

Ignorance no excuse for financial advisers



I was looking last week through the published list of investors defrauded by Bernard L. Madoff and recognized a name. He was a former client, and I felt bad for him but not surprised.

I remember a discussion with him when he had become restless with achieving normal stock market returns. Another adviser had told him of opportunities where he could earn above-average returns whether the market was up or down. He said these guys were "really smart."

I asked him questions about how they achieved these returns: how much risk they were taking, and how much leverage (debt) they employed in their strategies. He didn't know. They were really smart and, apparently, I wasn't.

I tried to get answers by calling the managers, but I was stonewalled. I told the client that I couldn't recommend the investments because I didn't understand them. He was disappointed in my answer. I eventually lost him as a client. I thought I had let him down.

Another story:

I had a colleague years earlier, a fellow tax professional, who came to me one day and told me he didn't want to be a tax guy anymore. He wanted to be part of the action - and earn the money that the sales guys made. He was going to promote tax shelters to brokers. I wished him well, and he left my group.

Later, I saw him make a presentation to a group of brokers, extolling the virtues of an investment in a historic resort property in Florida. In the middle of rattling off glowing statistics about this particular investment, he stated proudly: "And there are already 2,000 room-nights booked in advance!"

Someone in the room interrupted politely: "Excuse me, Bob, but that number is 20,000, not 2,000." Bob looked at the professional who had corrected him with a blank expression for a few moments, then looked up to the rest of the room with a big smile on his face and said: "Even better!" I stood in the back of the room and watched the brokers wag their heads in disgust.

Obviously, Bob didn't know what he was talking about. What was the industry standard? Was this predictive of great performance or poor performance? He didn't know. What about the rest of the information he was conveying? Could it be believed and relied upon?

Bob's ethical lapse was not his ignorance - we are all ignorant about something. His failing was to feign expertise, and to attempt to persuade people to invest in a product that he did not understand. Luckily, in this case, his audience was well-informed and appropriately skeptical. Unfortunately, there are other audiences that are uninformed and naive.

Madoff's alleged activities were not simply mistakes or violations of ethical standards. They were crimes. And he bears full responsibility for his actions. But there are others who need to ask what role they may have played in the financial ruin of so many. How many investment advisers and financial planners recommended these investments to their clients while having no knowledge of what it was they were recommending?

Some advisers conducted reasonable due diligence, relied on the expertise of others, and were defrauded along with their clients. Others did nothing of the sort. They didn't do their homework.

What seems obvious in hindsight should have been obvious in advance to someone whose job it is to analyze investment opportunities for clients. If they suspected no wrongdoing, but just couldn't figure out what was happening, they needed to recommend against the investment because they didn't understand it. It's possible they would have lost the client in the process. Sometimes integrity has a short-term price.

The same can be said about many of the so-called structured products and derivatives that were at the center of the Wall Street collapse. In many cases they were being created, packaged, repackaged, leveraged, and promoted by people who didn't understand them.

Those who give advice to others and those who design investment products have a moral obligation to know what they are doing. There are life savings, retirements, and college educations at risk.

So to brokers, advisers, accountants, planners, bankers, and anyone else who is apt to give investment advice: It's OK when you don't understand an investment, but say so and don't recommend it. The price of ignorance can be incredibly high.

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