

Comment on 09-25 'Suitability' and 'Know Your Customer'

Introduction

This is an important opportunity for FINRA to add the words 'Modern Portfolio Theory' and 'Diversification amongst negatively correlated asset classes' and 'Diversification within an asset class' all well known and totally accepted in Finance as tools to reduce risk. These concepts are the bedrock of Finance and are known as Modern Portfolio Theory. They are tested on the Series 7 examination, Chartered Financial Analyst (CFA) exam and the Certified Financial Planner (CFP) exams. Every undergraduate text on investments contains chapters on this concept.

Dr. Harry Markowitz and Dr. William Sharpe were awarded the 1990 Nobel Prize in Economics for developing these concepts. The importance of these tools to measure and allocate risk are beyond dispute. Yet nowhere does the FINRA mention these foundational concepts.

The current Rules on 'Suitability' and 'Know Your Customer' are like Swiss cheese since they talk about assessing risks or the broker determining that client understands the risks.....yet NOWHERE is HOW to assess risks articulated by FINRA and nowhere is the client told that, for example, 90% of his/her return will be a function of allocation between asset classes and that diversification WITHIN asset classes can reduce risk to that of the particular market of the asset class itself.

If we draw an analogy to the medical profession, a doctor must explain the risks of a medical procedure. This is known as 'informed consent'. Although FINRA rules on 'Suitability and "Know Your Customer"' are to serve the equivalent function in the brokerage industry, by totally avoiding mention of Modern Portfolio Theory, or diversification amongst negatively correlated asset class or diversification within an asset class...these FINRA rules as constituted do little to inform the customer and do not serve to require brokers to properly inform their clients of risks and known tools to avoid risks. To continue the analogy...these FINRA rules serve merely to say that the broker must tell his/her client there is risk in any market trade...without quantifying the risk and giving alternatives to reduce risk. It would be as if a Doctor were to discharge the informed content obligations to a patient by merely saying 'surgery, doing nothing, and Pharmaceutical therapy all have risks' without assigning probabilities to those risks and without telling the patient that other alternative mechanisms exist to reduce risks. As the FINRA rule now stands...it allows gross malpractice, as would the Doctor in the above analogy commit if his/her informed consent were that lax. Further, the current rule allows brokers to fudge on risk tolerance documents and then argue after the fact that the client wanted high risk concentrated equity investments.

Lack of Investor Knowledge

Retail brokerage clients rely heavily upon the advice of their brokers. Seldom does a broker articulate to an investor the fundamental principles of Finance needed to make informed decisions about risk tolerance and realistic investment objectives. Brokers thus encourage the purchase of more risky (high commission) investments by being selective with disclosures to the

investor.¹ A survey by The Securities Industry Association found that Sixty-two percent of all investors surveyed in 1999 stated they that they desired average or below average risk.² This number rose to 68 percent in the 2002 survey.³

This survey also found that fifty-eight percent of all investors stated that “they rely on professional financial advisers when making equity purchase and sales decisions.”⁴ In 2002 40% of brokerage clients looked to the broker as the “most” important source of information, down from 43% in 2001 the previous year.⁵ “As in the past, a large proportion of investors agree [sic] that the securities industry should be doing more to educate the public about how to make good investments. Eighty-two percent agree in 2003, the same as in 2002. In the three previous years the figures were 84% (2001), 81% (2000), and 78% (1999).”⁶ Under the title of “big problems” the study found that “(f)orty-six percent cite insufficient disclosure of risks to investors as a big problem, up from 45% in 2002 and 34% in 2001.”⁷

The financial illiteracy of retail investors is illustrated by the John Hancock Financial Services annual survey of investors.

consistent with past surveys, most participants have only minimal active involvement with their plans...

•More than half spend no more than twenty minutes a month planning for retirement or managing/monitoring investments;

•More than half say they don't have time to manage their retirement investments; and

•Nearly half say they have little or no investment knowledge and less than 20 percent consider themselves relatively knowledgeable (the numbers have gotten consistently worse with each survey)...

•Nearly 45 percent think money market funds contain stocks and less than 10 percent know they contain only short-term investments; and

² The Investment Company Institute and Securities Industry Association, *Equity Ownership in America, Demographics of Equity Investors* 12 (2002), at <http://www.sia.com/research/pdf/equity_owners02.pdf>. It must be remembered that this survey polled investors of all ages, the average being mid-to-late 40s. Younger investors would be seeking higher risk.

³ *Id.*

⁴ *Id.* at 16.

⁵ Securities Industry Association, *Annual SIA Investor Survey Investor's Attitudes Towards the Securities Industry* 2003, 58 (Nov. 2003), at <<http://sia.com/publications/pdf/Investorsurvey2003.pdf>>.

⁶ *Id.* at 16.

⁷ *Id.* This study also found that fifty-five percent of customers saw “as a big problem the lack of internal controls to prevent irresponsible or wrongful actions, compared to 54% in 2002 39% in 2001 and 33% in 2000.”*id.* at 15. In addition, “(s)ixty-six percent cite as a big problem the industry's reluctance to punish wrongdoers, compared to 68% in 2002 and 41% in 2001.”*id.*

**Less than 25 percent know the best time to invest in bonds is prior to a decrease in interest rates.⁸*

Further, this survey found that “40 percent of respondents say they don't know what to expect for average annual returns for stocks, bonds, money market and stable value investments for the next five and 20 years. Of the 60 percent who believe they do know, their expectations remain overly optimistic.”⁹

An AARP survey found, among investors over 45 years of age, that 48% did not understand that diversification of assets reduces risk. Forty-three percent believed that Mutual Funds are insured by the FDIC and “only (41%) consumers correctly report that a ‘no-load’ mutual fund involves no sales charge but does have maintenance fees the consumer must pay.”¹⁰ These results are echoed in a recent Merrill Lynch survey.¹¹

The Federal Reserve has become increasingly concerned about the financial illiteracy of investors, as the following quote illustrates.

As history has shown, the rate of change and the pace of innovation will only continue to increase within consumer retail markets. This is true of retail financial markets as well. The net result of these changes is that an ever-increasing number of consumers will be able to access an ever-increasing number of financial products. That scenario suggests both increasing benefit and increasing risk for consumers of financial products. When they are appropriately evaluated and used financial products allow an increasing number of people to achieve financial goals previously considered out of reach. In contrast, inappropriate or careless use of financial products can put a consumer in a deep financial hole from which it can be both difficult and time consuming to recover.¹²

The U.S. Securities and Exchange Commission (SEC) has similar concerns. Its “primary mission...is to protect investors and maintain the integrity of the securities markets. As more and more first-time investors turn to the markets to help secure their futures, pay for homes,

⁸ Press Release, Wayne Gates, General Director, Market Research and Development, John Hancock Financial Services Survey: For Most Americans, Early Retirement Dreams Evaporating (May 24, 2004) at <http://www.johnhancock.com/company/newsroom/most_recent/john_hancock_401k_survey_early_retirement_dreams_evaporating_05_24_04.html>.

⁹ *Id.*

¹⁰ Sislena Grocer Ledbetter, *2003 Consumer Experience Survey: Insights on consumer credit behavior, fraud, and financial planning*, AARP Knowledge Management, (October 2003), at <http://research.aarp.org/consume/cons_exp_1.html>.

¹¹ Press Release, Merrill Lynch, Employer Plan Management for the Merrill Lynch Retirement Group, Merrill Lynch Announces Results of “retirement Preparedness Survey” (Aug. 12, 2003) (“Hayes noted a two-fold problem that needs to be solved — a lack of basic investment knowledge and a lack of financial advice and planning. ‘For the second year in a row, we were alarmed to discover that over half of the Americans surveyed believe that 401(k) accounts are guaranteed by law. No such guarantee exists,’ she said.”), at <http://www.merrilllynch.com/about/press_release/08122003-1_ml_announces_pr.htm>; See also 1999 N.Y. Att’y Gen. Elliott Spitzer, *From Wall Street to Web Street: A Report of the Problems and Promise of the Online Brokerage Industry* (1999), at <http://www.oag.state.ny.us/investors/1999_online_brokers/full.pdf> (containing a survey of financial literacy among online investors).

¹² Governor Mark W. Olson, Increased Availability of Financial Products and the Need for Improved Financial Literacy, At the America's Community Bankers 2003 National Compliance and Attorney's Conference and Marketplace, (Sept. 2003), at <<http://www.federalreserve.gov/boarddocs/speeches/2003/20030922/default.htm>>.

and send children to college, these goals are more compelling than ever.”¹³

Thus it is clear that, in the majority of cases, retail investors will openly admit to being financial illiterates.¹⁴ These financial illiterates look to their broker for guidance. Alone investors do not possess the requisite tools with which to make an informed decision as to their risk tolerance and realistic investment objectives. Thus the salient question is, has the broker and brokerage firm sufficiently instructed the retail investor on the realities of Finance so as to make an informed decision on a course of risk tolerance and realistic investing objectives?

Active Management: It is well known in Finance that active management of a portfolio underperforms the market indexes, on a risk adjusted basis, the vast majority of the time.¹⁵ To be 95% sure that skill and not random events caused a portfolio manager to beat the market index, a portfolio manager would have to beat the market index by 1% for 308 years or for a lifetime by 12%.¹⁶ Statistically, the 5 year investment returns of financial newsletters explained only 6% of the future return.¹⁷

Economic forecasts are equally flawed. Every year the Wall Street Journal publishes a piece that catalogues these dismal Wall Street predictions. “You really can't say enough bad things about how bad the consensus has been in forecasting interest rates,” says Stephen K. McNees, an economist at the Federal Reserve Bank of Boston who also analyzed data from the Journal's surveys. ‘As an investor, you clearly would have done much better flipping a coin or assuming that rates would remain unchanged.’¹⁸ Economic forecasts are touted since 50% of the variation of a company's income is explained by the variations in the aggregate income of

¹³ *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity* (Dec. 1999), at <<http://www.sec.gov/about/whatwedo.shtml>>.

¹⁴ Dr. John Kenneth Galbraith's famous phrase, frequently quoted by Wall Street professionals, sounds a similar clarion. “We have two classes of forecasters: Those who don't know -- and those who don't know they don't know.” Tom Herman, *Your money matters: Weekend report: How to profit from economists' forecasts*, Wall St. J., Jan. 22, 1993.

¹⁵ E.g. Arnold Wood, *Fatal Attraction for Money Managers*, Financial Analysts Journal, (May-June 1989) (Examines why professional money managers are “so consistently poor at our profession”). The majority of the money managed in the financial markets is institutional money. The ‘smart’ money does not trade as aggressively or actively as most individual brokers. Charles Keenan, Institutional Investor International Edition, *Investing: Portfolio Strategy, Adding a bit of zest: enhanced indexing attempts to blend the best traits of passive and active investment styles. It's proved to be a popular combination* (Apr. 2003). Similarly, the most actively traded group of institutional investors, and arguable the more skilled Hedge Fund managers, fared poorly. Greg Jensen & Jason Rotenberg, Bridgewater Associates, Inc., *Bridgewater Daily Observations* (“When we strip many hedge fund “strategies” from the beta that underlies them, we find that quite often, they are not wearing any clothes at all...”.) (Feb. 2004). “Institutional investors have a comparative advantage. They can better bear short- to intermediate-term active risk. They need not add value every month, every quarter, or even every year. Their liabilities are far more diversified across time than the liabilities of most individual investors. They are therefore in a better position to profit from the short-term risks that the individual investor finds difficult to bear.” Robert Arnott; & Max Damell, *Journal of Investing, Active versus passive management: framing the decision* (Spring 2003).

¹⁶ Mark Hulbert, *The Misuse of Past-Performance Data*, in *The Psychology of Investing* 152-4 (1999).

¹⁷ *Id.*

¹⁸ Tom Herman, *Your money matters: Weekend report: How to profit from economists' forecasts*, Wall St. J., Jan. 22, 1993; See also Jon E. Hilsenrath, *Where are the good forecasters when you really need them? The Economy: Forecasters' Vision Clouds During Turning Points* Wall St. J., Jul 1, 2002 (“Economists from the Federal Reserve Bank of Atlanta recently studied the past 16 years of The Wall Street Journal's forecasting surveys and found that economic prognosticators are at their worst when the economy is at a turning point, just when some sound advice on the outlook is most useful.”).

the economy.¹⁹ It is well known that earnings and intrinsic value drive equity prices.²⁰ Investors must be advised of the historical returns of equities.²¹ Similarly, investors should be advised that Mutual Funds have underperformed the market indexes, even without taking into account the increased costs associated with Mutual Funds such as back and front end load fees.²²

Diversification: Known as the 'Rule of 100'²³, an investor should have as a percentage of their portfolio, approximately the same number as their age, in bonds or cash. The allocation

¹⁹ E.g. Nicholas Gonedes, *A Note on Accounting-Based and Market-based Estimates of Systematic Risk*, Journal of Financial and Quantitative Analysis (June 1975).

²⁰ E.g. John Y. Campbell & Robert Shiller, *Stock Prices, Earnings and Expected Dividends*, Journal of Finance, 661-676 (July 1988) (Price/earnings ratio averaged over 30 years explains over 57% of the annual return of the market index).

²¹

	Comp	Arith	Risk	Div Yld	Comp	Arith	Risk
1926-1997	10.6	12.6	20.4	4.6	7.2	9.2	20.4
1946-1997	12.2	13.4	16.7	4.3	7.5	9.0	17.3
1966-1981	11.5	12.9	19.5	4.1	-0.4	1.4	18.7
1966-1997	11.5	12.9	17.0	3.9	6.0	7.5	17.1
	TOTAL	NOMINAL	RETURN %		TOTAL	REAL	RETURN %

Historical Equity Returns

Comp = compound annual return, Arith = arithmetic average of annual returns

Risk + standard deviation of arithmetic returns

Jeremy J Siegel, *Stocks for the Long Run* the definitive guide to financial market returns and long-term investment strategies 13 (1998)

²²

	All Funds	Wilshire 5000	S&P 500	All Funds-Wilshire 5000
1971-1997	11.86%	13.12%	13.16%	-1.44%
1984-1997	18.83%	15.91%	16.99%	-2.52%

Equity Mutual Fund and Benchmark Returns: Annual Compound Return, Excluding Sales and Redemption Fees

Jeremy J Siegel, *Stocks for the Long Run* the definitive guide to financial market returns and long-term investment strategies 273 (1998)

²³ E.g. Fleet, *Balancing Your Retirement Account, Rule of 100-a simple approach*, at

<[http://www.thesystemsgroup.com/downloads/401k/Balancing%20Your%20Retirement%20Account%20\(Rule%20of%20100\).pdf](http://www.thesystemsgroup.com/downloads/401k/Balancing%20Your%20Retirement%20Account%20(Rule%20of%20100).pdf)> (Feb.13, 2002).

between stocks and bonds is the most important decision that can be made about a portfolio.²⁴ The stocks must also be well diversified.²⁵

The majority of the movement of a stock price is a function of the over all movement of the market itself. The remainder of movement is a function of first the specific industry and finally the particulars of the company itself. This concept is easy to grasp. The purpose of diversification is to diversify away all of the industry and firm specific risk. This leaves only the market risk, also known as the systematic risk, as not diversifiable. A diversified portfolio should have no more risk than the market risk.

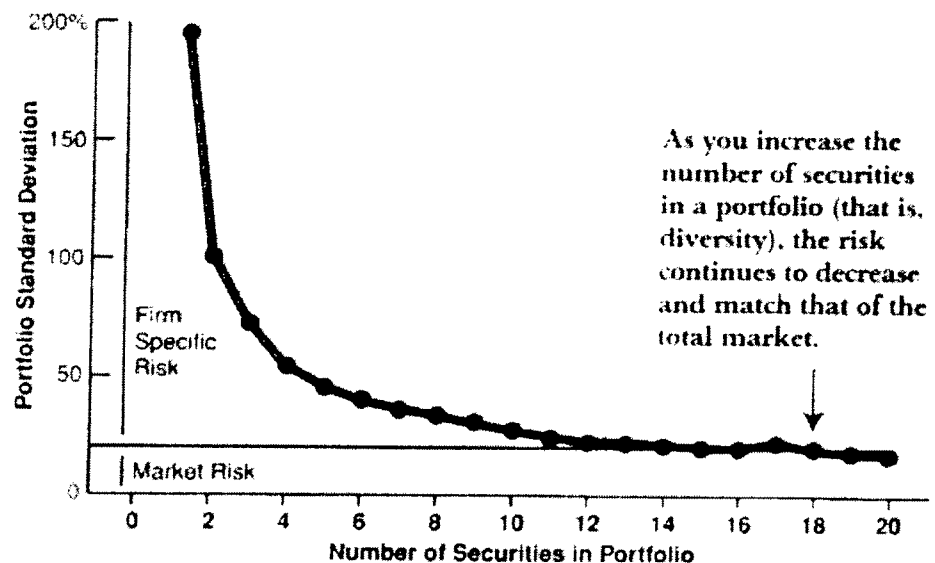
Thus the ability to 'pick stocks' is a limited skill mostly dependent upon the future movement of the market itself. Any deviation from the 'Rule of 100' is suspect. As a group, retail investors have consistently held an average of 45% in bonds and cash, roughly the average age of survey

²⁴ E.g. Gary P. Brinson et al., *Determinants of Portfolio Performance*, Financial Analysts Journal 26 (Jul-Aug 1986) ("A study of 91 large US pension plans was conducted to determine the effects of investment policy, market timing, and security selection on their total return and the variability of that return. A simple framework is provided based on a passive, benchmark portfolio representing the plan's long-term asset classes, weighted by their long-term allocations. Results of data from 1974-1983 indicated that investment policy dominated market timing and security selection and explained on average fully 93.6% of the total variation in actual plan return.")*id.* See also Roger G. Ibbotson & Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?* Financial Analysts Journal 26 (Jan.-Feb. 2000) (validating the findings of Brinson).

²⁵ Modern Portfolio Theory shows that it is not the number of different stocks that are owned in a portfolio that creates diversification but rather how each stock is correlated with the other stocks in the portfolio. These concepts of diversification are well accepted and were first articulated over 52 years ago in 1952, by Dr. Harry Markowitz. He shared the Nobel Prize for this work. *Stocks concentrated within the same industry do not diversify a portfolio.*

The stocks used to generate the portfolio shown in the graph were generated randomly.

Example of Diversification across Securities



Douglas Heath & Janis K. Zaima, *Contemporary Investments*, 2nd ed. 379 (1998).

respondents.²⁶

The weak track record of Wall Street 'Research' not a recent event:²⁷ A broker should inform the retail customer that its Analyst Buy Recommendations far exceed Sell recommendations? For example, one study found this ratio to be 15 to 1.²⁸ Brokerage firms title these recommendations 'Research', thus any caveats should be clearly articulated.

What makes this fact all the more relevant is that ***some brokerage firms forbid their brokers from recommending the sale of stocks that are on the recommended list.*** For example, The Morgan Stanley Dean Witter & Co. MSDW Compliance Guide 1999 Solicitation Policy, states "Financial Advisors should not solicit transactions in securities that are contrary to the opinion of MSDW Research (i.e., soliciting purchase of a security when MSDW's opinion is either "hold" or 'Neutral,' or soliciting sale of a security that is rated either 'strong buy' or 'outperform')." Similarly, the Prudential Securities, Compliance Policies & Procedures, Section 6, Solicitation of Orders Policy (Aug. 1998), states "Financial Advisors are discouraged from soliciting "sell" orders against Research Department's 'hold' or 'buy' ratings. However, such solicitations are permitted provided the recommendation is suitable for the client and the Research Department's opinion is disclosed to the client."

Conclusion

TO SUMMARIZE, as the rule stands today clients are to be told about risks but not about the only tool known to Finance that describes the risks. It is like saying a doctor has to obtain 'informed consent' but the doctor only says 'everything has risk' without giving probabilities and a list of side effects and alternatives.

Brokers and investors lack a standard by which to measure risk and thus the broker is free to argue...'who could know this loss would occur'...'once in a lifetime downturn'...'risk is everywhere'...and other patently preventable losses to investors due to bad investment advice.

²⁶ **Percent of Investor Portfolios allocated to Cash, Bonds and Bonds Funds**

	2003	2001	2000	1999	1998
CDs, Cash, Money Markets	22%	26%	28%	25%	25%
Bond Mutual Funds	7%	11%	11%	11%	11%
Individual Bonds	7%	8%	8%	8%	8%
Total Cash and Bonds	36%	45%	47%	44%	44%

* Question not asked in 2002

Securities Industry Association, Annual SIA Investor Survey Investor's Attitudes Towards the Securities Industry 2003, 58 (Nov. 2003), at <<http://sia.com/publications/pdf/Investorsurvey2003.pdf>>.

²⁷ Forgetting the Analyst Conflicts that has led to recent multi-billion dollar fines, analyst 'Research' has long been flawed. "For example, Michael Sandretto of Harvard and Sudhir Milkishnamurthi of M.I.T. completed a massive study of the one-year forecasts of the 1,000 most widely followed companies... Financial forecasting appears to be a science that makes astrology look respectable." Burton G. Malkiel, *A random walk down Wall Street* including a life-cycle guide to personal investing 169-170 (1999).

²⁸ E.g. Kent L. Womack, *Do brokerage analysts' recommendations have investment value?* Journal of Finance 51 (Mar. 1996). See also Roni Michaely, *Conflict of interest and the credibility of underwriter analyst recommendations*, The Review of Financial Studies 653 (1999) (analysts recommendations associated with underwriting underperformed nonaffiliated analysts).

Getting MPT and 'Diversification amongst negatively correlated asset classes and diversification within an asset class' into these rules would be a HUGE step towards protecting investors. No where are these foundational tools of Finance mentioned on FINRA's website. No where does FINRA require a broker to properly inform their clients of these basic tools of Finance for which the Nobel Prize was awarded. That is shameful.

The pertinent facts and principles in this article are well known to market professionals, are part of any disclosure that claims to be informative, but are not always fully disclosed. Merely stating that markets are inherently risky and unpredictable does not satisfy the fiduciary obligation of fully informing a retail customer. It is fiduciary obligations and 'Financial Informed Consent' associated with suitability that separates the brokerage industry from being mere salesmen of disposable items such as shoes and paper products. Suitability obligations allow the brokerage industry to call itself a 'profession'. The professional obligation of 'Financial Informed Consent' benefits all parties.²⁹

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²⁹ An unsuitable investment product is an inefficient deployment of capital. It harms the markets, as well as being a loss for the individual investor. It fosters increased regulation, an anathema to the industry.