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From the Desk of Tom Sedoric

Straight Talk with Tom Sedoric

Incentives Misaligned

May 2012

How do I get paid? It's a good and fair question. It is also one that every client and investor should ask of their financial advisor, banker, politician, attorney, and insurance agent – because it is the key to a successful and transparent relationship. Simply put; if I am being less than crystal clear on how I am compensated for doing what I do, then I am not meeting the standards I have set.

Of course, this is obvious, right? Think again. When it comes to the question of misaligned incentives, nothing is quite what it seems. When Greg Smith, an international junior hedge fund executive with Goldman Sachs, publicly announced his resignation with an opinion piece in the New York Times in March, it created a brief furor over the issues of corporate culture and the margining of client and firm interests. We don't yet know the whole story of Smith's very unorthodox departure from the world's largest and possibly most important investment bank. But Smith's perception that Goldman Sachs was becoming more concerned about making money for itself than its clients struck a loud chord.

"I have always taken a lot of pride in advising my clients to do what I believe is right for them, even if it means less money for the firm. This view is becoming increasingly unpopular at Goldman Sachs," Smith wrote. "To put the problem in the simplest terms, the interests of the client continue to be sidelined in the way the firm operates and thinks about making money."

Smith laid out a list of sins he witnessed at Goldman Sachs – employees selling clients less than sterling opaque investments and calling the clients "muppets," or treating them little more than human ATMs. For client stewards far away from the multi-billion dollar deals and multi-million dollar performance bonuses of Wall Street, this comes as no surprise. The $300 plus million in client assets we manage annually might be a rounding error at a mega firm, but is very real for us and our clients. But the issue Smith raised – who is best being served by a buy or sell recommendation? – is one that must be asked time and time again and it matters equally on Wall Street as it does on Main Street. If there is a breakdown of trust, there is no doubt in my mind that the corrosive effect can infect the entire system.

There are cultural and historical reasons why most clients and even allegedly savvy investors have no idea how the people handling their money are compensated. Clients don't ask the question in part because it was one of those money topics considered distasteful to talk or ask about. This notion belongs in a more casual era – before computerized trading and sophisticated investment platforms barely understood by the mathematical wizards that devise them. Smith rightly called them "any illiquid, opaque product with a three-letter acronym."

I believe anyone entrusted with the funds of their clients should make it a priority to tell those who trust them exactly how they are compensated. Is it a fee on assets or, for example, by the number of products they sell? This matters for obvious reasons. We all have a bottom line to meet but if I do better at the expense of my client's bottom line then I have failed to meet my main ethical obligation as an advisor. The best situation is pretty typical – the client sees their portfolio properly managed and the advisor or manager is compensated for properly navigating the rough seas of investing.

The Smith story created a hornet's nest of accusation and counter-accusation about the money-making practices of the largest investment banks. Perhaps because of the number of Bloomberg terminals sitting on the desks at Goldman, New York City Mayor Michael Bloomberg felt compelled to visit the troops and give them a public show of support. Regardless of his credibility, the issues Smith raised are really no different in scope than those unearthed by the financial crisis in 2008. Consider what Fed Chairman Ben Bernanke said in the fall of 2009:

"Compensation practices at some banking organizations have led to misaligned incentives and excessive risk-taking, contributing to bank losses and financial instability,"

I consider the Smith controversy but the latest chapter in an attempt to put the transparency horse back on course. The Fed knows the Wall Street compensation schemes that focus on the short term are dangerous, especially when combined with a dubious standard of transparency. We don't know what, if any, real impact the Dodd-Frank financial regulations will have. In short, we may not have a subprime bubble, but we do have the potential for a cynical, psychological one that assumes history doesn't repeat itself and that institutional greed is the highest virtue.

In case you're wondering, our team is compensated based on our client's success under regulations established back in 1940. It's also worth noting what Bernanke also said in 2009: "The Federal Reserve is working to ensure that compensation packages appropriately tie rewards to longer-term performance and do not create undue risk for the firm or the financial system," We, along with like-minded colleagues across the country who serve their clients, have already set a transparent standard.

Perhaps Wall Street should learn something from our practice and follow the example.

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