



# Investment Insights

Kevin Kennedy

## Eyes Wide Open

---

For the past two years, scandal has swept Wall Street, as the objectivity of investment research and recommendations has been called into question in the wake of devastating stock market losses. On April 28<sup>th</sup>, the Securities & Exchange Commission announced a \$1.4 billion settlement with Wall Street firms, which was characterized by the SEC Chairman as “the largest overall monetary payment in Wall Street history.” For many of these massive global investment firms, the fines are relatively inconsequential in terms of their long-term impact. More important to the small investor is how this settlement may open investor’s eyes to the way they receive and act on investment recommendations.

Over my fifteen years in this industry, I have seen many sides of this business. I have worked at large, global investment banks, and also at smaller, independent firms such as the one I am associated with now. This business is much like any other: it is driven ultimately by profits. However, unlike many businesses, these profits can come at the expense of something far more important: the trust of the company’s clients. Clearly, many of the firms involved in the SEC settlement put their interests ahead of those of their clients. Investments were offered and recommendations were made not to benefit the client, but rather to add to the bottom line profits of the firm.

Many investors wonder how this situation could exist, and how they can avoid being taken advantage of in the future. To answer this question, it is important to understand how the industry operates.

One of the largest contributors to a brokerage firm’s profits is revenue from investment banking. Investment banking, in broad terms, is the business of raising money for companies (hint: IPO’s), facilitating mergers, and trading for the firm’s own accounts. Relative to investment banking, the retail brokerage operations (working with individual investors) can be a much smaller slice of a firm’s profits. For example, only 26% of Merrill Lynch’s 2000 revenues were derived from commissions, with the remaining 74% coming from investment banking, trading, and institutional money management services. As the numbers illustrate, the individual investor was not the primary source of Merrill Lynch’s profits.

This is important to understand because it ties in directly to the question of how these large Wall Street firms could compromise their integrity with the individual investor. An excerpt from the Wall Street settlement documents illustrates this well: Goldman Sachs telecommunications analyst, in regards to his steadfast “buy” recommendation on WorldCom as the stock declined 99% from November of 1999 to July of 2002, said “Investment banking considerations have prevented me from making a change.” Investment banking is the profit center, and in some cases the individual investor was sacrificed to preserve the profits of the firm.

Clearly, this situation is not acceptable, but, in my opinion, the recent settlement will not do a lot to change the way many Wall Street firms make money, and thus may not prevent investor interests from being sacrificed in the future. Understanding how your investment advisor copes with and addresses these potential conflicts of interest is critical in trusting your advisor and making smart choices in the future.

Ten years ago, before all of these conflicts of interest were front- page news, I made a decision to operate my business as free from inherent or perceived conflicts as possible. For me, this meant aligning myself with an independent brokerage firm that offered a broad, non-proprietary range of investment choices for my clients. It also meant offering clients the ability to work with me on a fee basis in addition to the typical commission-based relationship, thus taking the emphasis off selling products and moving it towards offering solutions and information. I also incorporated independent research sources such as Morningstar, Standard & Poor’s, and Value Line into my practice. It is important to me to always place my client’s interests first, and act as their guardian in a world full of conflicting financial advice.

As you look to form a long-term relationship with a financial advisor, make sure she or he always puts your interests first. Be aware of how she or he gets paid, how they formulate the recommendations they present to you, and how they address the types of conflicts that may be present within their own firms as highlighted by the Wall Street settlement. It may take decades to fix a system that has many inherent flaws, so don’t assume the settlement recently reached will result in an overnight change in the conditions that caused so much distress for individual investors. A good financial advisor can play an important role in helping you reach your financial goals, but make sure you go into the relationship with your eyes wide open.

*Kevin Kennedy is president of Kevin Kennedy, LLC, a registered investment advisor firm in Alameda. Reach him at 510-748-1898 or [Kevin@KevinKennedyLLC.com](mailto:Kevin@KevinKennedyLLC.com). Stocks, bonds, and mutual funds involve risk, including loss of principal. Past performance is no guarantee of future results.*