share, on average, and three cents per share is not unusual.

Smaller trades, however, are often more expensive than larger trades, and more complex securities are also more costly to trade, whether they are international stocks or limited partnerships.

Fixed-income commissions. Commissions on fixed income securities transactions are less than for equities. For Treasury securities, which have the largest and most liquid fixed-income market, trades are normally done in lots of $5 million for Bills and $1 million for bonds. The spread between the bid and asked price (what buyers are willing to pay and sellers are asking) is normally 1/32 of a point, but can rise to 1/4 of a point for smaller lots. 1/32 of a point translates into 3.125%, which comes to $31,250 on a $1 million bond.

Commissions on corporate bonds are invisible, because they are imbedded in the bid and asked price. A bond may have a bid price of 102 1/2 and an offering price of 103. If someone sells the bond at 102 1/2 to a broker who then offers and sells it at 103, then that half a point difference is like a commission.

When you buy or sell a bond, the broker-dealer calls around to several bond houses to get the best price. In other words, they shop it around. As you can imagine, this is a very hazy area. The lack of posted, public prices is in stark contrast to equities markets, where bid and asked prices are readily available. If you are doing your own trading, you have

to be sure that brokerage houses are getting you the best deal. If your money managers are handling your portfolio, and therefore your trades, they should be doing their trades through broker-dealers that will shop around for the best price.

Wrap Fees

Wrap fees accounts charge one fee for all the services associated with an investment account. For a fee that normally ranges from 2% to 3% of assets, a broker-dealer will provide consulting services, help select an investment adviser, pay all trading commissions and other transaction costs, cover all administrative fees, and provide custodian and all other services needed. The wrap fee usually includes the investment advisory fee, as well.

Wrap fees have become popular during the past several years because large broker-dealers like Merrill Lynch and Shearson Lehman Brothers (now Smith Barney Shearson) began pursuing business strategies of accumulating as many assets as possible under management. Many other broker-dealers have followed a similar strategy. Once they have the assets in house, they charge fees based on the amount of assets under management and also offer a wide range of financial services — brokerage services, retirement planning, life insurance, mortgages, home equity loans, and savings accounts.

The other trend encouraging wrap fees is the desire of stock brokers to stop giving advise on individual stocks, preferring instead to sell financial products. They can make plenty of money as salespeople, and they can avoid law suits by angry investors who may have suffered losses on stocks their brokers recommended.

With wrap accounts, brokers work with a group of investment advisers with whom their broker-dealer has contractual relationships. They help their clients decide what kind of investment they want to make, e.g. bonds, large-capitalization stocks, growth stocks, value stocks, real estate, or venture capital. Then the broker helps pick from among the investment advisers in their fold that do that kind of investing. For the purposes of these wrap accounts, the investment advisers will accept smaller investments than they otherwise would. For example, they will accept a minimum of $100,000, when their normal

minimum might be $1 million. But the investment advisers do not have to service the account; that often time-consuming job is left to the stock broker.

Wrap fee accounts have opened some of the best investment advisers in the country to smaller retail clients. Sometimes, they have achieved excellent returns in this way. Still, there are several problems with wrap fee accounts. They are expensive, allow for the possibility of conflicts of interest, encourage investment advisers to trade less than they might otherwise, and provide access to only a limited selection of investment advisers.

- Expensive. Fees depend on the size of the account, the type of securities under management (e.g. debt or equities), and the investment advisers. (See the Table below for several examples of fees.) Two parts of the fee that can be excessive are the broker's cut and commissions. The broker is paid indefinitely, even though his or her services might only be what an investment adviser would normally do. While, the wrap fee may save money if many trades are made, it is more likely to lead to limited numbers of trades and overpayment of commissions.
- Limited selection of investment advisers. With a wrap fee arrangement, you will only have access to those investment advisers that have an arrangement with your broker-dealer. If an investment manager has not signed agreement with your broker, that investment manager will not be in the group your broker wants you to choose from.
- Encourage less trading. Since the total amount of fee and therefore trading commissions to be paid is fixed, some investment advisers may trade in your portfolio less than they would under normal arrangements. In other words, in volatile securities markets, a fairly large amount of trading may be called for to maximize the value of your investments. But with total commissions fixed, investment advisers will be likely to limit the amount of trading they do. Some very large investment advisers refuse to accept accounts that limit the amount of trading they do.
- Potential for conflict of interest. With wrap fees, there is a danger that brokers will guide investors toward investment advisers with whom they have the most lucrative deal, and these may not be the ones that are best suited to the investor's needs. Another potential conflict of interest lies in brokers guiding investors toward those investment advisers, custodians and others who will run trades through the brokers or do other things that might benefit the brokers at the expense of the investors.

The advantages are that wrap fees are set in advance, so no matter how may trades are transacted in an account, the cost to the client can not rise. Thus the portfolio manager

has no incentive to "churn" the account (i.e. trade excessively in order to earn more commissions). On the other hand, there may be an incentive to trade less than called for, since at some point the commissions would have to come out of the securities firms' own pocket. Other disadvantages of wrap fee arrangements to the client are that they are often expensive and can encourage conflicts of interest, which are discussed below.

At one large firm that uses wrap fees a great deal, they start as high as 3% of the amount of the portfolio, for small portfolios, from $100,000 to $500,000. For the next $500,000, the fee is 2.20%. The fee is 1.90% for the next $1 million, and falls to 1.70% for the balance over $2 million. Remember that these are marginal fees. So for example, the fee for a $300,000 account would be $9,000. For an $800,000 account, the fee would be 3% of $500,000 plus 2.20% of the next $300,000, or $15,000 + $6,600 = $21,600. As the following table shows, an $8 million account would cost $15,000 for the first $500,000 (500,000 X .03) plus $11,000 for the next $500,000 (500,000 X .022) plus $19,000 for the next $1 million (1,000,000 X .019) plus $102,000 for the last $8,000,000 (.017 X 6,000,000). The total fee would be $147,000.

Calculation of a Wrap Fee for an Account of $8 million

Account Fair Market Value		Annual Fee Rate	Annual fee	
Up to	$500,000	3.0%	$15,000	
Next	$500,000	2.2%	$11,000	
Next	$1,000,000	1.9%	$19,000	
Balance Over	$2,000,000	1.7%	$102,000	(.017 x 6,000,000)
TOTAL			$147,000	

Everything is Negotiable

Always remember two things about prices in the investment industry:

- you can often find better prices by shopping around; and
- many prices are negotiable.

Of course price is not always the most important variable, because the services included in the deal and the quality of those services can vary greatly. Better service is often worth a higher price. We discuss that issue in the next section.

Remember, too, that negotiating should not be seen as a fight to see who ends up as King of the Mountain. Negotiating should be an exploratory process where both parties articulate their needs and resources and try to find a way to work together where both gain; where both win.

Fees Aren't Everything — Performance Can Be More Important

When buying or selling securities, the execution of those trades is very important. Some traders can sometimes get you higher prices when you sell a security and lower prices when you buy. There are several ways they might do this. For large trades, the trader might want to sell the block over a span of several days, to prevent the sudden sale of the large block from pushing down the price of the stock. Another technique is to check prices in several markets — New York Stock Exchange and regional exchanges like the Boston, Philadelphia, Midwest and Pacific Stock Exchanges. Prices might be slightly higher or lower in other markets. A third way sometimes used in large firms is to "cross" big blocks of stock with another client of the same firm that is selling what you're buying or buying what you're selling.

In those ways, traders can often save their client one eighth or one sixteenth or one thirty-second of a point. That may not sound like much, but it can add up to big bucks on big trades. Also, that one eighth to one thirty-second of a dollar per share can be more than the commission you are paying. One eighth is 12.5 cents, one sixteenth is 6.25 cents, and one thirty-second is 3.125 cents per share. You should be paying about three cents per share on your big trades, and no more than six cents on even your small trades.

Don't be overly concerned with fees! Fees are important, but so is performance. In fact, performance can be much more important than fees. Investment management, securities trading, custodian services and consulting services — all of these are areas where quality is extremely important. Often, the way a trade is "executed," or carried out, can gain

you or cost you more than the commission costs. And a good investment manager is worth way more than the fee you pay. Ditto for a consultant.

So when thinking about fees, remember to always keep your eye on the ball. Fees are but one part of what is most important to you: the net return on your investments.

10 Conflicts of Interest

Conflicts of interest are rife in the world of finance, and must constantly be watched for. For example, consider a consultant that owns its own broker-dealer, and does all the trades through its own broker-dealer. It seems simple enough: the institutional investor pays for the consulting with the commission income generated when trades are made. Then you don't have to pay a separate consulting fee.

But a deeper look reveals potential problems.

1 The consultant makes more money when money managers do more trades. Therefore, the consultant might guide an investor to managers that turn their portfolios over more often than to those that trade less often.
2 The consultant may not consider or recommend money managers who refuse to execute their trades through the consultant's broker-dealer;
3 When a money manager is dismissed by an investor, often with the agreement and even the initiation of the consultant, that money manager's portfolio is often liquidated, which generates a great deal of commissions for the consultant, who recommended the switch in the first place.

To guard against investment advisers paying commissions to themselves or to some company they have a close relationship with (and who might be obligated to return "the favor" some day), one endowment requires that all of their Registered Investment Advisers disclose who they sold every security through.

Another way to guard against conflicts of interest is to clarify early in the relationship what you will and will not tolerate from your investment adviser. One endowment sends an 8 page letter to each investment adviser, stipulating what it will and will not allow.

Here are several practices that will help you avoid conflicts of interest or potential conflicts of interest:

- Open and separate negotiations. Require open and separate negotiations with all parties involved. That way there can be no hidden fees or cross subsidies. And you will know what each activity and service costs you, so that you can easily compare costs.
- Anyone can have a chance for any of your business. You should always allow anyone who does not have any of your business to bid or compete for it. Wrap fee arrangements, by contrast, locks you into only a few investment advisers, traders and custodians.
- Require in your contracts that the other party will not charge you any more than what they charge anyone else. This is commonly called the "most favored nation" clause, which originated in trade negotiations between countries.

11 Resources

These are few good and complete overviews of the investment industry. There are, however, many sources of information available, including periodicals and books.

Investment Policy, Charles D. Ellis, Irwin Professional Publishing, Homewood IL, 1993.

Pensions and Investments magazine, issued monthly, published by Crains Business Publications, Chicago, IL.

Institutional Investor magazine, issued monthly, published by Institutional Investor, 488 Madison Ave, New York, NY 10022.

Nelson Publications, Port Chester, NY 10573. This company publishes several very useful directories, including ones for Consultants and Investment Advisers.

The New York Institute of Finance has an extensive catalogue of "Publications for Investment Professionals," including books and cassette tapes, ranging from the technical to the popular. Write the NY Institute of Finance, 2 Broadway, New York, NY 10004-2207, or call 800-227-NYIF (6943). Several of the following publications are available from that catalogue.

Handbook of Investment Products and Services, Victor L. Harper, New York Institute of Finance, New York, NY.

The Stock Market, Richard Tewels and Edward S. Bradley, John Wiley & Sons, New York, NY.

Foreign Exchange Markets in the United States, Roger M. Kubarych, Federal Reserve Bank of New York, New York, NY.

The Handbook of the Bond and Money Markets, David M. Darst, McGraw-Hill, Inc., New York, NY.

The Money Market: Myth, Reality and Practice, Marcia Stigum, Irwin Professional Publishing, Homewood, IL.

Securities Law Handbook, Harold S. Bloomenthal, Clark Boardman Company, Ltd., New York, NY.

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