SIGMA INVESTMENT COUNSELORS

Sigma Summaries

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What Would Your Mother Expect You To Do?

I define a conflict of interest as "a situation in which a person, such as a public official, an employee, or a professional, has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties. " There are three key elements in this definition. First, there is a private or personal interest. Often this is a financial interest, but it could also be another sort of interest, say, to provide a special advantage to a spouse or child. Taken by themselves, there is nothing wrong with pursuing private or personal interests, for instance, changing jobs for more pay or helping your daughter improve her golf stroke.

The problem comes when this private interest comes into conflict with the second feature of the definition, an "official duty" — quite literally the duty you have because you have an office or act in an official capacity. As a professional you take on certain official responsibilities, by which you acquire obligations to clients, employers, or others. These obligations are supposed to trump private or personal interests.

Third, conflicts of interest interfere with professional responsibilities in a specific way, namely, by interfering with objective professional judgment. ***A major reason clients and employers value professionals is that they expect professionals to be objective and independent.*** *Factors, like private and personal interests, that either interfere or appear likely to interfere with objectivity are then a matter of legitimate concern to those who rely on professionals — be they clients, employers, professional colleagues, or the general public. So it is also important to avoid apparent and potential as well as actual conflicts of interests. An apparent conflict of interest is one in which a reasonable person would think that the professional's judgment is likely to be compromised. A potential conflict of interest involves a situation that may develop into an actual conflict of interest.*

Michael McDonald, PhD.
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So, you ask, "This is cited because?"

Shortly after publishing my December Sigma Summary (which discussed the necessity of a strong ethical foundation in businesses advising clients regarding their finances), I received a thoughtful letter from a dear friend and long time client. She inquired as to how we common stock analysts at Sigma differed from those on Wall Street who, she noted, were being derided by the press for their "conflicts of interest." Good question, I thought, and probably a topic worth discussing.

There are many potential conflicts of interest in the investment advisory/securities business. Because of these many conflicts, policies and laws exist to deter most unscrupulous operators. Indeed, an entire issue could be devoted to the many potential, and real, conflicts of interest in this industry. I will save that for another day, though.

The question my friend asked, however, was how Sigma's analysts differed from those on Wall Street, and why Wall Street's analysts had a "conflict of interest" while Sigma's did not. Quite simply, the answer lies in the fact that Sigma analysts have one, and only one, responsibility – to its investment advisory clients. The Wall Street brokerage firms whose analysts were under fire were from firms that both advise investment advisory clients and also engage in investment banking activities. Hence, they have "two masters." This is no different than a lawyer who represents both the plaintiff and the defendant. He cannot be an advocate for both.

As a quick primer, an investment banker is charged with raising money for a client company to enable it to grow. The measure of effectiveness is the cost of capital. When selling bonds, the investment banker wants the company to pay as low a rate of interest as possible. When selling common stock, the investment banker wishes to achieve as high a price as possible. In contrast, an investor wants to receive as high a rate of interest as possible on a bond, or pay the lowest price for a stock. These competing interests typically are resolved when ***informed*** buyers and sellers come together and strike a deal.

But what if the buyer receives his information from the investment banker? Further, what if the investment banker makes more money by advising the company for which the capital is being raised, than what is earned advising the investor? A conflict exists – plain and simple. A quick re-read of Dr. McDonald's definition of a conflict of interest captures precisely what had been happening by those Wall Street firms that engaged in both investment banking and investment advisory efforts.

Of course, this conflict has plagued Wall Street for many years. The abuses simply grew more and more egregious as the sums paid to the investment bankers grew in the frenzied deal-making environment of the late 1990's. It culminated in the indictment of several prominent analysts last year. Frankly, this is the primary reason investors have grown so utterly disenchanted with common stocks as an investment – precipitating one of the longest and most damaging bear markets in modern U.S. history.

As Dr. McDonald avers above, and which bears repeating, "A major reason clients and employers value professionals is that they expect professionals to be objective and independent." In this regard, when we conduct our common stock research at Sigma, our sole motivation is to determine if an investment in that stock will help our clients achieve their investment objectives by virtue of including it in their portfolios. No other consideration is given. Indeed, if we decide that a stock is appropriate for our clients, we make sure every portfolio for which the stock would be a suitable holding, is invested in the shares before any of the employees of Sigma buy it for their own accounts. Similarly, when it is determined that a stock is to be sold, client sales are made before employee trades.

So Alice, there it is. I hope I enlightened you, and your fellow Sigma clients, about the differences between Sigma analysts and Wall Street analysts.

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Before closing this letter, I did wish to announce that Sigma Investment Counselors was recently approved by the National Football League Players Association to provide investment advisory services to their active and retired football players. We are proud of this achievement as only a limited number of advisors were approved and we think this reflects well upon the firm. So, refer us to your football-playing friends!

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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