Excess Returns

Monthly insights for investment marketing and sales professionals

July-August 2014 Volume 4 | Number 7

Fraud is everywhere. You need only open your email on any given day to become a potential fraud victim. In the capital markets, the specter of fraud inspires fear and loathing among prospective investors and underscores the need for clarity and integrity in investment marketing. This issue of *Excess Returns* considers the investment marketing lessons we can learn from fraud.

With best wishes,

Liz

Liz Hecht
Founder, Principal and Director of Research

In This Issue

The By-Products of Greed
Under the Mattress
Enough.

Alpha Partners is an investment marketing firm specializing in research and presentation strategy. Our goal is to create alpha (excess returns) by helping investment firms win, keep and diversify assets under management.

Alpha Partners LLC
435.615.6862
alphainvestmentmarketing.com

The By-Products of Greed

I have been indulging lately in my favorite guilty pleasure: watching back-to-back episodes of CNBC's *American Greed*. This chronicle of white collar crime has all the fascinating predictability of Gordon Ramsay's *Kitchen Nightmares*. In *Kitchen Nightmares*, the location may be different, but the plot is always the same: the kitchen is dirty, the employees do not get along, the menu is confusing, the decor is passé and the restaurant is on the brink of financial ruin … until Mr. Ramsay comes to the rescue.

In episode after episode, the plot of *American Greed* is also always the same: false guarantees are made, diversification is absent, the perpetrators live large and far beyond their means and gullible investors frequently lose everything they have. Only with investment fraud there is no Gordon Ramsay to the rescue. If they are caught, the perpetrators often go to jail, but this brings little solace to the victims. "At least she gets three hots and a cot [three hot meals a day and a bed]," laments one victim of a perpetrator in prison, "while I sometimes don't know where my next meal is coming from."

So what does all this have to do with sophisticated institutional investors? A lot, as it happens. Starting with Season 1 in 2007, the list of *American Greed* episodes includes the prominent CIO of a company that once managed institutional assets, CEOs of large public companies (Tyco, WorldCom and HealthSouth) and of course Bernard Madoff, who defrauded the 4,800 investors in his $64.8 billion hedge fund. Madoff's investors inlcuded retired firefighters and schoolteachers as well as endowments, foundations and formerly well-regarded funds of hedge funds.

The Lessons of Fraud

From my perspective as an investor, investment marketer, student of fraud and potential future victim, I see several investment marketing lessons in all of this:

Be prepared to ask and answer questions about fraud. It is surprising that more RFPs and RFIs[1] do not include explicit questions about fraud. Because, let's face it, virtually any investment process, no matter how robust, remains vulnerable to misinformation and outright lies. Information can always be fake and the lawyers, accountants, fund managers and government regulators hired to protect investors sometimes fail to do so. If your firm practices fundamental, bottom-up research, how has your team's hard work and experience protected your investors from fraud in the past? And what additional due diligence might your company have incorporated into the investment process to protect investors in the future? If yours is a quantitative investment strategy, how do the rules of portfolio diversification protect your clients? And if your process relies almost wholly upon information produced by other investment firms — as in a fund of funds, for example — how do you safeguard your investors against inaccurate reporting? The answers to these questions can reveal a potential process weakness, show the process to be particularly strong given superior due diligence or demonstrate skill based on good old-fashioned gut instinct.

Consider who your investors are and why they need the money. By becoming a student of fraud and its victims, one develops a better sense of who the end investors are and why serving them well matters. Fraud victims can include universities unable to provide the same number of scholarships as previously, foundations forced to close and municipal funds forced to scale back on critical services such as sanitation or road repair. People who lose their homes, who are forced to go back to dangerous physical work after having retired or who no longer have the money needed to provide special care to a sick child. People like Miriam Siegman, a Madoff victim, 65 years old and living on food stamps, who testified with great eloquence at Madoff's sentencing: "Victims became the by-product of his [Madoff's] greed. We are what is left over, the result of stunning indifference [on the part of] politicians and bureaucrats."[2]

Develop a healthy respect for your firm's compliance department. Early in my career, I used to dread meeting with legal and compliance teams because of the dampening effect legal concerns can have on marketing language. "Strong investment returns" become "solid investment returns" (whatever that means) and examples that clarify the investment process frequently are gutted, cut altogether or larded with incomprehensible footnotes. But if you become familiar with the misrepresentations of the world's worst fraudsters, you begin to appreciate the critical role that compliance plays. If you want to have a better relationship with your firm's compliance department and a better understanding of the need for transparency in reporting, studying fraud is a great place to start.

Avoid opulent displays. As any *American Greed* fan will tell you, the face of fraud is one of conspicuous consumption. Think Kenneth Lay consulting with Jeffrey Skilling on fabric swatches for Enron's new corporate jet in the 2005 documentary, *The Smartest Guys in the Room*, or former Tyco CEO Dennis Kozlowski's $6,000 shower curtain. And while the frugal among us have been taught to mistrust the trappings of wealth, most fraud victims are impressed by lavish spending, seeing it as a sign of success. "They were driving Hummers and wearing Italian suits," says an *American Greed* victim describing her first meeting with the individuals who led her to financial ruin. The marketing lesson for investment companies is to project a physical image to the world that is formal and professional without ostentation.

Support investor education. In school, most of us were taught many things we would never again need to know. Courses on the basics of finance and investing, however, were notably absent from most high school and even college curricula. But one could argue that the future of the investment industry depends on preventing fraud, and one of the best forms of prevention is teaching investors to diversify and mistrust any form of guaranteed return.

Over the course of an average week, I typically receive fake solicitations from banks and credit card companies, fake tax notices and even fake notices to appear in court. I always dutifully report these while experiencing a sense of futility: the only follow-up I ever receive, if any, is a formulaic email. I once called the Utah Attorney General's office to report a potential instance of fraud. The woman who took my call did not want to be bothered even pretending that she was concerned about my possibly being a fraud victim. In fact, she made fun of me ("Maybe you could file your own lawsuit," she said, dripping with sarcasm).

I hung up feeling less angry than puzzled. But then I remembered how busy her office must have been at that time because the then-Attorney General of Utah was in the midst of being investigated for, yup, you guessed it: fraud.[3]

Under the Mattress

Every time the latest Wall Street scandal breaks, certain reluctant elderly investors in my family say to me "They are all a bunch of crooks and I am going to put all of my money under the mattress." Whereupon I take a deep breath and explain, again, all the good things the capital markets have to offer and where we would all be without them. But then working against me there is the perception of Wall Street perpetuated by Hollywood. Who can forget Leonardo DiCaprio as Jordan Belfort in *The Wolf of Wall Street* literally giving the finger to unsuspecting investors on the phone? And then of course there are the negative perceptions created not only by prominent fraudsters but also by the headlines about high-frequency trading, punitive surrender charges, the shortcomings of active management, inherent conflicts of interest and all the sad and sorry events of 2008.

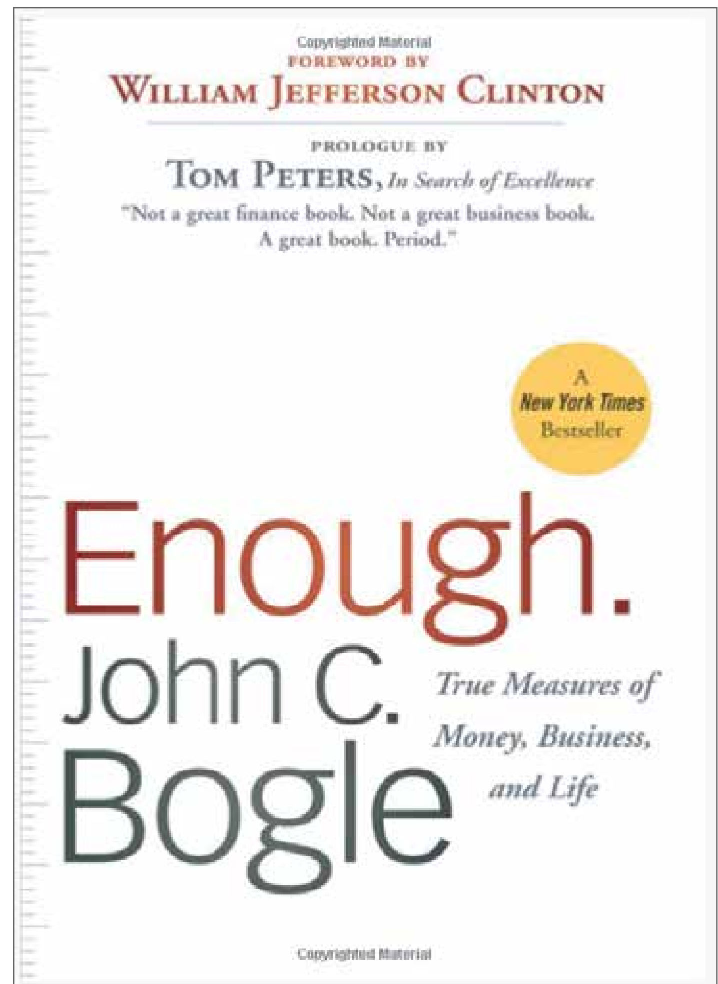
A 2014 study by Merrill Lynch shows that my elderly Wall Street-averse family members are not alone in having become leery of the financial markets. Alarmingly, the Millennial generation appears to mistrust Wall Street as well. ("Alarmingly" because as baby boomers exit the markets, younger generations need to hold up the demand side of the equation.)

"It's important to note," states the Merrill Lynch report, "that according to our survey of young investors, the 2008 crisis itself didn't directly cause the misgivings that Millennials have toward the financial services industry. Rather, the data suggest that the crisis merely *confirmed* the doubts that young people[4] already had of Wall Street and financial services firms — doubts that have only been fanned by recent events and trends, from the Eurozone's repeated credit emergencies and the U.S.'s fiscal tribulations, to Bernie Madoff and the ongoing controversies over high-frequency trading." Says Adam Katz, an advisor with the firm's Private Banking and Investment Group, "[the Millennials] have watched what's gone on over the last decade, and they pretty much feel like they might as well put their money under the mattress." Another recent UBS study similarly describes Millennials as being "skeptical about long-term investing" as the way to achieve their goals.

On the bright side (I am reluctant to end this article on such a depressing note), the Merrill study found that the next generation of investors is significantly more interested in using their money for social benefit, by investing consistent with their values and funding philanthropic ventures.

Enough.

I love the one word followed by a full stop title of this 2009 book by John C. Bogle, who founded the Vanguard 500 Index Fund in 1975. I also like the titles of its chapters. For example: "Too Much Speculation, Not Enough Investment" and "Too Much Complexity, Not Enough Simplicity." In a world where fraud is fueled by excess, this book reminds us of all the forms of excess that, while not technically fraud, are inimical to the long-term financial health of investors. Mr. Bogle's book is also an inspiring meditation on the need for economy and balance in all aspects of one's life.



1. RFPs and RFIs = Requests for Proposal and Requests for Information.
2. From *Tangled Webs: How False Statements Are Undermining America: From Martha Stewart to Bernie Madoff*, by James B. Stewart.
3. The former Attorney General of Utah, John Swallow, subsequently resigned and now may face criminal charges.
4. The Merrill Lynch survey polled investors between the ages of 18 and 35.

© 2011-2014 Alpha Partners LLC

Alpha Partners LLC
Marketing for Excess Returns®
1062 Oakridge Road South | Park City, UT | 84098

You are receiving this newsletter as a member of the investment community. If you no longer wish to receive it, please respond to this email with "No More Penguins" in the subject line. To subscribe to this newsletter, send an email with your request to info@alphainvestmentmarketing.com
Your privacy is important to us. We will never rent, sell or share any information that you provide.