Why Are Investors Mistrustful?

In reading the July/August edition of the CFA Institute's magazine, an article called "Fragile Trust" by Susan Trammell caught my attention. There's no doubt that popular confidence in financial services firms was sorely shaken by the 2008 crisis. But it's still sobering to consider the results of a 2013 survey by Edelman Trust showing that only 46% of respondents expect financial services firms to do the right thing, dead last out of 18 industries considered.

A survey by the Economist Intelligence Unit last year asked financial services executives about the benefits of improving ethical conduct at their firms, and the most popular choice was that it would improve their ability to "withstand unexpected and dramatic risks". People who work in Finance recognize the value of high ethical standards, and yet the public doesn't perceive that the industry operates in this way.

Part of it relates to confusion or simply misunderstanding of the difference between brokers-dealers versus investment advisors, or "sell-side" versus "buy-side" in Wall Street parlance. And indeed, why should non-institutional investors even need to know the difference? The structure of U.S. financial regulatory oversight need not be a concern of those outside it. Most investors simply want to invest their money through people whom they can trust. And while that does qualify a pretty healthy majority of finance professionals, the lower standard applied to broker-dealers (sell-side firms) versus investment advisors (buy-side) can expose unwitting investors to abuse.

Broker-dealers don't have a fiduciary obligation to their clients, simply a requirement to meet a lower standard of suitability and disclosure. Their clients are regarded as being responsible for their own decisions, so while a broker can offer advice ("I think this is a good investment") he's not under the fiduciary obligation of an advisor to put the client's interests before his own.

Many investors find this subtle distinction meaningless or are unaware of it. But it's what enables, for example, unlisted registered REITs (Real Estate Investment Trusts) to be sold to clients in spite of underwriting fees that can reach 15% of the invested amount. I wrote about just such an example, of Inland American Realty and its underwriter Ameriprise, last year. The fees were in the prospectus so deemed to be disclosed, although it's expecting a lot to think people will wade through 100+ pages of a legal document. And the regulators were not totally absent as subsequently Massachusetts settled civil claims with Ameriprise on just this security, complaining of high fees and conflicts of interest. The conflict of course comes from the fact that the broker recommending (i.e. selling) the security to their client is receiving the egregious underwriting fees. A fiduciary standard would disallow such a transaction. Such applies to investment advisors but not to broker-dealers.

It seems to me that for the financial services industry to raise itself from being 18th out of 18 industries in surveys of public trust, more and more individuals will need to willingly behave as if the fiduciary standard applies to them even if it does not. Every profession needs to retain the trust of its clients, and Finance needs to as much as any other. The CFA Institute's Future of Finance Initiative is a good place to start, and professionals on both the sell-side as well as the buy-side can choose to conform to its principles voluntarily. Many already do – the rest ought to.