The Quarterly Report

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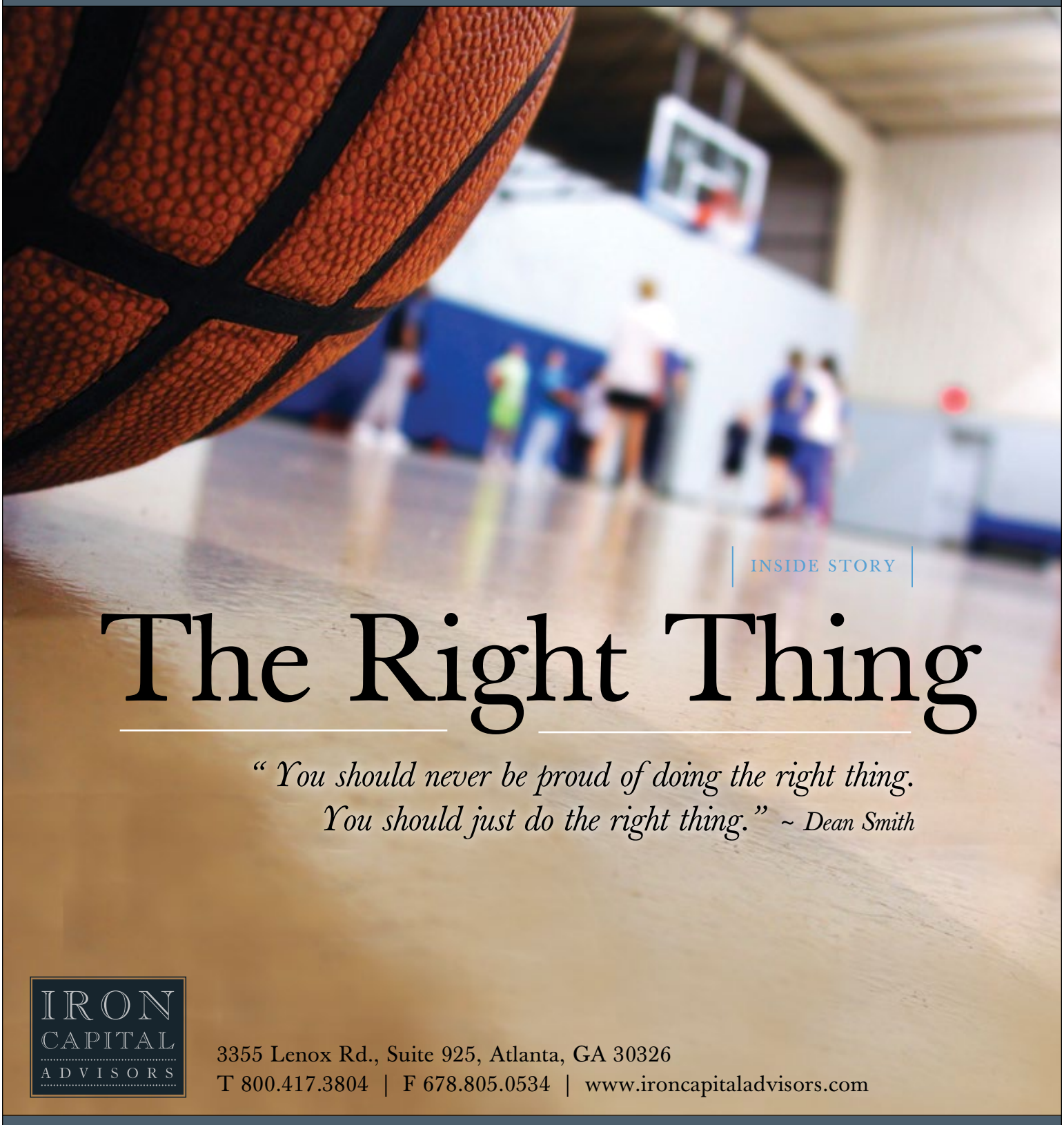

INSIDE STORY

The Right Thing

" You should never be proud of doing the right thing. You should just do the right thing." ~ *Dean Smith*

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The Right Thing

Growing up in North Carolina in the 1970s there were two kinds of kids: those who worshiped the ground Dean Smith, legendary basketball coach of the North Carolina Tar Heels, walked on; and those who thought he was the devil himself. I was in the former camp right up until the day my beloved late Uncle Dag convinced me that I should get my education at Wake Forest and not that school on the other end of Tobacco Road.

For all of his success it is easy to forget that Smith was not hired because anyone thought he could win. He was a young assistant who had never been a head coach. He was asked to step up when Frank McGuire was forced to resign because of NCAA violations. Smith was hired the same day McGuire was fired and told that wins and losses didn't matter as long as he ran a clean program and represented the university well. He went on to win more than 77 percent of the games he coached and 879 games total. He also lived up to his original mandate.

Smith was a man who was not afraid to stand up for what he thought was right. When he was still a young assistant coach he helped desegregate Chapel Hill. His minister had asked Smith if he would accompany him and a black member of their church to dinner at a white-only restaurant, and Smith agreed without hesitation. The restaurant they chose was one where the basketball team often had team meals. The owners knew Smith, who was not famous yet, and did not wish to risk losing the team's business, so they served the trio and the desegregation of Chapel Hill was begun. That story remained largely unknown until author John Feinstein found out about it while researching a book on Smith. When Feinstein asked him to verify the story, Smith asked who had told him about it. Feinstein revealed his source and Smith said, "I wish he hadn't done that." Surprised, Feinstein said, "Dean, you should be proud of doing something like that." Smith looked him in the eye and said, "John, you should never be proud of doing the right thing. You should just do the right thing."

A few years ago I decided to volunteer to coach my son's basketball team. I was telling a client about the decision and he said, "I bet you'll be really good at it."

There are indeed many similarities between coaching and being an adviser.

I thanked him, then asked why he had that opinion. He told me that coaching is mostly about teaching and that is a lot of what we do as advisers. He is right – there are indeed many similarities between coaching and being an adviser. The skills needed to convince someone to save more money can be very helpful when convincing a young player that he needs to pass the ball every once and a while. One could argue that risk control in investing is a little like defense in sports: It may not be as exciting as offense, but it is often what wins championships.

Unfortunately for both sports and investing, the strongest link between the two may be the skewed incentives of those involved. Today the traditional financial adviser is really a salesperson whose world revolves around bringing in assets. This role evolved over time. Originally the term adviser was reserved for money managers, who were hired and paid a fee to make investment decisions on behalf of their clients. The clients who could afford such service were either institutions, such as corporate pension plans, or very wealthy individuals. Most investors went without the help of an adviser.

These investors purchased various investments through salespeople known as stock brokers. The role of the traditional stock broker has been eliminated by technology, however the salespeople have survived by re-branding themselves into financial consultants and eventually financial advisers. When we bring on a new client we ask them who manages their money now. Our older clients

will answer, "I do, and John is my broker at Merrill Lynch." Younger clients will say, "Merrill Lynch manages my money."

In basketball, coaches like Dean Smith used to run summer camps, and elite young players spent their summers going to such camps. Many of these have been eliminated or greatly reduced. In their place we now have leagues, the largest of which is the Amateur Athletic Union (AAU). The issue with this transition is that the incentives of those who coach in camps and those who coach teams in a league are very different. The goal of a camp is to develop players, while the goal of a league team is to win games. If a young player with a lot of raw talent but poor footwork goes to a camp, the coaches will want to focus on that footwork and get him moving more efficiently. If that same player joins a summer team, that coach has other priorities. They must compete so the coach has to teach the players his offensive plays, which takes a lot of practice time away from fundamentals like footwork. Coach wants to help his kids, but the last thing he needs is his star player worrying about footwork in the middle of a tournament where they play two or three games a day. If he tries to fix the skill issue he is likely to see his star not play as well as the new footwork has not become natural yet, and therefore they will lose games and the coach will lose his job. As a result, college basketball is full of very talented players that have very little skill. The NBA has been forced to create a minor league system and employ "skills coaches." The solution that gets talked about for this problem is rule changes to make it easier to score. Those may or may not be good ideas, but they do not address the real issue.

Similarly, in the investment world investment advisers who are paid a fee to manage a client's portfolio are incented to manage that portfolio well and help it grow. Conversely, financial advisers are paid commissions for selling products and are incented to sell more products to more and more people. When I bring this to someone's attention for the first time I usually get this look of astonishment. Most refuse to believe it, because no one in their right mind would design an industry like that. But remember today's investment industry wasn't designed; it evolved.

Investment advisers represent their clients as fiduciaries. According to Wikipedia, "A fiduciary is a person who holds a legal or ethical relationship of trust between himself or herself and one or more other parties.... Typically, a fiduciary prudently takes care of money for another person. In such a relation, good conscience requires the fiduciary to act at all times for the sole benefit and interest of the one who trusts." This is exactly what investment advisers do – they manage the investments of others.

In the aftermath of the financial crisis many people were shocked to find out that this is not what financial advisers do. Financial advisers sell products and are no more responsible for those products than any other salesman in any other industry. People were shocked to find out that financial advisers might sell products they themselves would never buy, and were horrified to learn that financial advisers would agree to buy investments from one client in order to sell them to another. That is the definition of being a broker after all, but their business cards stopped using that word years ago.

In response our leaders in Washington have now decided that all advisers should have to be fiduciaries. Doesn't that sound wonderful? Unfortunately, there are a multitude of problems with this, but for the sake of space we'll just discuss the most obvious one: A commissioned salesperson cannot act in the

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REVIEW *of* ECONOMY

Back to reality. After two quarters with 4.6% and 5.0% growth respectively the 4th quarter of 2014 came in at 2.2%. The 1st quarter is expected to be slow as well. Once again pundits are over reacting. The new normal – slow but steady growth – is still intact and we are moving along at a pace of 2% to 2.5% growth.

The official unemployment rate dropped to 5.5% and jobs appear to be making a slow but steady comeback. Workforce participation remains low but has been slowly improving.

Inflation has negative in January and barely positive in February. Many are worried about when the Fed will raise rates, but it won't happen until inflation gets nearer to the 2% target. If they do raise rates it will be nominal and more of a test for market reaction than anything else. +

REVIEW *of* MARKET

A rough ride to nowhere. The S&P 500 rocked back and forth but finished up only 0.95% when it was all over. Small company stocks did better up 4.32% but international markets were the best place to be up 5%. After a year where nothing did well except the big name domestic indices, we had a quarter that was just the opposite.

Bonds were up with the Barclays Capital US Aggregate Index up 1.61%. High yield bonds did better during the quarter with the Merrill Lynch High Yield Master Index down 2.53%.

International markets were the best place to be this quarter. The MSCI EAFE index finished up 5%. Emerging markets were also up this quarter with the MSCI Emerging Market index up 2.28%. +

MARKET *forecast*

WE CONTINUE TO BE CAUTIOUS about the near term as earnings growth has slowed. However, we are still confident in the longer term. Valuations on equities remain reasonable although they are getting closer to fully valued. The rotation we expected this year seems to have begun, as areas left behind last year have done better.

U.S. large cap stocks are still attractive. International stocks look better from a valuation perspective and are beginning to gain momentum. Emerging markets remain the most attractive on a valuation basis. Small company stocks remain overvalued.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down. +

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sole interest of his clients, since the commission is a huge conflict of interest. I know what you are thinking: Sure the commission is a conflict, but my financial adviser is a good guy, he goes to my church and coached my son, he would never succumb to conflicts.

Issues like this are very interesting for people like Dan Ariely. Ariely, a professor at Duke University, is a pioneer in what we call behavioral economics, the study of how people actually act in real world settings as opposed to how traditional economic models suggest. Traditional economics assumes greed, and therefore would assume that a commission-based adviser would do whatever he could get away with to maximize his commissions. Behavioral economics show that, as you suspected, most people have a moral compass which prevents them from cheating to the maximum. In his book, "The Honest Truth About Dishonesty", Ariely presents many studies which show that while most people will cheat if given the opportunity, they only cheat by a little. However, one of his findings is that conflicts of interest are stronger than most think.

The normal reaction to conflicts of interest from regulators is to demand disclosure. Ariely did this in one of his studies, and in fact the people who disclosed the existence of a conflict acted even worse. His theory is that the open acknowledgement that the conflict exists eased their conscience and allowed for greater cheating. But wait, it gets worse. Another great contributor to cheating is the distance between the cheater and the ones being cheated. Financial advisers are sellers of products, and those products are designed and managed by people far removed from the actual investor. Finally, the nail in the coffin of moral behavior is witnessing someone else cheating and not only getting away with it, but being rewarded for it. Financial advisers are rewarded for selling more products and bringing in more clients. Your guy may be a straight arrow, but if there is one bad apple in his office whom he sees getting praised and rewarded, then your guy will likely follow suit, or leave the business in disgust.

Firms like Iron Capital are part of that fundamental change

In other words, Ariely suggests a list of things one can do to help promote honest behavior, and today's traditional financial industry does just about every one of those things wrong.

Many sports pundits believe that the rules of college basketball need to be changed. They want to shorten the shot clock and make it easier for the offensive players to move. They believe that changing the rules will bring back the glory days when players actually made half or more of their shots and teams routinely scored eighty points or more in a game. These rule changes may or may not be a good thing, but one thing is certain: Changing a few rules is not going to magically enhance the skill level of the average college basketball player. To do that there will need to be more fundamental changes to the current AAU system.

In like fashion, Washington wishes to stamp the word fiduciary on anyone who calls themselves an adviser. That may or may not be a good thing, but one thing is certain: Calling a broker a fiduciary isn't going to magically end conflicts of interest. To do that, we will need fundamental changes to the industry. Firms like Iron Capital are part of that fundamental change. I'm often asked if I'm proud of that. As Dean Smith said, "You should never be proud of doing the right thing. You should just do the right thing."

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