Is the Investment Consulting Industry Ethical?

By Rex Macey, CIMA®, CFA®, CFP®

I have received professional designations from Investment Management Consultants Association®, the CFA Institute, and the CFP Board of Standards, all of which have codes of ethics and/or standards of professional conduct.1 I would describe the countless individuals I have worked with over the past 30 years as ethical, but the industry as a whole does not hold itself to an equally high level of ethics. What surprises me most is that most people in the industry (I’m referring less to the advisors and more to those whose primary focus and purpose is to drive revenue and manage the bottom line) are oblivious as to why the industry is viewed with such disdain. Here I will try to unravel the paradox of how the industry can be less than the sum of all these ethical individuals. For the most part it comes down to systemic lapses in honest disclosure.

Let me gloss over the boring definitions of ethics except to say I’m referring to professionals who believe in the advice they are giving. Unfortunately there are always going to be examples of individuals and firms that do not behave ethically.

In my opinion, the largest lapse is that active management is oversold. As Nobel Laureate William Sharpe wrote in “The Arithmetic of Active Management,” “after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.”2 It’s not that advisors shouldn’t recommend active management, it’s that their clients are not well-informed by the advisory community. And as further evidence, Sharpe’s arithmetic holds even before taxes are considered.

Another lapse is that taxable clients are treated too much like institutional clients. Studies have found that taxes have a significant negative impact on returns, averaging 1 to 3 percentage points per year for the typical active manager.3 In addition, asset location often is ignored. The CFA Institute has had an after-tax performance standard in effect since 2006, but I’ve yet to see it implemented. There must be instances where it has been implemented, but it does not appear to be industry practice. I believe that this factor supports my opinion that the industry does not embrace high ethical standards.

You’d have to be very young (with great eyesight) and serving a life sentence to have time to read all the fine print in agreements, contracts, and websites. In my opinion, disclosure in a document you know won’t be read is not highly ethical. If we can’t scrap the mind-numbing contracts, I’d like agreements to have a page of normal-size print in red outlining the risks such as “active management on average underperforms passive management” and “active management strategies are likely to result in higher and maybe accelerated tax payments than a passive or a tax loss harvesting strategy.”

The ubiquitous “past performance is no guarantee of future performance” is hardly an informative statement. It’s so obvious that it often deters people from bothering to read further because they figure this is the most important point.

And then there are the hidden fees. I am particularly alarmed by advisors who “sit on the same side of the table” with their clients and claim to be fee-based while their firms mark-up municipal bonds from their inventory, or their firms get fees and trading revenue from fund companies.

We think of ourselves as professionals, and in my mind, being a professional means putting clients’ interests ahead of our own. This includes informing them of risks including the likelihood of the outcome, and informing them of the pros and cons of alternatives.

Many consultants require track records of asset managers but have none of their own. They hide behind the fig leaf that the client makes the ultimate decision. For example, if a consultant is presenting several managers she thinks can do the job, then she should at least take the average of the recommended managers. And be sure to include the transition costs of switching managers. Where is the performance standard for consultants?

I am being hard on the industry, but let me be soft on the individuals. The individual Volkswagen salesperson who unknowingly sold a diesel vehicle that was less green than promised was not unethical in my

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book. Many professionals in the investment consulting business are not aware of the industry’s many sins.

Statistics is a tricky subject and many are indeed tricked by it. An individual fund, or manager, may look outstanding and appear statistically significant. It’s easy to be fooled by this. But the significance vanishes when one looks behind the curtain and combs databases looking for excellent performance. As an example, there is roughly a 1 in 1,000 chance of my flipping 10 heads in a row, but if I examine 1,000 coin flippers, odds are pretty good that I’ll find a perfect record. When the excellent coin flipper (or fund manager in the case of an investment example) is presented to the client, the client is usually unfamiliar with the process used to arrive at the nomination and often the track record looks more impressive than it should.

Active management has its benefits. The research done to support active management helps allocate assets efficiently. The paradox is that the entire economy benefits from efficient markets, but those who pay for active management on average do not enjoy higher returns. Indexers get a free ride on active management. They enjoy the benefits of efficient markets and liquidity without paying for those benefits. Does that sound ethical?

My objection to active management is only that its record as a whole is not fully and accurately portrayed by those who know or should know the arithmetic. Thus clients are not getting all the information they need to make a fully informed decision.

I think the industry as a whole also is reluctant to tell clients about how low expected returns might be over the next seven to 10 years. There are a few who call it the way they see it.4 There’s a reason messengers beg not to be shot. Prospects do not shower assets on those who say the pickings will be slim. Still, silence is neither honesty nor highly ethical.

I’m not sure much of this can be addressed by the industry itself. Tobacco required a labeling law (e.g., active management can be dangerous to your wealth). The industry attracts those who believe in high fees—or rather the services they are delivering for high fees—and see themselves as ethical. They are unlikely to embrace a warning they don’t think applies to them.

Clients are better off with their advisors than without because advisors perform better than the individuals would on their own. DALBAR studies show how far dollar-weighted returns fall below time-weighted returns.5 The industry is not evil, but I would not give it a high mark on ethics, and I don’t think I or my fellow professionals should expect high marks from the public.

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Endnotes