Interim Market Correspondence
July 12, 2011

The Differences Between Brokers and Financial Planners

When people abroad come to the USA, where do they settle down live? You can find out in an interactive map created by an organization called Trulia Insights here: http://insights.truliablog.com/vis/global-pursuits/ (Note: you may have to click on the graphic to activate it.) Click on a country, and it shows which areas of the U.S. those foreign nations are buying houses in; click on one of the leading U.S. cities (including, surprisingly, Brownsville, TX and Brooklyn, NY), and you see where the foreign homebuyers are coming from.

Meanwhile, sometimes it can be difficult to explain the cultural differences between financial planners and wire house brokers. However, at a recent financial services conference in San Francisco, author Michael Lewis--the celebrated author of 'Liar's Poker,' 'The Big Short' and 'Moneyball' talked about his own experiences as a broker--and as a writer about brokers and their world.

Lewis told the audience that he had written 'Liar's Poker,' which is basically an expose of how Wall Street does business, as a kind of warning to college students entering the workforce. He said that he had always found it ridiculous that the large brokerage firms (in his case, Salomon Brothers, but including also Smith Barney, Merrill Lynch, First Boston and Goldman Sachs) would hire somebody like him, an Art History major out of college who knew nothing about finances, and set him to work giving financial advice to institutions and wealthy people with nothing more than a little sales training. "I had a college roommate who should have been an oceanographer," he said. "He had a passion for it. But he was offered so much money that he ended up working for Bear Stearns."

After he wrote 'Liar's Poker,' Lewis naturally assumed that he had forever burned his bridge with Wall Street, by telling the world how ridiculous (and, often, pernicious) it was in a NY Times best seller. Yet when the credit default crisis swept through Wall Street in 2008, Lewis became interested again. "I had no idea that Wall Street could ever get more absurd than it was when I worked there," he told the audience. "But back then, if a big Wall Street firm designed a zero sum trade, you did NOT want to be on the other side of that trade. But with all the amazing losses from the credit default swaps and CDMOs and everything else, somehow Wall Street had become the dumb money. Incredibly bright people had created doomsday bonds that brought down the finances of the bigger firms."

So Lewis tentatively called up some of the players in Wall Street, and was astonished to find that they were willing--even eager--to talk to him. Then he got what he described as the shock of his life. "They would say to me, the only reason I'm talking to you is because you're the reason I got into this business," he said. "They would tell me, I was in college and didn't know what I wanted to do with my life until I read Liar's Poker."

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Somehow, Lewis realized, his intentions had been subverted. "I discovered that my book had a dog whistle effect of calling people into Wall Street," he said, "which was exactly the opposite of what I intended."

Lewis was asked what he believed to be the most important lessons of his book about the credit meltdown. His answers were surprising. He said that Wall Street's incentive structure is (this is the term he used) "badly screwed up." Hundreds of executives and brokers had an inkling that they were creating awful investments, but they managed to tell themselves, 'Just let it last until the end of the year, and I'll get my bonus.' Then they would say, 'Just let it last one more year, so I can get my next bonus.' "If you incentivize people not to see something, they won't see it," said Lewis. "It is amazing what people won't see if they're paid not to."

By mid-2005, the structured product departments at the Wall Street firms were generating so much money that they had virtually taken over their companies. And Wall Street had taken over the ratings agencies, giving them ever-more-fanciful analyses of the products they were selling, and then paying for the companies to ratify the analyses that they had created. Lewis said that he was particularly disturbed that Goldman Sachs could create securities that were designed to fail, and then sell them to their customers at a profit, and then profit some more by betting against them.

None of those incentives have changed since the meltdown. Unlike financial planners, who owe a duty of loyalty to the people they advise, brokers most profitably work against the interests both of their clients and society. Lewis pointed out that the executives' right below top management, who are in the middle of creating profitable securities that eventually fail spectacularly, usually find themselves in a financial sweet spot. Their customers lose everything, their bosses are called on the carpet and sometimes fired (though seldom given jail terms), but these people right below the bosses profit on both ends of the crisis. In the run-up, they pocket millions as the flawed securities are shoveled into customer portfolios. Then, when the securities blow up, they are the indispensable experts who are called on to fix the mess--and earn millions more during the cleanup phase.

Meanwhile, the government has been bailing out Wall Street every ten years or so. "We have a capitalist system except for the highest-paid capitalists, who enjoy the benefits of socialism," said Lewis. "They were massively subsidized, and as soon as they got back on their feet, they started undermining the people who were trying to fix the problem." In describing the lobbying attacks on Congressional efforts to rein in the worst behavior, he said: "It's like a patient in the emergency room who wakes up and immediately attacks the doctor who saved his life."

Meanwhile, brokerage firms are permitted to pose as agents of the customer when in reality they are serving as agents of their firms.

Some of this may be changing. "People are starting to suspect that Goldman doesn't have their best interests at heart," Lewis told the group. "When I did my book tour, the first thing I noticed is that people were angry. They wanted to know who to lynch."

Nevertheless, Lewis said that he fully expects another crisis within ten years, at one point saying "I can see that the next collapse is being built now, though we can't see it yet." In response to a question, he said that individually, there are a lot of really nice people working on Wall Street. But the incentives have to be changed before the crises will end. "When people are rewarded for behavior that is just horrible for society, then the one thing you know is that this will happen again and again and again," Lewis told the audience. "Today, on Wall Street, you can get rich doing creative things that are absolutely disastrous for investors and society."

Is there a solution? Lewis said that if he were made the top regulatory agent of the securities world, the first thing he would do is break up the big firms, and then forbid the industry from making bets for themselves when they are also advising investors on those same securities--basically ending the practice of trading for their own accounts. He would ban credit default swaps and some other derivatives, and absolutely forbid firms from betting against the securities they have sold to their investors. "Today, we allow Goldman to buy insurance on somebody else's house," Lewis said. "That gives them an incentive to throw lighted matches at your house and be rewarded handsomely if it burns." And he would require people who run hedge funds to have their own wealth in the fund, taking the same risks that they were exposing their investors to.

Does Lewis expect any of this to happen? Cheerfully, he said: "Not really."

Lewis's next book is about the European debt crisis.

Fixing Social Security

These days, as Congress debates the debt ceiling issue, Social Security is suddenly front page news again. If you want to see the lighter side of the debate, click here: http://www.youtube.com/watch?v=OAnI6y-xC84&feature=related.

The first thing to understand is that there IS a solvency problem with Social Security. Alice Munnell, Director for the Center for Retirement Research at Boston College University points out that, according to the Congressional Budget Office, the Office of Management and the Budget and the Government Accountability Office, the benefits promised to future retirees exceed the scheduled taxes that are projected to be taken in. In fact, last year, Social Security began paying out more in benefits than it received in payroll taxes--years earlier than projected, due to the 2008 Great Recession.

The second thing to understand is that Social Security is not going away; too many people today and in the future depend on it for a crucial part of their retirement income. Munnell notes that Social Security accounts for 87% of non-earned income for the poorest third of households over age 65, 70% for the middle third and 37% for the highest third.

So the question becomes: how can Congress bring Social Security back into revenue balance. To help illustrate some of the trade-offs, the American Academy of Actuaries web site includes a game that allows all of us to fix Social Security--you can make your own adjustments here: http://www.actuary.org/socialsecurity/game.html and discover a variety of ways to balance the books, some more painful than others. You could, for example, move up by one year the day when people have to wait until age 67 to claim maximum benefits, and after that index the retirement age to maintain today's ratio between expected retirement years and work years. This, alone, would solve 20% of the funding problem, and some would argue that it should have been done years ago.

As an alternative, you could reduce the annual cost of living adjustments in Social Security payments by half a percentage point. This would reduce the projected deficiency by 40%. Of course, it would also erode the purchasing power of elderly people who count on Social Security for a significant part of their income.

We could reduce benefits by 5% for future retirees, which would solve 31% of the problem.

Or we could reduce the benefit formula for the top half of earners, who theoretically are less dependent on Social Security in retirement. That would solve 43% of the projected Social Security deficit. It would also

mean that people who are able to fund a comfortable retirement will get much less out of the system than they put into it.

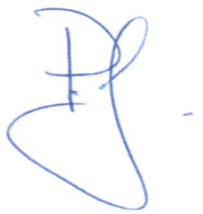
On the other side of the ledger, we could incrementally increase the revenues going into the Social Security system. For instance, if we raised the payroll tax rate from the current 6.2% to 6.7% for employees and employers, 48% of the shortfall would go away. As an alternative, we could tax Social Security benefits like we do IRA and pension benefits, which would make up 14% of the projected shortfall.

As you can see, none of these proposals, by itself, will bring Social Security back to fiscal health. If you're looking for an out-of-the-box solution to add to the mix, consider an article in the Christian Science Monitor, where former U.S. Secretary of Labor Robert Reich notes that a big (and largely undiscussed) problem with Social Security is the shifting balance of workers paying into the system to retirees collecting from it. Forty years ago, he says, there were five workers for every retiree; today, there are three. In 20 years, perhaps less, the ratio will be 2:1--that is, every two workers in America will have to pay whatever is required to support one retiree's Social Security benefits.

How would you fix this problem? Reich proposes that we allow more immigrants into the U.S.--that immigration reform and entitlement reform are linked.

As the deficit debate goes forward, you'll hear a lot more about how to "fix" Social Security. Consider this a cheat sheet on the options that various parties will eventually put on the table.

Sincerely,



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