



PROTECTING AND EDUCATING THE INDIVIDUAL INVESTOR SERIES



By Nicholas E. Terezis, CFA

The Individual Investor's Answer to the Lies and Abuse of Large Wall Street Firms is the Fee-Only Investment Advisor!

The critical ingredient for individual investors attempting to achieve a level investing playing field is to have a fee-only investment advisor. Although there is never a guarantee that a fee-only investment advisor would be able to deliver better investment results than any other type of investment firm, at least an individual investor is not disadvantaged by biased advice and high fees.

Every year large Wall Street banks and brokerage firms are fined by the Securities and Exchange Commission (SEC) and other regulators for lying to and stealing from their clients. Usually, these firms pay their fines, fire sacrificial employees, promise to make (small) changes in the way they do business, sweep the incident under the rug, and then promptly pursue another method of stealing from their customers.

Investors wrongly find a false sense of security when they deal with "prestigious" financial institutions. The craftier, more prestigious institutions concoct gray-area-of-the-law schemes to steal from clients. If they believe that this scheme is technically not illegal or would be tough to prove as being illegal, then these large firms in a sense have a license to steal from their clients. Though these methods of theft may lie in the gray area of the law, they are clearly in the black area between right and wrong.

I do not wish to condemn every person who works for one of these large firms, because the majority of people working there are good honest people. However, like the common cold, it only takes a few immoral people to spread the disease of greed and theft throughout the organization. Before you know it you hear people saying, "Well everyone is doing this, so it must be ok."

Let there be no doubt, the SEC and other regulatory bodies are the good guys. They impose rules and fines to protect investors from anyone who would try to lie or steal, including the investors own financial companies. While the SEC is able to impose rules and fines, the biggest problem it faces is that no regulatory body will ever be able to impose morality.

One of the SEC's goals is to create a "level playing field" for all investors. No one would want to invest in a market where the cards were stacked against them. The concept of a level playing field is critical to the success of well functioning financial markets. In order to insure a level playing field, the SEC has instituted numerous laws. For example, the SEC forces financial companies to disclose all of their fees and conflicts of interests. The question then becomes, "Do the individual investors really know what these disclosures mean?" I think not. Otherwise, the large Wall Street banks and brokerage firms would have fewer clients and the fee-only investment advisors would have more.

Let's review some of the common large financial institution disclosures and figure out what they are really saying:

Disclosure Example #1: Our financial company gives investment opinions on companies with whom we have investment banking relationships.

This disclosure means that the financial company has an incentive to give you biased investment advice! Of course, whether you get honest advice or biased advice depends on the integrity of individual people. When dishonest people are involved, this is how it may happen. A business (lets call it Dot-Com company) wishes to raise money and contacts an investment bank.

Dot-Com is told that it must issue new debt, have an initial public offering, or issue more stock in order to raise money. The investment bank's job is to find investors willing to buy Dot-Com's new debt or stock. Logically, no investor would want to buy Dot-Com's debt or stock unless it sounds like it will be a good investment. The investment bank's research analysts are pressured/bribed to write investment opinions saying how great Dot-Com would be as an investment. Many times in the past (and surely in the future) these research analysts knew that these investments were terrible, but their fear of getting fired and greed for large compensation overcame their moral objections. What then typically happens is: the stocks are touted as being great investments by the financial company; individual investors buy the stock (including the clients of the large financial institution); the investment bank is paid huge sums of money by Dot-Com for helping raise money; and the stock price of Dot-Com eventually falls when people discover that the company is a poor investment.

Disclosure Example #2: Our financial company gives investment advice and is also a brokerage firm or is affiliated with one.

This disclosure means that the financial company has an incentive to give you biased advice, which can result in your being charged the highest expenses possible for a product that might not be appropriate. Many of these expenses are not easily seen. Let's look at some of the expenses that can be seen, some that are hidden, and how all of this results in biased advice:

Transaction Fees for Buying and Selling Stock

The conflict of interest is fairly obvious in this situation. Brokers make more money when they talk you into buying and selling more stocks (churning). Therefore, they always have new "hot stock" ideas that will allow them to make more money from your transactions. Along with the transaction expense that you see on your trade confirmation, the brokers make a little money every time they buy or sell stocks. This is done by making your buy or sell price a little worse than what it could have been (bid/ask spread).

Wrap Fee Programs

Due to increasing competition, brokers were forced to come up with a program that did not appear to be as

expensive. Their answer was wrap-fee programs, or as I like to call it the wolf in sheep's clothing. Brokers charge a flat fee based on assets under management. They would like you to believe that they do not benefit in any other way from your account. However, as we just discussed every time a transaction takes place, brokers make money from the bid/ask spread. Since investors do not see a commission charge, they think it does not cost anything.

Expensive Products

Often brokers will try to sell other products such as limited partnerships, complicated derivative products, or funds. Some of these products pay the brokers larger amounts of money if they are able to sell them. Thus, an incentive is created for the broker to sell you an overpriced and often inappropriate product.

So how is an individual investor supposed to survive in this shark tank? The answer is by hiring a fee-only investment advisor. Fee-only investment advisors do not have any of the aforementioned conflicts of interest. They do not engage in investment banking activities, and they are not brokers. Fee-only investment advisors are paid only by the investor and no one else! Therefore, there is no incentive to do anything other than what is best for the client. Further, fee-only investment advisors usually only charge fees of 0.5% - 2.0% per year vs. full service brokers that charge something closer to 2.0% - 5.0% per year (after all of the hidden expenses have been included).

Marathon Strategic Advisors is a fee-only investment advisor that specializes in creating customized investment portfolios based on the client's unique financial goals, risk tolerances, return expectations, investment horizon, tax brackets, and cash flow needs. Please do not hesitate to call us for more information on our company and the services we provide.

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