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Greetings of the season!

In continuation of Multi-Act's series on "Challenges faced by families in Managing Wealth", I wanted to share some of our experiences and observations with respect to one more of the challenges that we face as custodians and managers of our family's investments.

One question that comes up frequently is:

Where have all Fiduciaries gone?

The financial structure: by that we mean that the incentives for the way in which financial services are bought and sold is structured very much against the investor. Families need to be very careful in understanding the inherent & implicit conflicts of interest and incentives of intermediaries and need to take safeguards to protect themselves. The concept of Fiduciary responsibility has been severely diluted and the transactional nature of relationships means that families should exercise "caveat emptor".

In the last article we talked about the macro challenges that families face today in preserving & transitioning wealth. As if this was not difficult enough, we would argue that today this challenge is magnified for families because of the change in the financial structure of intermediaries since the 1990's. Serious long term investors need to understand more deeply how the intermediaries are being compensated, the structure of the incentives in their financial relationships and keep adequate safeguards in place.

Sometime in the 1990's a new model of financial product & services delivery emerged in the US and then spread to the rest of the developed world. Much of this new model emerged under the guise of de-regulation and bringing a "freer" market to financial services & products. All this, in the name of lowering the cost structure of financial products and services. Some of the goals were achieved, but with unintended costs and consequences that makes it difficult to determine whether this new model is a net benefit to the society.

Many of the elements of the new model jumped over into financial markets in the Emerging Markets and India as liberalization of capital markets spread across the globe. There is no doubt that there are many benefits of this: wider product & investing choices, wider choice of instruments, lower brokerage commissions, much lower friction and transactional costs; but the new model also had some unintended consequences and costs.

Banks increasingly sold financial products and services with their compensation in the form of commissions on the product they "distributed", brokerages underwent a change from being partnerships with "deep" old family relationships of almost a counseling nature to corporate entities that got rewarded from the frequency of transactions.

As more of the financial intermediaries became public entities with quarterly earnings report, the fiduciary nature of relationships between financial services provider and financial services buyer started to break down.

We would argue that the basic structure of financial intermediaries now means that the incentives are hopelessly adversarial and that despite several attempts at reigning in mis-selling, the structure of the financial industry virtually assures that incentives to mis-sell are too large to eliminate.

The period 2000-2002 provided a first glimpse of the costs and consequences when the tech bubble was first fomented and then burst. Many brokers/dealers paid large settlements to regulatory authorities for their misdeeds in addition to agreeing to several changes in their practices. Unfortunately, this did nothing to alleviate the fomenting of the housing bubble and the global ramifications of the crash of the housing & credit bubble.

Families responded to both these episodes so close after each other, with an intense mistrust of financial intermediaries but even so they have not found a viable alternative. This is simply because families with means have no option but to engage in capital market activities as a crucial adjunct to safeguarding their wealth and earning an inflation adjusted return.

So why do we advocate a different approach and different model for families?

Consider this:

a) For the most part banks; brokers are publicly listed companies with high return on equity targets and a necessity to show quarterly earnings growth,

b) Most of the premises they occupy are high rent premises-partly because clients equate lushness with safety and

c) Many of the personnel in the financial services industry have high compensations and high bonuses.

In fact, despite the tremendous losses incurred by investment bankers and brokers on these institutions in 2008-9 which necessitated public infusions and guarantees, compensation to financial personnel has been almost impossible to reign in as the financial sector has tried to protect their incomes.

In such an environment, with budgets and revenue targets, is it a wonder that financial intermediaries have taken to "hard selling" of products whether the customer needs the product or not? Given the complexity of the products they sell and the relative lack of knowledge is it any wonder that clients buy product that rarely deliver on their expectation or what is being sold?

We have seen families responding to this change by interfacing their transactions with the financial intermediaries through the use of a sophisticated investor whose incentives and compensation is determined solely by taking the clients interests into account.

We would argue it is very important for families to understand the structure of the compensation and incentives in any financial transaction & financial relationship.

Families need to ask the following questions:

1) How is the financial intermediary being rewarded in this transaction?
2) How much is the financial intermediary being rewarded? Is the compensation fair to me in relationship to what is being delivered?
3) For what function is the financial intermediary being rewarded?
4) Are there any disguised fees or charges?
5) How are the intermediaries interests aligned with my interests and goals from the capital markets?

   Unless families are in a position to answer all these questions in a clear manner, we may not be able to achieve even modest objectives in their interactions with the capital markets.

We will continue our series on "Challenges faced by families in Managing Wealth" and look forward to your feedback and questions if any.

With best regards,

Prashant Trivedi, CFA

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