The pros you've hired to manage your money are more deeply conflicted than you may think. BY JUSTIN FOX

FROM RUSSIA WITH LOVE: This double agent *did* look out for James Bond—because she fell for him. Don't expect the same from your fund manager.

PHOTOFEST

DOUBLE AGENTS

THE MARKET-TIMING SCANDALS OF THE PAST months have made one thing very clear: Mutual fund executives don't always have their customers' interests at heart.

But then, wouldn't it be strange if they did? The people who run mutual funds have needs, hopes, and dreams of their own. Most obviously, they want to make money. The same is true for brokers, hedge fund managers, and financial planners. These people are *agents*, hired to act on someone else's behalf. Many do a perfectly good job. Many don't, usually for the simple reason that their interests and those of their clients don't happen to coincide.

That is what economists call the "agency problem." They have been studying it at least since the 1700s, when Adam Smith mused in *The Wealth of Nations* about the conflicting interests of landlords and sharecroppers. But interest in the agency problem, much of it focused on the relationship between corporate shareholders and CEOs, really took off in the 1970s. The big question at the time was how to motivate managers to work tirelessly on shareholders' behalf instead of just padding their expense accounts. For a while it looked as if the answer was to let executives participate in shareholders' gains by means of options and other stock-related compensation. We all know how that turned out: Some executives took such large helpings that nothing was left for shareholders.

That danger is inherent in the principal-agent relationship. The only way to get an agent to identify completely with your interests is to let him have all the profit, which obviously is not in your interest. So we

must make tradeoffs between giving our agents enough incentive to work hard for us and keeping them from taking too much of our money. Those tradeoffs are especially stark when it comes to managing money. In other businesses, companies that charge substantially more for a product than it costs them to make it are said to have created a valuable brand. But when a mutual fund manager, broker, or financial advisor charges you more for his services than they are worth, the value of those services—which are meant, after all, to maximize your wealth—declines. In money management, you get what you don't pay for.

Just how much are we paying? John Bogle, founder of the Vanguard mutual fund family and perennial industry gadfly, estimates that Wall Street's annual take—from mutual fund fees, brokerage commissions, bid-ask spreads, and the like—is in the neighborhood of $500 billion, of which $300 billion comes out of the equity business. That's 2.3% of the total market capitalization of U.S. stocks—and it's being taken out of investors' pockets every year.

Some of this is the unavoidable cost of capitalism. It pays for the infrastructure that makes investing possible and rewards those who come up with useful market innovations. But that still leaves billions upon billions of dollars that can best be described as the cost of Wall Street's agency problem. The problem is probably most acute among the people who got Wall Street started: the brokers. "The industry has forever been kind of fundamentally malformed," says John Hirtle, a former Goldman Sachs broker who for the past 16 years has been running a Pennsylvania-based investment firm called Hirtle Callaghan. "If you look at the way the public receives investment advice, it's receiving advice from the manufacturer. Investment banks manufacture securities. It's like getting your health-care advice directly from Merck."

That doesn't mean brokers are always bad for your financial health. A broker who spends her career in one community, sits next to her clients at Rotary Club meetings, and sends her kids to the same schools that they do has lots of reasons to give good advice. But the financial incentives faced by a traditional broker are all about selling—especially selling her own employer's products. That is equally true of those who call themselves financial planners but get commissions from selling mutual funds or variable annuities (we'll discuss the less conflicted variety of financial planner later).

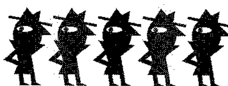
An added conflict evolved at big brokerages as trading commissions shrank and investment banking became a big profit center in the 1980s and 1990s. Some Wall Street firms came to see the executives who gave them IPO and M&A business as their true customers, so the "research" they handed out to brokerage customers evolved into puffery. In effect, they'd become double agents, shifting their loyalty to new paymasters while still collecting from the old ones.

That, you may remember, was *last* year's stock market scandal. Compared with brokerages, mutual funds had a squeaky-clean reputation, so this year's revelations that several fund companies allowed employees and favored hedge funds to trade in and out of their funds after-hours to make a quick buck have been especially shocking. Mutual fund companies get paid a percentage of the assets they manage, which means they're not as obviously conflicted as the big brokerages are. "In the long term ... our interests and those of our shareholders are very closely aligned," says Paul Haaga Jr., executive vice president of Capital Research & Management and chairman of the Investment Company Institute, the mutual fund trade group. But while employee-owned Capital, which manages the American Funds, has a good record of keeping focused on that

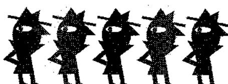
"The public is receiving investment advice from the manufacturer. It's like getting health-care advice directly from Merck."

And the Conflict-o-Meter says ...

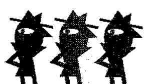
Some traditional brokers are trustworthy, and some fee-only planners aren't. But the greater the conflict of interest, the greater the chance that the one who benefits most isn't you. The more red agents below, the more potential conflicts.



TRADITIONAL BROKERS They make money when you trade, and they make money when you buy their employer's products. Guess which ones they're more likely to push?



COMMISSION-BASED FINANCIAL PLANNERS They're similar to brokers. Plus, they want to sell you whole life insurance.



MUTUAL FUNDS The more assets they gather and the higher the fees they charge, the more money they make.

HEDGE FUNDS They make their money by making you money. But they take a big cut—and they can take big risks.

DISCOUNT BROKERS They charge lower fees than traditional brokers do, and they have fewer in-house products to flog. But it's in their interest if you trade a lot.

FEE-ONLY FINANCIAL PLANNERS Their fees are transparent, but they can be steep.

YOU No conflicts. Just a few million years' worth of evolution pushing you to make bad investment decisions.

long term, the fund business as a whole does not.

The problem "starts with the way they call them mutual funds, like it's the Mutual of Omaha or some farmers' co-op," says U.S. Senator Peter Fitzgerald, an Illinois Republican who emerged this fall as an outspoken critic of the fund business. "The whole name of the industry is false and misleading." While mutual funds are formally structured as nonprofit organizations whose shareholders decide who'll manage the money and how much they can charge, all fund families but Vanguard are effectively controlled by a separate investment advisor. And most of those advisors are as far from nonprofit as you can get.

With profits at publicly traded fund advisors regularly topping 25% of revenues, banks, insurance companies, and brokerage firms have been buying into the fund business in a big way in recent years. These new owners understandably want a return on their investment, and they aren't always willing to wait around for the "long term" that Capital's Haaga talks about. That puts fund managers under pressure to deliver big profits *now*.

One way to do this, of course, is to run mutual funds that beat the market. But when it comes to the large-cap stocks that dominate the portfolios of big mutual funds, there is almost no evidence that fund managers *can* consistently beat the market. (What evidence there is favors value investors, but only over the very long run.) With off-the-beaten-track securities like small-cap stocks, smart money managers probably can make a difference. But the ability to outperform the market declines as funds get bigger. So a market-beating small-cap manager who wants to keep beating the market must turn away new investors—behavior that's anathema to the managers of a profit-maximizing public company.

In sum, being an astute and responsible manager of clients' money doesn't pay, at least not in the short term. What pays is charging high fees and aggressively gathering assets. The problem with high fees is obvious: They come right out of shareholders' pockets. And the proven ways to bring in new assets—advertising, paying brokers to sell the fund, creating new funds that specialize in the hot sector of the moment—don't make existing shareholders any richer.

Indeed, the practices of the mutual fund industry —coupled with the performance-chasing ways of investors—appear to have left shareholders *poorer*. By examining fund inflows and outflows from 1984 through the end of 2002, Boston-based research firm Dalbar calculated that the average equity mutual fund investor made only 2.57% a year. That's less than inflation during a period in which the S&P 500 returned 12.22% a year.

Is there a better way? Well, yes, if you have plenty of savvy and plenty of dough. But the agency problem never entirely goes away. For example, you can put money into hedge funds, those unregulated mutual funds traditionally open only to investors with a net worth of more than $1 million. Hedge fund managers pay the bills by charging a flat percentage fee on assets under management, just as mutual funds do. But they get really rich from performance fees, so they're usually more interested in beating the market than in gathering ever more assets. Several academic studies have shown that hedge funds did in fact outperform both market averages and mutual funds in the 1990s. To justify the huge fees that most managers charge, though, outperformance will have to continue—and with ever more hedge funds being launched, that is unlikely.

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Even less conflicted are the so-called fee-only financial planners, who offer not the chimerical promise of beating the market but personalized advice on how to achieve financial goals. Fee-only planners charge by the hour, by the project, by percentage of assets under management, or some combination thereof. The catch is how much they charge. Because their advice is for you and you alone—and because you and you alone are paying for it—fee-only planners can't use mass-production techniques or charge mass-production rates. One industry source estimates that fee-only guidance makes financial sense only for those with at least $500,000 to invest.

Gary Schatsky, a New York–based planner and spokesman for the National Association of Personal Financial Advisors—the fee-only trade group—contends that even with a net worth of $100,000 it pays to fork over a few thousand dollars for a one-time review of investments, insurance, and taxes. But ongoing, personalized, unconflicted financial guidance remains the province of the wealthy. Billionaires have always been able to set up their own full-time investment offices. Now there are also firms like Hirtle Callaghan—whose co-founder we quoted earlier—which provides the services of a "chief investment officer" to accounts of $5 million and up.

If your stash is in the low six figures (or for that matter, five or four), there's no clear solution to the money-management agency problem. Which leaves your very own self. After all, you can be trusted to act in your own interests, right?

Actually, no. Most people are shockingly inept at making decisions involving uncertainty and risk, which is what investing is all about. Princeton psychologist Daniel Kahneman shared last year's Nobel Prize in economics for his groundbreaking research into the mental shortcuts humans take when making risky decisions—probably evolutionary leftovers of the days when we devoted much of our mental energy to avoiding being eaten by tigers. Reams of academic research now document investors' tendency to buy high, sell low, and generally behave in as self-defeating a manner as possible.

So there *is* good reason to hire an agent to look after your money. You just need to be very, very careful about how you pick him and how you pay him. F

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