

Lecture 18: Professional Money Managers and their Influence

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National Securities Markets Improvement Act of 1996 (NSMIA)

- All advisors managing more than \$30 million must register with SEC
- Those managing less than \$25 must register with state securities regulator

Financial Advisors

- Regulated in most countries
- In US, those giving investment advice for a fee must register with the Securities and Exchange Commission as an investment advisor
- SEC in turn requires passing of exams sponsored by Financial Industry Regulatory Authority FINRA (until 2007 merger with NYSE, National Association of Securities Dealers NASD). Series 65 or Series 66 Registered Investment Advisor exam
- National Association of Personal Financial Advisors (NAPFA.org)

Financial Planners

- Comprehensive planning for life, rather than just picking stocks
- Not regulated, not licensed in most countries
- In U.S., financial planners must be registered as a financial advisor first.
- In US, Financial Planning Association, FPA.ORG
- Certified Financial Planner (CFP) designation, awarded by Certified Financial Planner Board of Standards, Inc.

Assets of US Households & Nonprofits (Table B-100)

2007-IV in \$Billions

- Real estate \$22483
- Pension funds \$12779
- Equity in noncorporate business \$7892
- Deposits \$7389
- Corporate equities \$5447
- Mutual funds \$5082
- Consumer durables \$4035
- Bonds \$2730
- Life insurance \$1205
- Other \$3051
- Total \$72093

Liabilities & Net Worth of US Households & Nonprofits (Table B-100) 2007-IV in \$Billions

- Home mortgages \$10509
- Consumer credit \$2551
- Loans & other \$1315
- Total liabilities \$14375
- Net worth = $\$72093 - \$14375 = \$57718$

(Per capita net worth in dollars \$192,000)

Mutual Fund History

- In 1920s, many investment companies bilked small investors
- Massachusetts Investment Trust (MIT) in 1920s had only one class of investors, published portfolio, redeemed on demand
- Became model for mutual fund industry
- Investment Company Institute

ETFs vs. Mutual Funds

- First Exchange Trade Fund: Standard & Poors Depositary Receipts (SPDRs, Spiders), AMEX 1993
- SPDRs hold portfolio of S&P index
- Management fee: 12 basis points
- Automatic creation and redemption
- QQQs, I-Shares
- Macro securities are analogous to ETFs, but are based on an index. (AMEX). Macro Securities Research LLC, Macro Financial LLC

Trusts Not Always Institutional

- Common law countries allow individuals to appoint friends as trustees.
- Spendthrift trust increasingly common form of inheritance. Planning for divorces decades hence.

Pension Funds

- First pension funds in world: late 19th Century.
- Retirement was not invented until then.
- Increase in life expectancy in 20th Century brought large numbers of elderly people for first time in human history.

General Motors Pension Plan 1950

- In labor negotiations, GM Chairman Charles Wilson proposed fully funded plan managed by financial professionals.
- Proposed investing in the stock market, rather than fixed incomes, but no more than 5% in any one stock. Diversification.
- Wilson made stunning proposal that funding *not* be invested in GM stock.

Studebaker Pension Default, 1963

- UAW accused of acquiescing in underfunding of pension plan so that it could obtain a false “victory” in prior negotiations with management.
- After default, UAW negotiated full benefits for senior workers, little or nothing for others.
- Scandal led to Employee Retirement Income Security Act (ERISA) 1974.

Employment Retirement Income Security Act (ERISA) 1974

- Act was in response to abuses in earlier defined benefit pensions
- Prohibits pay-as-you-go pension plans, defined benefit plans must be fully funded.
- Funds must be adequate:sound actuarial principles.
- Created Pension Benefits Guarantee Corp.
- Prudent person standard for managers
- Minimum vesting standards. An employee for ten years has complete vesting

Prudent Person Rule

- ERISA: Investments must be made with “the care, skill prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

Pension Funds Types

- Defined Benefit: Traditional, old-line manufacturing, supported by labor unions. Now in decline. Not usually indexed.
- Defined Contribution: Employee contributes to own account. 401(k) plans begun in 1981 in US.
- In defined contribution, individuals choose allocations across broad asset classes.

O'Barr & Conley Study

- O'Barr & Conley (*Fortune & Folly*, 1992)
“questions [about pension strategy] elicited lengthy narratives about such cultural issues as history, politics, and relationships, but little talk about economics or finance.” (p. 75)
- Fund executives “rarely rise above their personal perspectives to articulate a corporate vision.” “too busy living through an event to stop and analyze it.” (p. 76)