

# SANTA BARBARA NEWS-PRESS



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## More Wall Street smoke and mirrors

### EXCLUSIVE OUTLOOK: Paul Orfalea, Lance Helfert and Atticus Lowe

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Many travelers enjoy the benefits of frequent-flier miles without recognizing them as bribes to choose one airline's service over another's, regardless of quality. Lacking any useful differentiation or dedication to exceptional service, airlines offer "free" trips to buy customer loyalty. Of course, the trips aren't really free; all of the airline's customers ultimately pay for them.

Wall Street has its own version of "frequent-flier" benefits. In exchange for trade business, brokers offer "soft dollars" to fund and portfolio managers, who typically redeem these for research reports from the brokers. But some managers buy more than reports with soft dollars and seem to enter an ethical "grey area" when they use soft dollars for travel, online subscriptions or other standard costs of doing business.

Basically, managers can "buy" stock research and other goods and services by trading through brokers who charge higher commissions and "rebate" services back to the fund managers. Wall Street seems to find these monetary kickbacks perfectly acceptable. What's wrong with this picture?

First of all, managers may face a conflict of interest, choosing brokers for their soft-dollar offers rather than for the quality of their knowledge and service. Secondly, the brokers and portfolio managers are not merely bartering services because the individual investor pays the costs, in the form of increased trade commissions. Not only do soft dollars amount to a hidden fee for investors, they also hide something else: the fund manager's level of dependence on third-party research.

#### WHAT ARE THEY HIDING?

To be fair, though we refer to "hidden fees," portfolio managers generally disclose soft-dollar use, albeit in small type. But they rarely explain the impact of soft dollars, and we believe investors would be quite surprised to learn they could be paying 1 or 2 cents per share in commission, rather than the 5 cents or more required to fund a soft-dollar relationship. Knowing that a portion of their trade expenses get kicked back to the manager may produce feelings stronger than surprise.

Third-party research is a good thing because it typically reduces conflicts of interest. Some of the most egregious recent scandals involved analysts disingenuously promoting stocks to help their own



companies win investment banking business. Regulators and legislators have been calling for more third-party research to avoid such corruption, but replacing one conflict of interest with another may not be the solution.

Managers owe it to their clients to source the best possible research on potential investments, and they should be willing to pay for this research or conduct it themselves. Moreover, they should disclose payments so clients understand how their fund's resources are managed. Investment professionals expect such transparency from our public companies, and we should live up to this standard ourselves.

#### **LIFTING THE VEIL**

We suspect that some managers obscure their use of soft dollars for two reasons. First of all, the research may be used to benefit parties other than those who paid for it, since the manager and/or his company certainly oversee more than one fund. Naturally, prudent investors want their fees and other expenditures dedicated to their own capital appreciation.

Also, cash payments for research would disclose to what degree the manager depends on outside research. Investors who believed they were getting a hands-on approach might be disappointed to learn that some managers conduct no research of their own, choosing instead to buy research with their client's money.

One way for investors to take charge of the situation and learn more about the impact of soft dollars would be to ask for a comparison of account performance both net and gross of fees. Frankly, this is always a good practice because fees and expenses affect every portfolio. But where a soft-dollar relationship exists, account performance will have to excel to cover the additional costs. In other words, find out if the soft dollars are being put to good use!

#### **FOX GUARDING THE HENHOUSE**

Soft dollars are a huge source of revenue for brokers, particularly small and midsize firms, and they have lobbied hard to prevent regulation of any kind.

In November, the NASD's Mutual Fund Task Force submitted recommendations to the Securities and Exchange Commission limiting, among other things, the ways in which soft dollars can be used. They recommend that research bought with soft dollars clearly benefit investors, and that advisers should give more information about soft-dollar use to a fund's board

Not a very strong position, in our opinion.

In other words, "self-regulation" once again amounts to "pretending to take action."

We believe that soft dollars are a questionable practice, and that investors are better served when managers simply pay for services and charge fees apropos to their expenses.

We question the effectiveness of portfolio managers who depend entirely on third-party research and need to disguise the costs by using soft dollars. Investors deserve managers who manage, not outsource, an activity as critical to stock selection as research.

We note that many airlines are now bankrupt or near bankruptcy. One can buy loyalty for a while, but in the end, it must be earned through quality and performance. We hope our colleagues on Wall Street

are paying attention.

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