What The Heck Was That?

GUERDON T. ELY, MBA, CFP®, AIFA®

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"What the heck was that?" was the punch line for a joke that I can't forget, even though it wasn't all that funny. The line was delivered about fifty years ago by a magician who was performing at my intermediate school. To distract our attention while executing his illusions, he kept up a constant banter of adolescent jokes. The one in question was about his wife practicing for a community play. Her one line, "Hark! Is that a cannon I hear?" was to be delivered in response to the distant rumble of battlefield artillery. However, when her big moment arrived, she was so startled by the loudness of the sound effect that she screamed the "what the heck" line, instead of the one she had so diligently practiced.

Recently, the financial world was startled by the very public resignation of Greg Smith from Goldman Sachs. In a New York Times op-ed, he explained the reasons why he was leaving. "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." The next day, in an agreeing response, John Bogle wrote, "When I came into this field, the standard seemed to be 'there are some things that one simply doesn't do.' Today, the standard is 'If everyone else is doing it, I can do it too.' When we replace moral absolutism with moral relativism, traditional ethical standards go by the board." So how did Wall Street lose its moral compass?

Michael Lewis, the author of The Big Short, believes it all began "…when, in 1981 [John Gutfreund]… turned Salomon Brothers from a private partnership into Wall Street's first public corporation." Lewis claims that from that moment on, Wall Street became a "black box" where "…the shareholders who financed the risk taking had no real understanding of what the risk takers were doing, and, as the risk taking grew even more complex, their understanding diminished." Wall Street went from a place where profits were made by serving clients and allocating capital to productive pursuits, to a place where smart people could make big money making risky bets. In the process, Lewis says, "The customer became, oddly, beside the point." He doubts that Wall Street would have ever become so highly leveraged with such exotic securities and so alienated from its clients if the firms had remained as partnerships. With their own money at stack, Lewis suspects, "The short-term expected gain would not have justified the long-term expected loss."

But with Wall Street executive compensation tied to quarterly results and insulated from long-term consequences, Lewis says, "They can get rich making dumb decisions." The CEO's of all the major Wall Street firms were on the wrong side of the mortgage crisis. "All of them… either ran their public corporations into bankruptcy or were saved… by the United States government. They all got rich, too."

Since I first got into the financial services business thirty years ago, the joke has been that Wall Street takes risky bets because if they win they get to keep it, and if they lose the government bails them out. It's another one of those jokes I can't forget, even though it isn't funny. What makes it even less humorous is after the 2008 financial crisis and the passage of the Dodd-Frank bill, nothing seems to have changed. In 2011, Jon Corzine bankrupted MF Global by betting the farm (and it appears a lot of farmers' money) on a highly leveraged European debt scheme.

Corzine's fiasco was another "What the heck!" moment where Wall Street's greed and incompetence were exposed. By subordinating clients' and shareholders' best interests to their own interests, Wall Street is not-so-magically making client funds and shareholder value disappear.

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ELY PRUDENT PORTFOLIOS, LLC
10 DECLARATION DR., SUITE D
CHICO, CA 95973

(530) 895-0636 OR (800) 560-0636
WWW.ELYPORTFOLIOS.COM
GTELY@ELYPORTFOLIOS.COM