Beware of Brokers With Agendas

The Motley Fool
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There are lots of things to be wary of when investing.

You need to keep your unhelpful human tendencies in check, for one thing. Succumb to greed and you may hang onto an overvalued stock too long, hoping to wring a few more dollars out of it, only to see it crash later. This happened to me long ago with AOL (which has now been absorbed into **Time Warner** (NYSE: TWX). Mom was right when she told me to sell — at least some of my shares — when they were well above $70 per share. But no, I was envisioning them at $100 per share, drooling at how much richer I'd be. Well, they've been trading well below $20 per share for quite a while now. (Moms are often right.)

Succumb to fear, and you may sell out of good holdings just because of a temporary problem or an overall market slump. I was able to take advantage of other people panicking back in 2002, when shares of **Johnson & Johnson** (NYSE: JNJ) took a brief nosedive. Their loss, my gain.

But back to my point. You need to be careful, and thoughtful, when investing. You need to beware of internal roadblocks to success — like greed and fear. (Learn more in an entertaining Seth Jayson article on the seven sins of stock-picking.) But you also have to watch out for external roadblocks to success — which often come in the form of conflicts of interest.

Conflicts of interest
We've covered this topic countless times in Fooldom over many years, because it's just so prevalent in so many forms. Below are just a few instances, as examples:

Bill Mann interviews former SEC chief Arthur Levitt Shannon Zimmerman on Funds and the Feds A Day in the Life of a Stockbroker

Here's a conflict of interest you really need to be aware of — because it may involve your broker and your portfolio. If your broker recommends mutual funds to you, you should think twice, or even thrice, before investing in them. That's because some brokerages offer their own mutual funds along with other companies' funds. Not surprisingly, they make more money when people invest in their own funds. Therefore, these brokerages have been known to reward their employees for securing new shareholders for these funds.

This results in scenarios like the following: You're in the market for a mutual fund. You ask your friendly broker what she recommends. She, toiling for Acme Brokerage, tells you that Acme has some fine funds and recommends that you plunk your hard-earned money into one or more of them. You

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do. Unfortunately, your Acme fund isn't such a good fund. It may sport higher fees and poorer performance than you can get elsewhere.

Basically, you've been had! She got a larger commission by getting you into a company fund than she would have gotten had she recommended a better fund. (It's almost hard to blame her. She's trying to make a good living, after all, and the system is set up in a way that puts her in a tough position. She may have to choose between being able to remodel her kitchen and recommending the best funds to her clients.)

In a 2002 article at MSN.com, Timothy Middleton detailed how bad this problem has been, giving as an example **American Express** (NYSE: AXP), which at the time was about to start reducing the commission it paid its stockbrokers (who are in many ways mutual fund sales people, but whom the company refers to, perhaps somewhat misleadingly, as "financial advisors") when they sold non-AmEx funds to clients.

Middleton offered a reason why the AmEx funds might have needed such strong selling pressure: "American Express funds are lousy. Only three of the complex's 189 funds ranked in the top quarter of its Morningstar category over the three years ended June 30, and only 27 ranked in the top half. An astonishing 86% were below average. Since the beginning of 2000, investors have yanked nearly $3 billion from the complex. American Express is not the only Homer Simpson among proprietary fund companies; they're all underachievers." He cited as other examples **Merrill Lynch** (NYSE: MER) and **Morgan Stanley** (NYSE: MWD). (If you're a Homer Simpson fan, pop into our 742 Evergreen Terrace discussion board.)

If all this sounds kind of illegal, well, it kind of is. But where there are clever people, undesirable rules can often be worked around. Instead of paying sales people more for one fund than another, for example, a fund company may levy a fee on them for selling non-in-house funds and waive the fee (or make it lower) when an in-house fund is sold.

All is not lost

Fortunately, our friends at the Securities and Exchange Commission and on Capitol Hill have been looking into requiring fund salespeople to disclose to you how they're compensated when you buy Fund A or Fund B from them, along with the same info on comparable funds. Some research suggests that this disclosure may not stop people from signing up for the recommended firms, but it's a step in the right direction, and at least investors will be making more informed decisions.

Specifically, the "Mutual Fund Transparency Act of 2005" bill, recently introduced by Sen. Daniel K. Akaka (D-HI), would, among other things, require brokers to disclose to fund-buying clients (in writing) how much compensation is being generated by the transaction. The Investment Company Institute (the mutual fund industry's trade association) adds that, "Another new section of the bill would direct each national securities association to adopt rules requiring that a broker that provides individualized investment advice to a person will have a fiduciary duty to that person; act solely in the

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best interests of that person; and fully disclose all potential conflicts of interests and other material information prior to the time that the investment advice is first provided to the person and at least annually thereafter."

This all sounds good, but I'm not all that hopeful. After all, it still needs to be passed by Congress, and if it even gets that far, it may end up losing some of its few teeth in the process. I say "few" because disclosure, while good, won't necessarily stop people from ending up in subpar funds. And even if a strong bill is passed, brokerages may still find ways to engage in shenanigans.

What you can do

You don't have to be a victim of this practice. Here are some things you can do:

Don't rely on a stockbroker for recommendations. Note, though, that some actually do serve their customers well, so perhaps just make sure that the one you use is a good one. We've long suggested that the best person to make important financial decisions for you is... you. If you have the time, interest and temperament to learn all about investing and to practice it with discipline, you might do much better selecting your own stocks and funds than many brokers would do for you.

Consider letting us help you find top-notch mutual funds. Grab a free trial of our *Motley Fool Champion Funds newsletter,* and see which funds our analyst Shannon Zimmerman has recommended. Together, his picks have nearly doubled the market's return (last I checked), with a bunch racking up double-digit gains in the last year.

We can point you to other market-beating investments, too, in our newsletters focused on undervalued investments, investments that generate income, small companies, potential rapid growers, and more. (Learn more about our newsletters, which you can try for free.)

Consider using a low-cost brokerage. The firms that charge you the most to trade are likely to also be ones offering in-house funds with so-so performance. Learn more about low-cost brokerages and how to select the best one for yourself in our Broker Center. (Did you know that you might be able to pay just $5 per trade — or less! — in commission at some brokerages?)

Keep learning

The mutual fund world is more interesting than you may think. Learning more about it may help you make a lot of money — or at least not lose too much money. Learn more in these articles:

The Case for Mutual Funds; Slam-Dunk Mutual Funds; You're Paying How Much?; Champion Funds Still Beating the Market; When Good Funds Go Bad; Is It Time to Sell?

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