WARNING: Blame Is Hazardous to a Firm's Health
RAISE THE BAR ON IDEA GENERATION

GET TO KNOW OUR POWERFUL EQUITY IDEA GENERATION CAPABILITIES.

> Robust screening EQS <GO>
> Backtesting EQBT <GO>
> Supply chain read through SPLC <GO>
> Relative valuation EQRV <GO>

Dig deeper to get the real story behind the data for sharper investment decisions.

To learn more and for a customized demo, visit Bloomberg.com/ideagen

Bloomberg
28 The Next Paradigm

Fund manager C. Thomas Howard believes the time has come to replace modern portfolio theory with behavioral portfolio management

By Nathan Jaye, CFA

32 A Fair Exchange

In the new market structure, can exchanges be trusted with a self-regulatory function?

By Sherree DeCovny

36 The Rise of Environmental Markets

"Putting a price on pollution will motivate technological change and will create investment opportunities," says Richard Sandor

By Nathan Jaye, CFA

"INVESTORS WILL LOOK AT ENVIRONMENTAL ASSETS THE SAME WAY THEY WOULD LOOK AT OTHER INDUSTRIES. ... IT’S GOING TO UNLEASH CERTAIN TECHNOLOGICAL CHANGE."
Is your risk model as balanced as your portfolio?

FactSet’s balanced, multi-asset class risk model gives you a true picture of your portfolio’s risk by allowing you to:

+ Monitor risk on any horizon
+ Leverage a Monte Carlo simulation approach
+ Include non-linear risk measures
+ Consider a full spectrum of assets
+ Examine risk trends
+ Integrate risk analytics at every stage

Only a true balanced risk model can holistically report risk across all asset classes. Find out what makes FactSet’s MAC model unique.

REQUEST A FREE TRIAL.
FactSet.com/balancedrisk
CFA INSTITUTE NEWS

6 In Focus
Leadership, Engagement, and Initiative
By Aaron Low, CFA

8 EMEA Voice
Financial Literacy: Opportunities and Challenges
By Nitin Mehta, CFA

10 APAC Focus
Learning from Our Stakeholders
By Paul Smith, CFA

11 The importance of the Regulator and Program Recognition initiative, the story of an outstanding mentor, and more

VIEWPOINT

COVER STORY

16 Blame, Accountability, and Performance
When investment firms play the blame game, performance is the loser
By Jim Ware, CFA, and Jason Hsu

17 Read Your Sharpe and Markowitz!
Even if modern portfolio theory is wrong, it remains a valuable analytical tool for investors
By Laurence B. Siegel

PROFESSIONAL PRACTICE

21 Analyzing bank performance and value

22 Learning to beat high-frequency traders

24 A growing problem: organizational structure

26 What really drives job satisfaction?

ETHICS AND STANDARDS

40 Market Integrity and Advocacy
• US Supreme Court ruling favors investor protection
• “An uneasy truce” with credit-rating agencies
• Managing conflicts of interest
• Restructuring GIPS governance

45 Professional Conduct
Ethics education and engagement

5 In Summary

47 Chapter 10
Stubborn Wisdom

“Such is the absurd trifling with which men seek to blind themselves, willfully abstaining from a sound exercise of judgment to arrive at the truth.”—Alessandro Manzoni, The Betrothed

In the mid-17th century, the French scientist Blaise Pascal began sketching his thoughts for a book that was never completed. Later published as Pensées, the journal includes the proposition called Pascal’s Wager, which was influential in the development of thinking about probability and risk.

Pensées begins with an examination of what Pascal considers the two basic types of minds: mathematical and intuitive. “It is to judgment that perception belongs, as science belongs to intellect,” he concludes. “Intuition is the part of judgment, mathematics of the intellect.”

Investors have a comparable challenge in trying to reconcile intuitive judgment and analytical rigor. Practitioners need both. Even if someone wanted to implement a strictly axiomatic system, the body of investment theory would have to be reconciled with its empirical defects. One alternative is to jettison the standard model. Advocating “behavioral portfolio management,” fund manager C. Thomas Howard says he began to develop his ideas “when the finance literature, which is empirical literature, turned decidedly against modern portfolio theory [MPT]” (“The Next Paradigm,” 28). Writing in defense of MPT, however, Larry Siegel argues that it is “a little like Newtonian mechanics in physics—we know it’s not exactly right but use it where we can because it is so useful” (Viewpoint, 17).

Regardless of their views on MPT, investors face a world that is heavily invested in such concepts. “At least in the US courts, the efficient market hypothesis is alive and well,” writes Kurt Schacht, CFA, explaining a key judicial ruling on investor protection (Market Integrity, 40). Another example is the legal notion of “investment grade,” which complicates the relationship between investors and credit rating agencies. As Jim Allen, CFA, points out, a recent study found 54 instances of regulations dictating the use of credit ratings for a wide array of purposes (“Gauging Investor Attitudes about Credit Ratings,” 41).

An observation from Pascal may help here: “Dull minds are never either intuitive or mathematical.” In other words, intuition and intellect are both modes of intelligence. When they are misused or badly out of balance, the consequences can be ugly. A kind of case study of this principle can be found in a very different book involving the 17th century, a novel called The Betrothed by Alessandro Manzoni. Set in Italy, the story begins when the wedding plans of Renzo and Lucy are disrupted by a duke who has wicked designs on the bride to be. A chain reaction of plot twists ensues, entangling Renzo and Lucy in the miseries of a dysfunctional society. There appears to be no problem that people cannot make worse by trying to solve it. Instead of applying intuitive wisdom or logical designs, they simply do what seems expedient.

One character in the novel sums up the situation when he says, “As to justice, I defy it: it does not exist; and if it did, I should equally defy it.” This statement might have come from a high-frequency trader if The Betrothed had been written today. High-frequency trading is often depicted as predatory and amoral, but rather than booing and hissing, many investors are taking the more productive task of learning how to outsmart high-frequency players (Trading Tactics, 22). More broadly, HFT is one of many changes raising questions about the ability of exchanges to fulfill their self-regulatory function. “It’s a bit of a black hole where the exchange isn’t really doing it anymore but the regulator hasn’t quite got up to speed,” says one expert (“A Fair Exchange,” 32).

In Manzoni’s novel, Renzo falls into “a bit of a black hole” when he arrives at Milan in the middle of a bread riot. Scarcity caused by a poor harvest has been compounded by a ruinous war and “insupportable taxes levied with a cupidity and folly unequalled.” Popular suspicion blames “speculators” and bakers. The municipal authorities, eager to fix blame on someone other than themselves, require bakers to sell bread at unsustainably low prices, which causes a crisis of bread production. The absurdity finds expression in the rallying cry of “Bread forever at a low price!” Eventually, a mob mentality breaks out, and bakeries are attacked and looted. The whole town seems to need an intensive course in ethical decision making (“Ethics Education and Engagement,” 45).

In effect, Milan experiences a “blame cascade.” If we think such irrationality is a byproduct of ignorance, we deceive ourselves. In fact, a blame culture is even more likely to take root in investment firms because they are full of highly intelligent people, who (studies show) tend to place greater value on being right. Moreover, according to new research, blame is “toxic to an investment culture” (“Blame, Accountability, and Performance,” 16). In any kind of work environment, however, achieving job satisfaction remains a perennial challenge (“Satisfaction Reaction,” 26).

For all its tragic events, The Betrothed is really a story of hope and redemption. Renzo and Lucy are eventually reunited. A notorious villain repents of his wickedness and uses his fortress to provide refuge for people displaced by war. He is aided in his conversion by the example of a saintly archbishop. In this virtuous character, who “took truth for the rule of his thoughts and actions,” intuitive judgment and logical precision seem to go hand in hand, yet his good works often seem like folly to those around him. “There is no remedy,” laments one of his clergy, “these saints are always obstinate.” Such stubbornness would have appealed to Blaise Pascal. “Man is obviously made to think,” he writes in Pensées, “and his whole duty is to think as he ought.”

Roger Mitchell, Managing Editor (roger.mitchell@cfainstitute.org)
Leadership, Engagement, and Initiative

By Aaron Low, CFA

Six years after the financial crisis, our industry is still in the healing process. Along the way, CFA Institute has committed significant resources to do our part in helping in this tenuous recovery. Our mission statement has been broadened to encompass the wider community and to state that we seek to lead our global profession by promoting the highest ethical and professional standards for the ultimate benefit of society. But there is still much to be done.

As the incoming chair of the CFA Institute Board of Governors, I am excited to work with the incoming CEO to lead CFA Institute on the next leg of our journey. Naturally, my highest priority will be managing the CEO transition and ensuring critical implementation of our new initiatives that will help further our mission.

Our interim CEO, Dwight Churchill, CFA, has assumed full responsibilities, and the seamless handover is testimony to the strength of the organization and its leadership team. It is business as usual. I am confident that the new CEO will perform no less capably. And that brings me to our important initiatives that will set the tone and ensure the relevance of our organization for years to come.

First, now more than ever, we remain committed to the Future of Finance initiative. The overwhelming embrace of the FOF by both the organization and membership has provided an unprecedented dose of volunteer and member engagement. This effort is not just another advocacy initiative. Its importance to our mission cannot be overstated. The FOF can help us map the genome of a well-functioning capital marketplace. It even has the potential to be a risk barometer. In the words of Roger Urwin, a fellow member of the CFA Institute Board of Governors and key architect and proponent of the FOF initiative, “it can better prepare us for the next crisis as well as attenuate the risks of that occurrence.” Indeed, the weak recovery, which has been called “the new normal,” still seems fragile and fraught with uncertainties. Surely, we are not immune to another crisis, and the FOF provides an avenue to engage in best practices for a sustainable and honest system. It is an exercise in generating good advocacy, thought leadership, and broader community engagement (including the broad spectrum of our membership) in one fell swoop. Looking at the numerous society initiatives, we have high hopes that this collective and creative spirit can help incubate a better and healthier financial ecosystem.

Second, there are some who view our next initiative, the China and India Project, as a revenue-growth aspiration. I rather think of it as an investment in risk management. Let me elaborate. Asia now accounts for about half of CFA Institute’s revenues, and this growth is led by China and India. So, we are already exposed to the Chinese and Indian markets. The irony is that our understanding of the region still lags far behind our knowledge of the US market. And this lack of understanding represents a risk that is difficult to ignore. If we continue to take for granted that our second-largest market is always going to be there without expanding our engagement, then we must be prepared to face unexpected consequences. I dislike the use of the term “too big to fail,” but that prospect certainly is not “too far from reality.”

Third, we need to strengthen our industry relations. We need to understand employers better, and they need to understand our values. We can do that and still remain a non-aligned organization, true to mission. Being independent does not mean we have to operate in a silo. We can influence businesses without being unduly affected. It is difficult for a lone charterholder or member to make a difference to his or her firm, but as the membership ratio grows, so will the impact of our values. Imagine how well our industry could develop if firms and businesses would embrace even some part of our values.

Our philosophy is etched in our absolute commitment to professional and ethical excellence. In all our activities, where best practices exist, we will lead, and where best practices do not exist, we will initiate. This guiding principle means investment in the best efforts to support our mission and a clear commitment to continually review and improve our engagement opportunities for our most important asset—our members. Because we are dependent on the dedication and professionalism of our members and growing this global talent pool is a competence in which we take special pride, our members will remain the critical element of our competitive advantage. We remain committed to lead efforts to improve global financial infrastructure, and together with you, our combined efforts will help make the world a better place for savers, investors, and our stakeholders.

Aaron Low, CFA, is chair of the CFA Institute Board of Governors.
## Financial Sector SPDR ETF

### Top Ten Holdings*

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Symbol</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan Chase</td>
<td>JPM</td>
<td>8.24%</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>WFC</td>
<td>8.15%</td>
</tr>
<tr>
<td>Berkshire Hathaway B</td>
<td>BRK.b</td>
<td>8.00%</td>
</tr>
<tr>
<td>Bank of America</td>
<td>BAC</td>
<td>6.22%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>C</td>
<td>5.92%</td>
</tr>
<tr>
<td>American Express</td>
<td>AXP</td>
<td>3.13%</td>
</tr>
<tr>
<td>American Intl Group</td>
<td>AIG</td>
<td>2.82%</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>GS</td>
<td>2.80%</td>
</tr>
<tr>
<td>US Bancorp</td>
<td>USB</td>
<td>2.76%</td>
</tr>
<tr>
<td>Metlife</td>
<td>MET</td>
<td>2.26%</td>
</tr>
</tbody>
</table>

* Components and weightings as of 12/31/13. Please see website for daily updates. Holdings subject to change.

### Potential benefits of adding Sector SPDR ETFs to your portfolio include:

- Undiluted exposure to a specific sector of the S&P 500
- The all-day tradability of stocks
- The diversification of mutual funds
- Total transparency
- Liquidity

### Time For A Stock Alternative

Visit [www.sectorspdrs.com](http://www.sectorspdrs.com) or call 1-866-SECTOR-ETF

---

An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus, which contains this and other information, call 1-866-SECTOR-ETF or visit [www.sectorspdrs.com](http://www.sectorspdrs.com). Read the prospectus carefully before investing.

The S&P 500, SPDRs, and Select Sector SPDRs are trademarks of The McGraw-Hill Companies, Inc. and have been licensed for use. The stocks included in each Select Sector Index were selected by the compilation agent. Their composition and weighting can be expected to differ to that in any similar indexes that are published by S&P. The S&P 500 Index is an unmanaged index of 500 common stocks that is generally considered representative of the U.S. stock market. The index is heavily weighted toward stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. The S&P 500 Index figures do not reflect any fees, expenses or taxes. Ordinary brokerage commissions apply. ETFs are considered transparent because their portfolio holdings are disclosed daily. Liquidity is characterized by a high level of trading activity.

Select Sector SPDRs are subject to risks similar to those of stocks, including those regarding short-selling and margin account maintenance. All ETFs are subject to risk, including possible loss of principal. Funds focusing on a single sector generally experience greater volatility. Diversification does not eliminate the risk of experiencing investment losses.

ALPS Portfolio Solutions Distributor, Inc., a registered broker-dealer, is distributor for the Select Sector SPDR Trust.

STATE STREET GLOBAL ADVISORS.
Financial Literacy: Opportunities and Challenges

By Nitin Mehta, CFA

As the father of two teenagers, I was curious about the recently reported findings of the first international assessment of financial literacy among 15-year-old students. Knowing that their generation’s ability to make good financial decisions may impact my own income in retirement, I felt personally invested in the results.

The Program for International Student Assessment (PISA), coordinated by the Paris-based Organisation for Economic Co-operation and Development (OECD), measured students’ understanding of some fundamental aspects of finance, including concepts, products, and risks. They were also tested in applying their financial knowledge to practical problems. Over half of the students had a bank account, and two-thirds earned money outside school hours, so most had experience in making some financial decisions. Yet the assessment revealed wide variation in the financial competencies of students within most of the 13 countries surveyed and room for improvement in all of them.

The strongest performance in financial literacy was achieved by students in Shanghai, China, while the weakest was in Colombia. In between these two distant outliers, students in the US performed just below average, and there was a wide distribution among European countries. Differences in GDP per capita explained only 16% of the variation, comparable to the impact of socio-economic status. At the same time, gender differences hardly mattered at all, contrasting with tests on adults that show a gender gap in financial literacy. Interestingly, students who held a bank account materially outperformed those who did not, pointing to the possible importance of financial inclusion and experience.

Why are such tests of financial literacy in the young important? Many governments have long realized the influence of financial education on the productivity and stability of their economic systems. The recent financial crisis put greater emphasis on that belief. Aiming the effort at the young begins the learning process early, and it is more efficient to channel programs through schools. Under Russia’s presidency of the G–20 in 2013, a number of initiatives were started to promote national strategies for financial literacy in many countries around the world. The PISA assessment now provides data which will guide further work.

CFA Institute is also committed to improving financial literacy. Guided by Benjamin Franklin’s dictum that “an investment in knowledge pays the best interest,” we focused one of the six themes under our Future of Finance initiative on the importance of financial knowledge in empowering investors. Two of our recently published guides—Statement of Investor Rights and Essentials of a More Secure Retirement—provide examples of our support for individual investors. In addition, there is a portal to investor tools and related resources on the CFA Institute website. A number of CFA societies are also involved in engaging with their local communities to improve basic financial literacy. As well as efforts aimed at investors, we launched the Claritas Investment Certificate last year to raise the level of understanding of basic finance, investments, and ethics among those who may support investment decision makers.

While improving financial literacy is a worthy goal, it is worth remembering that there are also limits to what may be possible. A US study published in 2006 revealed that only one in six consumers of financial products could calculate the cumulative interest over two years at 10% per annum on a balance of $200. (See Annamaria Lusardi and Olivia S. Mitchell, “Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education Programs,” University of Michigan Retirement Research Center Working Paper 2006-144 [December 2006].) More worryingly, only about half could divide a lottery prize of $2 million by 5 joint winners. If consumers have a limited capacity or wish to understand finance, then investment products, processes, and providers will have to become smarter instead. Just as a typical medical patient trusts his physician to look after his health, so a typical investor will need to trust an investment professional to tend to his wealth. Accordingly, investment practitioners will have to wrap the complexity of financial markets with the simplicity of product features and the reliability provided by good design so that the need for investors to learn is minimized.

With the growing shift towards the responsibility for saving by the individual, together with the assumption of attendant risks, greater financial literacy for investors and higher standards of financial acumen by providers of investment solutions are urgent requirements for a stable society.

Nitin Mehta, CFA, is the CFA Institute managing director for the EMEA region.
Investing Opportunistically: Separating the Beta from the Alpha

16–17 October 2014
Hyatt Regency Huntington Beach Resort and Spa
Huntington Beach, California, United States

With fundamental questions lingering in today’s global debt markets, there is an increased need for savvy bond investors who have the skills and insight to thrive in a new cycle and deliver value to investors.

At Fixed-Income Management 2014, leading practitioners will navigate through what’s happening in global credit markets, take a closer look at the long-term effects of monetary policies by central banks, and discover where leading investors are finding value.

Learn more about this special event and register now: www.cfainstitute.org/events.
Engaging our stakeholders is an important part of what we do as representatives of CFA Institute and our members. Over the past several months, I have had the pleasure of hosting a series of lunches with regulators and senior executives of investment firms so that they can share on an informal basis industry trends around behavioral standards in Asia Pacific. These occasions have yielded good practical feedback on what the investment profession is doing and needs to do to help restore trust among the investing public.

These discussions have strengthened our mutual understanding on such issues as protecting and enhancing brand value, policing the conduct of sales intermediaries, improving the behavioral standards of employees, and extending and improving employee education, especially in the area of basic business ethics. In general, all participants appreciate our efforts and view our educational programs as instrumental in achieving this goal. In turn, this input has been a great source of motivation for us to continue our outreach activities across the region.

It is also enlightening to hear from peers in investment management firms about their daily business challenges. The list is long, with concerns over fund distribution ranking as most prevalent. Most believe that the prevailing distribution model in Asia Pacific makes it hard to build brand value and to exercise influence over the way their products are sold. Distributors are increasingly driven by the size of sales incentives offered by managers and less so by product quality. Consequently, the scope for product misselling is increasing.

In Asia Pacific, funds are commonly distributed by banks, which have unrivalled retail market reach. But with myriad products on banks’ shelves, many almost indistinguishable from each other, how can a fund stand out? Investment management companies wield little control over who ends up buying their products, and customers can’t readily distinguish between brands. Disappointingly, no fund manager we spoke to placed their own behavioral standards at the heart of the brand value that they project to potential clients. Performance numbers were all. With such a narrow focus, it is not surprising to me that managers fail to distinguish their products from those of their peers and feel powerless to push back against the financial demands of distributors. Equally surprising was the widespread view that regulators need to increase their involvement in the policing of distribution policies and fees.

A firm’s adherence to ethics can and should embody its brand, creating trust and distinction and thus catalyzing sales growth. Just as the “organic” label offers buyers a healthier choice, the ethical promise of a fund’s brand should be a key differentiator. Investment management firms that rely heavily on intermediaries find it difficult to assert this differentiation.

There is truth to this argument. However, the distribution model should not be used as an excuse by firms for failing to build ethics into brand value. Distributors also have much to gain from selling trustworthy products. This area could benefit from more constructive dialogue, and CFA Institute can help facilitate it.

This challenge also speaks of the need for comprehensive investor education. A recent Cerulli Associates report says that retail investor participation in the Indian mutual fund industry is a low 20.3%. One of the reasons cited is that investors are skeptical of the benefits of investing in mutual funds. Indeed, across Asia, retail investors need basic, practical advice on how to pick a fund or fund manager.

Since we launched the Statement of Investor Rights last year, we have been fortunate to have societies in Asia Pacific that have pushed investor education to the top of their national agendas. In India, one of the ways we have been working with our society is by co-authoring an investors’ guide to shareholder meetings to help educate retail investors about their rights and responsibilities. The guide will be used by institutions across the country to supplement their own investor education initiatives. (The complete guide, An Investor’s Guide to Shareholder Meetings in India: Rights, Roles, and Responsibilities, is available online at www.cfapubs.org.) In the Philippines, our society has partnered with a nationwide personal finance television show to dispel myths about investing and to share best practices with the general public. In Singapore, we engaged with the Singapore Exchange to discuss how the finance community can work to deter stock market manipulation.

All of this points to the power of dialogue. An hour spent over lunch with our stakeholders is a valuable opportunity for us to learn their challenges and opportunities. It allows us to direct our efforts to where they are most needed. As I settle into my new expanded role as head of institutional partnerships, I look forward to meeting more institutional stakeholders outside of Asia Pacific and learning more about their business issues and to strengthening our partnership with industry.

Paul Smith, CFA, is managing director for Asia Pacific and global head of institutional partnerships at CFA Institute.
Winning Ways
MICHELLE CONNELL, CFA, MAKES AN IMPACT AS A MENTOR

By Michele Armentrout

Nicholls State University is deep in the heart of bayou country, about an hour’s drive southwest of New Orleans in Thibodaux, Louisiana. The campus was once part of a historic plantation and is sometimes referred to as “Harvard on the Bayou” by nostalgic alumni and passionate supporters. Most of the 6,500 students come from the surrounding area, and two-thirds of them are first-generation college students.

Yet, in only three years, with the guidance of mentor Michelle Connell, CFA, the Nicholls State University team has managed to make a name for itself as participants in the CFA Institute Research Challenge, competing with much larger universities at the Americas Regional competition.

In 2013, the Nicholls team scored exceptionally well on the written report and placed in the top four of 25 schools at their local competition, and in 2014, the team finished second overall out of 24 teams and earned a trip to the Americas Regional competition in Denver, Colorado, where they competed against teams from the United States, Canada, and Latin America.

Team leader Dmitry Lebedev credits their success directly to the leadership skills of Connell. “This would not have been possible without Michelle’s guidance and her motivational and mentorship skills,” he says. Lebedev recalls how Michelle constantly challenged the team during the six months of preparation as they developed the initial sell-side report. “She was so motivating and really made our team believe that we could compete and win not only against the best schools at our local challenge but the regional level as well,” he says.

Throughout her career in the industry, Connell has always been a mentor in some way. “I was the head of a tech sector for a private bank, and I mentored in that capacity, and I mentored at my Chicago firm with our analysts when I was a portfolio manager and a partner in training,” she says.

John Lajaunie, professor of finance at Nicholls State and faculty adviser for the CFA Institute Research Challenge, believes Connell’s team-building skills and willingness to help develop those around her make her an ideal mentor. “As further testament to her dedication,” he points out, “each year she traveled from Houston, Texas, to Thibodaux, Louisiana, to meet with the teams over a weekend to make sure they understood the project from a big-picture view all the way down to the details.”

All five of the team members agree that Connell’s analytical ability gave them the edge. “Michelle is highly analytical, and this helped us tremendously because it’s easy to take a company’s financials and competitive position and assume that the future will look the same as the past,” says Lebedev, “but she taught us to look at certain factors from all possible angles.”

For many of the team members, adds Lebedev, the mentorship experience with Connell affected the very way they approached the analysis process. “Her mentorship approach of questioning all of our assumptions in our analysis and providing constructive criticism ultimately developed our ability to ‘think forward,’” he says.

Connell’s performance as a mentor made such an impression on Shari Lawrence, associate professor of finance at Nicholls State and also a faculty adviser for the team, that Lawrence invited Connell to be a guest speaker in her executive MBA course. “Michelle brings practical experience into the classroom, and she has a gift in that she can explain complicated analytics in a way that can be easily understood by the students,” says Lawrence.

Known to go above and beyond, Connell was named Outstanding Volunteer for 2013 by CFA Society Houston. She remains an active member, serving on the society’s board and as chairman of the sponsorship and mentorship committees. “I’m trying to start a mentor program at CFA Society Houston because once the students get through the CFA Institute Research Challenge and go on to become part of the CFA Program, they need guidance from experienced professionals in the field,” Connell explains.

True to character, after the conclusion of the Local Challenge, Connell served as Lebedev’s career coach. “As a recent graduate of an MBA program, I was very frustrated when I started looking for potential career paths in the finance industry,” says Lebedev. “Michelle was tremendously helpful and critiqued my résumé and guided me through the whole job search and recruitment process.”

Even those students on the team who didn’t graduate this year have seen the benefits of their participation in the CFA Institute Research Challenge. “Several of the students have been called to interview for positions in Dallas, Houston, and throughout Louisiana because of their CFA Institute Research Challenge participation,” Connell notes. “My experiences as a mentor have made me realize that there is a great sense of pride in giving back to the next generation.”

Michele Armentrout is assistant editor for CFA Institute Magazine and a communications specialist at CFA Institute.
Regulator and Program Recognition Builds Trust

By Dan Larocco, CFA, CIPM

The investment industry currently has an acute trust deficit to overcome. According to the recently revised CFA Institute & Edelman Investor Trust Study, only 58% of survey respondents felt that investment firms could be counted on to do what is right (a slight improvement from the previous survey). Although this number might not seem too bad, it suggests that investors feel that the likelihood that investment firms will act in the investors’ best interests is only somewhat better than random chance.

The Future of Finance initiative is part of an ongoing effort by CFA Institute to rebuild trust in the investment profession and to reorient the profession toward a focus on serving the needs of society. In the process, the Future of Finance effort recognizes that trust in the profession will not improve until investment professionals make an individual commitment to act in an ethical manner. There is no substitute for individual accountability.

Anyone familiar with CFA Institute and its programs knows that CFA Institute did not discover the importance of ethics in the wake of the 2008 financial crisis. Rather, ethics has been one of the most important aspects of the organization’s cultural DNA since its inception. The founders of CFA Institute believed that ethics, a defined body of knowledge, and the examinations themselves were the requirements for allowing the practice of financial analysis to be viewed as a profession. And the organization demonstrated its commitment to this ideal by including ethics in the first examination offered in 1963.

Today, ethics is an essential component of the body of knowledge and the examinations for all levels of all programs offered by CFA Institute, the CFA charter, CIPM, and the Claritas Investment Certificate. On average, the ethics component accounts for 10%–15% of the topic area weights for all programs.

Current events clearly indicate that there is still much work to be done. How can the Regulator and Program Recognition (RPR) initiative help? First, it is important to understand the role of RPR, which is to seek recognition by regulators, educators, and other certifications for the portfolio of CFA Institute programs. In practice, this task means developing and presenting evidence that the requirements imposed by regulators, educators, and other certifications are already met by those who have successfully completed CFA Institute programs. For example, in the United Kingdom, the requirements to practice as a retail investment adviser can be partially met through the CFA Program. In Brazil, successfully passing Level II of the CFA exam exempts candidates from the requirements of taking the global content exams of the National Certificate of Professional Investment. In the United States, the University of California, Berkeley, waives two MBA courses for candidates who have successfully passed Level III of the CFA exam. The Professional Risk Manager (PRM) designation requires passing four different exams, but CFA charterholders are exempt from the first two. It is the goal of RPR to develop as many similar opportunities as possible for CFA Institute programs around the world, thereby increasing value for our members.

In general, to initially obtain the benefits of these waivers, a member must be in good standing with CFA Institute. This means that members who are not in compliance with the ethical principles strongly embedded in CFA Institute programs may not qualify for the waiver opportunities RPR seeks to develop. Also, members who may have originally qualified for such waivers may find that they have lost them if they have committed subsequent ethical violations. For example, in the United States, registered investment advisers must take the Financial Industry Regulatory Authority’s Series 65 exam in order to practice. That said, CFA charterholders are eligible for a waiver from that particular requirement. But a charterholder who lost the right to use the charter because of ethical violations would also lose the right to benefit from the waiver opportunity.

The commitment to ethical principles, which has always been at the core of CFA Institute’s mission and programs, combined with the increased visibility of ethics associated with the Future of Finance initiative and the tangible benefits created by the RPR initiative (as well as ongoing ethical behavior), will help create a virtuous circle reinforcing ethical behavior and, hopefully, over time, contribute to reducing the trust deficit that investment professionals face.

How can the Regulator and Program Recognition (RPR) Initiative help? First, it is important to understand the role of RPR, which is to seek recognition by regulators, educators, and other certifications for the portfolio of CFA Institute programs.

Dan Larocco, CFA, CIPM, is the manager of Regulator and Regulation Research at CFA Institute.
INVESTMENT MANAGEMENT: A SCIENCE TO TEACH OR AN ART TO LEARN?

Frank J. Fabozzi, CFA
Sergio M. Focardi
Caroline Jonas

“Has our finance theory, which many consider an idealization that does not take reality into account, failed investors?”

For more information, search “investment management art” on www.cfainstitute.org.

© 2014 CFA Institute

Literature Review

THE PRINCIPAL–AGENT PROBLEM IN FINANCE

Sunit N. Shah

“The principal–agent problem arises when the relationship involves both misaligned incentives and information asymmetry.”

For more information, search “principal agent” on www.cfainstitute.org.

© 2014 CFA Institute
On 1 September 2014, Aaron Low, CFA, became chair of the CFA Institute Board of Governors. He is principal of Lumen Advisors in San Francisco and Singapore, where he oversees Lumen’s operations in Asia. (For a special message from Low, see his In Focus column on page 6 of this issue.)

As the new chair, Low succeeds Charles J. Yang, CFA, who will continue to serve on the Board as immediate past chair.

Four new governors are beginning three-year terms on 1 September 2014 after being elected at the CFA Institute annual members meeting this past May:

**Scott Proctor, CFA (2017)**
eBay, Inc.
Philadelphia, Pennsylvania

**Lynn Stout (2017)**
Cornell University Law School
Ithaca, New York

**Michael G. Trotsky, CFA (2017)**
Massachusetts Pension Reserves
Investment Management Board
Boston, Massachusetts

**Hua Yu, CFA (2017)**
Morgan Stanley Huaxin
Fund Management Company
Shenzhen, China

The following governors will continue to serve on the Board for fiscal year 2015. As interim CFA Institute CEO and President, Dwight Churchill, CFA, also serves on the Board. In the list below, the year when a governor’s term will end is indicated in parentheses:

**Dwight Churchill, CFA**
CEO & President
CFA Institute

**Charles J. Yang, CFA (2015)**
Immediate Past Chair, CFA Institute
Board of Governors
T&D Asset Management, Ltd.
Tokyo, Japan

**Aaron Low, CFA (2016)**
Chair, CFA Institute Board of Governors
Lumen Advisors
Singapore

**Beth Hamilton-Keen, CFA (2016)**
Vice Chair, CFA Institute Board of Governors
Mawer Investment Management Ltd.
Calgary, Alberta

**Giuseppe Ballocchi, CFA (2016)**
Geneva, Switzerland

**Heather Brilliant, CFA (2016)**
Morningstar, Inc.
Sydney, Australia

**Robert Jenkins, FSIP (2016)**
London Business School
London, United Kingdom

**James G. Jones, CFA (2016)**
Sterling Investment Advisors, LLC
Bolivar, Missouri

**Attila Koksal, CFA (2017)**
Standard Unlu A.S.
Istanbul, Turkey

**Mark J. Lazberger, CFA (2015)**
Colonial First State Global Asset Management
Sydney, Australia

**Frederic P. Lebel, CFA (2017)**
HFS Hedge Fund Selection S.A.
Founex, Switzerland

**Colin W. Mclean, FSIP (2015)**
SVM Asset Management Ltd.
Edinburgh, United Kingdom

**Sunil Singhalia, CFA (2016)**
Reliance Mutual Fund
Mumbai, India

**Presidents Council Representatives for the Coming Year**

Daniel J. Fasciano, CFA, who served as the Eastern U.S. representative in 2014, is the new chair of the Presidents Council Representatives for 2015. The regional representatives for the coming year are listed below by region:

**ASIA PACIFIC**

Sharon Craggs, CFA
Standard Chartered Bank
Singapore

**CANADIAN**

Aaron Brown, CFA
Alberta Treasury Board & Finance
Edmonton, Alberta

Hua Yu, CFA (2017)
Morgan Stanley Huaxin
Fund Management Company
Shenzhen, China

**EASTERN U.S.**

Kathy O’Connor, CFA
KJ Capital Management LLC
New York City

**EUROPE, MIDDLE EAST, & AFRICA – EAST**

Lamees Al-Baharna, CFA
Bahrain Mumtalakat Holding Company
Bahrain Bay, Bahrain

**EUROPE, MIDDLE EAST, & AFRICA – WEST**

Anne-Katrin Scherer, CFA
Zug, Switzerland

**MIDWESTERN U.S.**

Leyla G. Kassem, CFA
Wells Capital Management
Minneapolis, Minnesota

**SOUTH CENTRAL U.S. & LATIN AMERICA**

Leah Bennett, CFA
South Texas Money Management, Ltd.
San Antonio, Texas

**SOUTHEASTERN U.S. & CARIBBEAN**

Christian Heuer, CFA
Crowe Horwath LLP
Brentwood, Tennessee

**WESTERN U.S.**

Ken Yee, CFA
Ridgecrest Capital, Inc.
Los Angeles
Call for CFA Institute Board Nominations

Each year, CFA Institute undergoes an extensive process to identify leaders from our profession to serve on the CFA Institute Board of Governors. It is particularly important that governors are representative of and nominated by the CFA Institute membership. The Board of Governors nominating committee encourages you to participate.

If you would like to nominate someone, please use the nomination form available on the Governance/Leadership section of the CFA Institute website. While the nominating process is ongoing year round, you will need to submit your nomination by Friday, 31 October 2014, for it to be considered at the next election.

To access the nomination form, go to www.cfainstitute.org/about/governance/leadership and select “Recommend a Candidate for Governor.”

Seeking Nominations for CFA Institute Awards

The Awards Committee of the CFA Institute Board of Governors, chaired by Beth Hamilton-Keen, CFA, is soliciting recommendations from the membership for award recipients.

The guiding principles of the awards are as follows:

- to encourage CFA Institute members and those in the investment profession globally to uphold standards of best practice, excellence, and financial market integrity; and
- to promote, in conjunction with other CFA Institute initiatives (e.g., ethics, education, professional standards, and advocacy) a framework for highlighting and rewarding those individuals who demonstrate the highest standards of professionalism and promote financial market integrity.

To access the recommendation form, go to the CFA Institute website’s “leadership” page. The award recommendation form, a description of each award, and additional background information can be found on this page. Deadline for submissions is 17 October.

CFA Institute staff and members of the Indian Association of Investment Professionals (IAIP) recently teamed up to develop An Investor’s Guide to Shareholder Meetings in India, aimed at educating shareholders about their roles, rights, and responsibilities and how to exercise them at shareholder meetings. The guide recently was unveiled at the Bombay Stock Exchange (BSE) by BSE Managing Director and CEO Ashish Chauhan, followed by a panel discussion with industry experts.
Blame, Accountability, and Performance
WHEN A FIRM’S CULTURE PLAYS THE BLAME GAME, PERFORMANCE LOSES

By Jim Ware, CFA, and Jason Hsu

When Focus Consulting Group surveyed more than 2,000 investment professionals globally, 95% of respondents agreed that culture is important to investment firm success. The obvious question becomes: What kind of culture? Jason Hsu and I teamed up to explore this question. He had the statistical firepower, and I had the data. The result is a paper called “Does a Culture of Blame Predict Poor Performance for Asset Managers?” The paper (available at papers.ssrn.com) describes our process in detail, but the big finding is as follows: Blame is toxic to an investment culture. Specifically, blame is inversely correlated with four success factors:

1. Loyalty (employees indicating that they are loyal to a firm and have little desire to work elsewhere).
2. Attracting talent (the ability of the firm to attract talent in the hiring process).
3. Owner mentality (the mindset of ownership: my behavior reflects an attitude of “we” not “us versus management”).
4. Overall success (as an employee, I feel like I am “playing for a winner”).

These correlations have been shown at the 99% confidence level. We can now say confidently that blame is a bad thing! The paper includes comments from investment management professionals, such as “This culture is toxic. When [portfolio managers] have success, it is all due to their brilliance. When they underperform, we analysts get blamed. It even extends to not owning the better stocks. We [constantly] get drilled in our weekly meetings about why we don’t own a name that is up 20%.”

What is it about blame that is so toxic? Why does it have such a negative effect? Employees in a blame culture are unlikely to display personal accountability or to proactively identify problems in which they play a part. Instead, some could be much more interested in pointing fingers with righteousness and hindsight, which creates a “gotcha” environment filled with fear and paranoia. Equally important, anecdotal evidence finds that when blame is high, people can often be unwilling to speak out about problems because they don’t want to “get other people in trouble” or be viewed as “grinding an axe.” It is difficult to imagine long-term investment success from an organization steeped in blame. On this point, Charles Ellis comments, “Agree! Investment management depends on communicating ‘soft shelled’ ideas when the conventional data is in opposition. Such communication depends on trust and careful listening—as described in Capital—which gets shut down by blaming.” (Ellis is referring to his book about the investment firm Capital Group titled Capital: The Story of Long-Term Investment Success.)

Still, why is it that smart people in investment firms do so much blaming? Research finds that the highly intelligent and competitive people often have the greatest “need to be right.” (For example, see High Performing Investment Teams: How to Achieve Best Practices of Top Firms by Jim Ware, Jim Dethmer, Jamie Ziegler, and Fran Skinner and Teaching Smart People How to Learn by Chris Argyris.) Organizations that are plagued with fault finding probably value “being right” as more important than “learning” (in a subconscious way). Indeed, perhaps we blame others precisely to satisfy the ego’s need to be right. When investment professionals debate in order to prove themselves right and others wrong, it reduces the possibility for learning and thus the possibility for improvement. When research analysts and portfolio managers focus on appearing to have the truth, they are also implicitly committed not to see both sides of the issue but merely to look for confirming evidence.

So, what is the solution? Are investment leaders stuck with a choice of (a) blame or...
(b) no blame but also no accountabil-
ity? Clearly, there must a third choice.
And there is. It involves developing a

culture in which people take responsi-

bility. The mindset of “taking respon-

sibility” is very different from that of
blaming. The person who takes respon-
sibility has learned to ask himself or
herself important questions: What is
my contribution to the outcome we
achieved? Specifically, what did I do
or not do and say or not say that con-
tributed to this result? As part of this
inquiry, I may ask colleagues or clients
for feedback, but my primary motiva-
tion is learning how my behavior con-
tributed to the outcome. I avoid the all-
too-tempting trap of pointing the finger
at others. In this view of the world,
accountability resurfaces in four ways.

First, individual and team goals are
made explicit so that one can mea-
sure exactly whether the goals are met.
Second, when individuals or teams fall
short of a goal, feedback is the first ac-
tion of accountability. Team mem-
bers are made aware of shortfalls, not
in a blaming way but in a factual way
relative to the goals. In high-perform-
ing firms, this first step—feedback—is
the approach that is used most often.
It will address and resolve most of the
performance issues. Obviously, skill in
providing feedback is important.

Third, when feedback does not work,
the reward system (bonuses, promo-
tions, etc.) kicks in. Employees who
are unable to raise their performance
receive fewer rewards—again, without
blame attached.

Finally, if explicit goals, proper feed-
back, and rewards do not resolve the
performance issue, it may mean there
is a problem with job fit. The employee
is in the wrong job. Still avoiding either
blaming or shaming, the manager may
need to discuss what a better job fit
would look like, whether within the
firm or elsewhere.

The critical thing to understand is
that blame has been “outed” as one of
the major causes of dysfunction and fail-
ure for investment firms. Blame creates
a fearful, cover-your-backside culture.
Employees become less open, less trust-

ing, and less effective. The antidote to
blame is taking responsibility, owning
our behavior, holding the mirror up to
ourselves, and (when appropriate) pro-
viding skillful feedback (not blaming)
to our colleagues. Firms that do these
things well all report that establishing
the right culture takes a while. Blame is
deep seated in our psyches and takes a
conscious effort to root out. But it can
be done, with great benefits for all.

Jason Hsu is co-founding principal and
c 
chief

investment officer with Research Affiliates. Jim
Ware, CFA, is founder of Focus Consulting Group
(FCG). Chuck Heisinger at FCG was instrumental
in providing FCG data to Jason Hsu for the white
paper on which this article is based.

Read Your Sharpe and Markowitz!
MODERN PORTFOLIO THEORY IS AN INDISPENSABLE TOOL FOR INVESTORS

By Laurence B. Siegel

In Jerome Lawrence and Robert Lee’s
classic play Inherit the Wind, based on
the 1925 “monkey trial” in which John
Scopes was accused of violating Ten-
nessee law by teaching evolution, cre-
ationists rally support for their cause
by displaying a banner saying, “Read
Your Bible!” Henry Drummond, lawyer
for the defendant, wishes there were
also a banner proclaiming “Read Your
Darwin.” If you’re going to argue for a
cause, Drummond seems to be saying,you’d better know it backward and for-
ward. And if you’re going to try to over-
turn somebody else’s views, you’d better
understand those views even better
than your opponent does!

For the same reason, I’ll argue that
the great innovations of William Sharpe
and Harry Markowitz, and the other
creators of classic finance theory in
the 1950s and 1960s, are worth study-
ing very closely—even though some of
their findings aren’t exactly right. Clas-

cic finance forms a base case or null
hypothesis against which empirical
facts, new theories, and conjectures
can be tested. Without it, we are lost. With
it, we have a set of very useful guide-
posts, a little like Newtonian mechan-
ic 
in 
physics—we know it’s not exactly
right but use it where we can because
it is so useful. We need to read our
Sharpe and Markowitz.

WHAT’S THE MATTER WITH
FINANCE TODAY?
The current state of knowledge in
finance (and particularly investment
management) is confusing not only to
many newcomers but also to some of
us who have been in the business for
decades. The efficient market hypoth-

esis (EMH), a cornerstone of classic
finance theory, says that security prices
reflect all available information and that
it’s impossible to beat the market consis-
tently. The EMH is on the ropes. Most
finance practitioners make their living
by violating it. They find inefficien-
cies in the market and exploit them—
for themselves and for their custom-
ers—and charge high fees for doing so.
This would be impossible if the market
was actually as efficient as academic
ics believed it was a few decades ago.

The related capital asset pricing
model (CAPM) and the portfolio selec-
tion technique known as Markowitz
optimization are also facing challenges.
A large body of evidence shows that
the CAPM is not exactly right. It does
not give very good forecasts of security
returns, conditional on knowing what the market return is. Low-risk (low “beta”) securities seem to beat high-risk ones even though CAPM predicts the opposite. Markowitz optimization, which is a way of putting numbers around the long-established practice of diversification, has been blamed for the failure of diversified portfolios to perform well in the crash of 2008.

Meanwhile, in Sweden, the Nobel Prize committee has added to the confusion by splitting the 2014 Nobel Prize in Economics between Eugene Fama, a leading advocate of the EMH, and Robert Shiller, who has devoted much of his career to overturning it. (Lars Hansen, an econometrician whose work has formed the foundation for much of the recent testing of theories in finance, also shared the prize.) Is the Nobel committee saying that both Fama and Shiller are right and that the EMH is valuable and so is the body of research casting doubt on it?

You bet. That’s exactly what they’re saying. But you might be wondering how two contradictory propositions can both be right.

WHAT’S A THEORY?
We’re most accustomed to hearing the word “theory” used in connection with the natural or physical sciences: the theory of gravity, theory of evolution, the theory of disease. Our understanding of gravity is still a work in progress. But the phenomenon of gravity, like evolution, is an accepted fact. (Quoted from “The Scientific Method” at chemwiki.ucdavis.edu, accessed on 14 July 2014.) In this context, EMH is merely a hypothesis, not a fully developed theory. It is testable and, when we test it in detail, we find it wanting. Markets are not perfectly efficient. In spite of this shortcoming, EMH is a valuable hypothesis because it focuses our attention on what a perfectly efficient market would look like and how real markets differ from that ideal. As Thomas Coleman, a professor at Johns Hopkins University and the author of A Practical Guide to Risk Management (published by the CFA Institute Research Foundation in 2011) and Quantitative Risk Management, writes, “EMH is powerful not so much because it is right or wrong—but rather because it (1) reminds us that generating alpha is hard (markets are not grossly inefficient) and (2) pushes us to ask where, why, and how much markets are inefficient.” (Quoted from a personal communication with the author. This article was critically reviewed by Professor Coleman, a longtime friend and occasional collaborator.)

If EMH is an imperfect yet valuable hypothesis, modern portfolio theory (MPT) rises to the level of an invaluable theory. I define MPT broadly as a collection of major propositions in finance starting with Markowitz optimization (1952) and ending with Black–Scholes–Merton option pricing (1973). If the elements of MPT are broadly construed and enumerated (in no particular order), we will get the seven great ideas of modern finance: (1) dividend or cash-flow discounting (asset price as a present value), (2) interest rate expectations hypothesis, (3) no-arbitrage condition, (4) market efficiency, (5) portfolio efficiency (mean-variance optimization and related concepts), (6) CAPM (relation between correlated risk and expected return), and (7) optionality and option pricing.

A strong candidate for an eighth great idea is arbitrage pricing theory (mapping security returns into multiple factors). And if we want to be ecumenical and bring in corporate finance, we might also include two other propositions: capital structure indifference and dividend indifference.

This is a pretty powerful body of knowledge. (From this point forward, I’m going to use “MPT” as shorthand for the whole list.) It is integrated. The parts fit, with each proposition consistent with all the others. It is testable and falsifiable. But the evidence for major parts of it, particularly market efficiency and the CAPM, doesn’t rise to the standard of “overwhelming evidence.” There are major doubts. So what is it useful for?

MPT’s propositions are useful as a null hypothesis and point of departure.

Take, for example, the CAPM. The CAPM says what the return on a security should be, given the market return, the riskless rate, and the beta or correlated risk of the security. We know that the actual return on the security will differ from the CAPM’s prediction.

We call the excess return “alpha,” and we credit the manager who picked that security with skill if the alpha is positive at a statistically significant level.

We know, then, that the CAPM cannot be exactly right because if it were, all alphas would be zero (on average over time). There would be no manager skill to measure. But we also need the CAPM to provide the benchmark for measuring the managers whose ability to generate alpha has invalidated the CAPM!

In other words, the null hypothesis, what we should believe for the time being until the data convince us otherwise, is that the market is efficient and the CAPM gives accurate forecasts. This is what a manager asserting skill seeks to disprove, and our bias should be to require quite a lot of evidence. The return forecast given by the CAPM is also the point of departure for an inquiry into whether a manager has earned an alpha that is (1) positive, (2) statistically different from zero, and (3) sustainable or repeatable. If a manager doesn’t pass those tests, he or she can be judged as
having delivered the return that the CAPM predicted and that could therefore be earned by combining a market index fund and a long or short position in the riskless asset (without paying the manager for any value added).

Without the CAPM, we wouldn’t be HQJDJLQJLQVFLHQWLÀFSHUIRUPDQFHPHD- surement. We’d be saying, “This return seems pretty good. It’s better than what Steve at the country club got.” There would be no thought of leveraging the market return up or down to create a neutral, objective benchmark.

The other propositions in the list are similar. They’re not universal truths, but are neutral base cases or starting points for an investigation.

So, Eugene Fama is right that the EMH is a vitally important concept against which all claims of market inefficiency or alpha generation can and should be tested. Robert Shiller is right that the EMH fails the test much more often and, more convincingly, than can be accounted for by accident and random variation; the market really isn’t perfectly efficient. (See also a very valuable article by Cliff Asness and John Liew, “The Great Divide over Market Efficiency,” Institutional Investor [3 March 2014].)

JUDGING MPT TOO HARSHLY?
So far, we’ve been evaluating MPT and its components as scientific theories, and they have fallen somewhat short. But economics is not a natural science. It’s a social science. Some might say (and I’m inclined to agree) that it’s a branch of animal behavior. What’s a theory in the social sciences? Is MPT a theory in that context?

The sociologists Hans Joas and Wolfgang Knobl write, Theories should be understood as generalizations. To put it the other way around, which may be easier to grasp, we might say: every generalization is already a theory. We use theories of this kind all the time, particularly in everyday life.... The modern social sciences ... now feature ... a plethora of competing theoretical schools (“What Is Theory?” in Social Theory: Twenty Introductory Lectures [Cambridge University Press, 2009]).

If, in the social sciences, a theory can be just a working hypothesis or set of conjectures, subject to empirical checks and countered by opposing or contradictory theories, then MPT is much better than that. MPT is a network of interrelated propositions, developed to describe a specific aspect of the way the world works, that is supported by enough evidence that well-informed people take it seriously as the starting point for further investigation. It is not “exactly true,” but there is no alternative set of propositions that is “more true” or even “just as true.”

RESPECT THE PARADIGM
And that is where MPT, the list of 10 great ideas shown above, stands. There are competing ideas, but none of them hangs together as an integrated body of theory. Nor do the competing ideas have anything like enough evidence behind them to overturn or replace MPT. Behavioral finance is a start, but I regard it as an enhancement to MPT or, more finely understood, a set of exceptions to a general rule—a list of situations in which MPT gives you only a pretty good answer instead of a great one.

Theoreticians should keep working on alternatives to MPT. But they should give proper respect to the body of knowledge they’re seeking to overturn. Meanwhile, practitioners should continue to pursue alpha. It’s out there. The market is not efficient. But it’s efficient enough that most investors will not beat the market with any consistency after proper adjustment for the risks taken and the explicit and hidden costs incurred. A few will.

Meanwhile, we’ll be building portfolios with an eye to risk, return, and correlation all considered simultaneously, as Harry Markowitz would have us do, albeit with some variations and enhancements. And, dear managers, if circumstances call for us to hire you to manage our assets, we’ll be mindful of the temptation for you to claim that you don’t pay attention to benchmarks and only buy the securities that go up. So, we’ll be measuring you. And we’ll be using CAPM-based techniques, pioneered by William Sharpe, to do so.

Laurence B. Siegel is the Gary P. Brinson Director of Research for the CFA Institute Research Foundation. This article expands on his foreword to the recent CFA Institute Research Foundation monograph Investment Management: A Science to Teach or an Art to Learn, which is available at www.cfapubs.org.

Illustration by Alex Nabaum
The GIPS Standards Annual Conference is the only conference of its kind focused on the implementation and application of the Global Investment Performance Standards (GIPS). Subject experts share best practices and speak to the key issues and major developments in the performance measurement field, making this conference essential for any performance or compliance professional.

Also consider attending one of the two full-day workshops held on 17 September 2014 just prior to the GIPS Standards Annual Conference:

- GIPS Standards Interactive Workshop
- The Fundamentals of Performance Measurement and Attribution

FEATURED SPEAKERS

Andy Andres  
SENIOR LECTURER  
Boston University

Andrew Bowden  
DIRECTOR, OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS  
US Securities and Exchange Commission

David G. Tittsworth  
PRESIDENT AND CEO  
Investment Adviser Association

Michael G. Trotsky, CFA  
EXECUTIVE DIRECTOR AND CHIEF INVESTMENT OFFICER  
Massachusetts Pension Reserves Investment Management Board

WITH SPECIAL THANKS TO OUR SUPPORTERS

ACA Performance Services  
Ashland Partners & Company LLP  
CAPS  
Informa Investment Solutions  
Kreischer Miller  
RIMES Technologies Corporation  
StatPro  
The Appraisal Institute  
The Spaulding Group  
Total Performance Solutions LLC

Learn more about this special event and register now: www.cfainstitute.org/events.
A new report from CFA Institute takes a look at 51 leading large banks in 16 countries before, during, and after the global financial crisis of 2007–2009. Titled Financial Crisis Insights on Bank Performance Reporting, the study uses data over the 11-year period from 2003 to 2013 to assess the key factors influencing price-to-book ratios (P/Bs) for these banks. It also analyzes disclosed fair loan values, impairments, and the market price of risk.

The study recommends specific policy steps to improve banks’ reporting and disclosure.

“Looking back to assess what banks faced before, during, and since the global financial crisis allows us a watershed moment for how to enhance the transparency of banks so that vitally important information can be made considerably less opaque,” says Vincent Papa, a director of financial reporting policy for CFA Institute and co-author of the report.

Evidence about the performance of banks in multiple markets shows the need to improve reporting and disclosure.

Enhanced risk reporting is necessary to reduce investor risk aversion toward banks.

A measure of total bank assets across jurisdictions would enable improved leverage reporting, which could signal rising risk.

**IMPACT OF LOAN IMPAIRMENTS**

Analysts know that a bank’s P/B is a key valuation metric in regard to the financial soundness of the institution and reflects investor views on performance, future profitability, and riskiness. P/Bs of many of the banks studied in the report declined significantly beginning in 2007 and remained depressed through a portion of 2012, regaining some ground in 2013. Low P/Bs make raising equity capital unattractive for banks.

The report assessed loan impairments—the accounting write-downs for the carrying value of loans—because loans are a vital element of a commercial bank’s total assets. The study found that delays in recognition of loan impairments can lead to balance sheets that are overstated relative to the capital market valuations of these balance sheets. This delayed recognition contributed to the decline in P/Bs that banks experienced during the global financial crisis because the numerator of the ratio was being adjusted downward faster than the denominator. This lagging recognition for loan losses and nonperforming loans was especially troublesome at banks in the European Union. Loan impairments also significantly contributed to reduced overall net income during various periods because they affected the expected future earnings of the banks, resulting in risk premiums that had a negative impact on stock prices.

Profitability measures, such as return on equity (ROE), are positively correlated with changes in P/Bs. Banks’ ROEs have declined since the start of the financial crisis. The study found that the positive correlation between P/B and ROE became weaker during the financial crisis, and the authors attribute this change to the historical ROE of each bank becoming less relevant for predicting both future ROE and the bank’s stock price.

Moreover, the overall cost of equity has exceeded ROE since the beginning of the financial crisis. Prior to the start of the crisis, ROE exceeded the cost of equity.

**RISK AND LEVERAGE**

Risk measures, such as the cost of equity and credit default swap (CDS) spreads, had negative correlations with P/Bs in the crisis. The rising cost of equity for a bank, together with increasing CDS spreads, indicates that risk rose as the P/Bs decreased.

According to data provided in the report, investors appear to have a higher level of risk aversion toward EU banks than toward their EU nonfinancial counterparts, which has translated into somewhat greater risk premiums and lower stock prices and P/Bs for EU banks.

The analysis also found that, although excess leverage is a source of risk, no discernible relationship exists between a bank’s leverage and its P/B.

**KEY POLICY RECOMMENDATIONS**

The report’s conclusions lead to three key policy recommendations. First, both the fair value and amortized cost of loans backed by securities should be reported on the financial statements. Second, enhanced risk reporting, as supported by several constituent groups, is necessary to reduce investor risk aversion toward banks as investors struggle to understand the complexity inherent in banks’ business models. Third, a measure of total bank assets that allows comparisons across jurisdictions is needed to allow for improved leverage reporting that could signal rising risk.

Lori Pizzani is a financial journalist based in Brewster, New York.

The full report Financial Crisis Insights on Bank Performance Reporting is available at www.cfapubs.org and may be accessed by visiting the Integrity & Standards section of www.cfainstitute.org.
Frequency Jamming
CAN INVESTORS OUTSMART HIGH-FREQUENCY TRADERS?

By Dennis Dick, CFA

The media frenzy around high-frequency trading has continued to intensify, and regulators are paying attention. The chair of the US Securities and Exchange Commission, Mary Jo White, has called for stricter scrutiny of high-frequency traders and for an examination of low-latency tools that may give an unfair advantage to certain types of proprietary trading strategies. But whether such advantages are fair or unfair, the machines are here to stay, and it appears that they have a significant edge over their human counterparts.

Does this situation mean that the trading game is over for human traders? Not so fast. Many traders have adapted to the new trading environment, and some traders are even thriving in it. Understanding their methods can help investors guard against the negative effects of high-frequency trading.

IGNORE THE HFT NOISE
Rob Friesen, president and COO of Bright Trading LLC [where the author of this article is employed as a proprietary trader], says his traders have adjusted by lengthening their time horizon. “Traders tend to be more successful when they ignore the short-term price fluctuations and are able to identify the longer term trend,” says Friesen. “They need to ignore the HFT noise.”

With high-frequency trading accounting for more than half of the market’s volume, the machines can cause a lot of intraday “chop” as they move into and out of their short-term trading positions. These short-term price oscillations can play with traders’ emotions and can cause them to shake out of a potentially winning trade.

Joel Elconin, a technical analyst at financial media firm Benzinga and a 25-year trading veteran, studies these short-term price oscillations. “Stock moves aren’t as smooth as they used to be,” he says. “Sometimes the bots will take the stock down just to shake out the little guy.”

High-frequency traders are very good at gauging short-term supply and demand. For example, if a stock appears to be breaking out on the chart and the short-term trading herd jumps in to play the breakout, a temporary pullback often will occur before the stock actually breaks out. “We call those failed breakouts ‘fake-outs,’” says Elconin. “The breakout traders jump in, and then the HFT players take it down on them, shake them out so they can buy the stock from them, and then drive the price higher.”

According to him, the key is to not get shaken out, because these short-term price oscillations have very little impact on where the stock is going in the longer term.

Friesen believes that traders should focus on the long-term drivers. “It’s not about chasing stocks up and down anymore; you have to do more homework. You have to understand the drivers behind the move. The bigger moves tend to come from fundamental and macro influences, as opposed to the mathematical noise from quantitative or high-frequency trading.”

ADJUSTING FOR NEW INFORMATION
One way to learn better ways to counteract HFT’s impact is to talk to people who face direct competition from HFT. That’s exactly what Fernando Oliveira did for his book Traders of the New Era, in which he interviews a group of day traders that have successfully adjusted to trading in this HFT world.

“Traders that have not lengthened their time horizon have struggled, and many have gone out of business,” says Oliveira, who is also a retail trader from Brazil. “You can’t compete with the high-frequency traders in scalping or market making.”

Many retail traders tend to be focused on the short term, seeking immediate gratification. They use scalping strategies that depend on getting quickly into and out of stocks, capturing small profits, but this approach puts those traders in direct competition with the high-frequency traders. Trying to beat the machines at their own game is difficult.

Scalping is not the ideal way to trade, according to Jeff Goldman, a proprietary trader and former market maker at Knight Capital. “The machines are very efficient at it,” he says. “On the illiquid stocks, if you place an order, the algorithmic trader will automatically jump ahead of you by a penny.”

For example, assume the NBBO (National Best Bid and Offer) on stock XYZ is $20 bid and $20.50 ask. If a trader places an order to buy the stock at $20.01, the algorithmic penny-jumper will instantaneously bid at $20.02. If the trader goes to $20.03, the penny-jumping program will go to $20.04. The algorithm will adjust to be at the top of the order queue and be first to interact with any incoming market orders, giving the algorithmic trader the best chance to scalp the spread. “It is hard to compete with them,” says Goldman.

Other advantages involve payment-for-order-flow arrangements in which high frequency trading firms buy order flow from the retail brokers so they can be the first to interact...
with the broker's marketable order flow. Again, this environment gives these firms a huge edge in scalping the spread.

But the biggest advantage that high-frequency traders have over human traders is their speed. The key to any scalping or market-making strategy is risk management.

“Scalping and market making is kind of like picking up nickels in front of a bulldozer. If you’re not careful, you may get run over,” says Goldman. “Human traders just aren’t fast enough to get out of the way and avoid being picked off by a more informed trader.”

This is where high-frequency traders excel. They can quickly adjust their orders for all new market information and are very efficient at canceling and adjusting their orders when adverse-selection risk rises. Also, they can quickly go from liquidity providers to liquidity takers, picking off slower participants’ limit orders that haven’t been adjusted for new market information.

**OVEREXTENDED MOVES**

Although the machines have monopolized short-term trading, they have very little impact on longer-term strategies. In fact, some of the inefficiencies that they exploit in the short term can actually lead to longer-term inefficiencies.

“HFTs will push stocks further, because they know somebody wants to buy or sell,” says Oliveira. “This can lead to a lot of overextended moves.”

Some high-frequency traders are more predatory. These traders try to detect institutional buyers and sellers by using algorithms called “order sniffers.” For example, if an order sniffer detects an institutional buyer in a specific stock, the predatory trader’s program will often step ahead of that buyer and try to run up the price so the institution will have to pay more. If it works, the HFT program will turn around and sell the stock to the institutional buyer at a higher price, pocketing the difference.

In addition, momentum-driven algorithmic traders may jump on board just because the stock is moving higher. The combined effect of order-sniffing algorithms and momentum-driven algorithms can lead to some very exaggerated moves. Such exaggerated price moves can offer the opportunistic longer-term trader some great entry and exit points.

For example, consider the recent move in Microsoft’s stock on 16 July and 17 July. The stock ran up three points in two days, a very uncharacteristic move for the issue, which has an average daily range of 50 cents. “There was a lot of institutional action in it, and the momentum traders got a little bit carried away,” says Elconin.

A trader or investor who was long this stock could use the run up in the share price as an opportunity to lighten up the position. Alternatively, the run up could be used to initiate a short position.

Friesen agrees that some opportunity exists. “High-frequency traders can push stocks out of their natural range,” he says. “They can cause the pendulum to have larger swings. You’ll often see stocks move in an unrelenting direction for an extended period of time.”

But when the tide turns, it turns quickly, and the momentum can quickly switch in the other direction. “I’m often buying new highs or selling new lows,” says Goldman, who often trades based on “feel” and considers himself a momentum trader. “But when I feel like the momentum is dwindling, when the stock move is starting to become exhausted, I’m very quick to exit my position.”

Of course, not all market participants are traders and many have no interest in timing daily price fluctuations. Yet, regardless of a trader’s time frame, all market participants compete with high-frequency traders at the moment of order execution. And adjusting trading tactics to the new trading environment can help to improve execution quality.

**TAKE LIQUIDITY**

One tactic that seems to be a theme among the successful traders interviewed in Oliveira’s book is to “take liquidity.” Goldman agrees with this approach. “Don’t worry about working the spread,” he says. “I rarely add liquidity anymore. If I’m trading something fairly liquid, I just lift the offer or hit the bid.”

A common misconception is that high-frequency traders are scalping only for pennies, which should have no real impact on the longer-term investor’s performance. But if the longer-term investor is using a lot of passive limit orders, those pennies could turn into dollars because high-frequency traders (and all market makers) like to lean on the book. They buy stock ahead of other participants’ limit orders, leaning on those quotes for protection. If the market suddenly starts to reverse, the high-frequency trader will quickly sell to the limit-order trader who is being leaned on. This tactic can cause some major slippage, or worse, it can lead to a limit order not getting executed at all.

“You tend to miss your fill when you’re on the right side of the trade [because the high-frequency traders step ahead of your limit order],” says Oliveira, “but you always get filled when you are on the wrong side of the trade [because the high-frequency traders pick you off].”

As a result, the longer-term traders not only are left with all of their losing trades but also miss some of their potential winning trades. In this case, the longer-term investor loses more than pennies. It is an unquantifiable loss, the loss of the missed profitable trading opportunity. For investors worried about such an outcome, Goldman has some practical advice: “Don’t miss a trade to save a penny or two.”

As regulators continue to look into high-frequency trading tactics, they may eventually even out the playing field. Although successful traders know that they can’t control the environment in which they trade, they can make adjustments for it. Such tactics as lengthening time horizon, avoiding the HFT noise, and taking liquidity have helped some traders stay profitable in this new trading environment.

Growing Up
AS FIRMS EXPAND, HOW SHOULD THEIR ORGANIZATIONAL STRUCTURES EvOLVE?

By Ed McCarthy

The private wealth management business continues to grow rapidly. According to Financial Advisor magazine's 2014 RIA (registered investment advisor) survey of 529 firms, total asset growth was up 20% in 2013, following 19% growth the previous year. The number of firms managing more than $1 billion swelled from 143 in 2012 to 170 by year-end 2013, making that group the largest in the survey.

Growth brings new challenges, especially for founders who handle multiple roles. This cohort often works directly with clients, brings in new business, and oversees day-to-day management. As assets under management (AUM) and the number of employees grow, the juggling act becomes more difficult and founders frequently consider reorganizing the firm. "What we find is that advisory firms' transformations are often based on the number of people in their business," says Mark Tibergien, CEO and managing director with Pershing LLC in Jersey City, New Jersey. "When you are under 15 people, I would say that typically the adviser or the founder is still very much involved in client activity," he says. "They hit a wall at 5 people, they hit a wall again at 15 people, they hit a wall again at 30 and then again at 50. What I mean by that is their span of control and the nature of the responsibilities seem to change at different levels of growth."

Refocusing a growing wealth management firm involves more than simply shifting around the organizational chart. Founders are often skeptical and detail oriented; they started their firms to retain control and hesitate to loosen up on the reins. "Delegating responsibility and holding other people accountable is more challenging than actually just doing it themselves," observes Rob Francais, CEO of Aspiriant in Los Angeles. "That piece of the evolution is hard from an organizational perspective."

REFOCUSING A GROWING WEALTH MANAGEMENT FIRM INVOLVES MORE THAN SIMPLY SHIFTING AROUND THE ORGANIZATIONAL CHART. FOUNDER ARE OFTEN SKEPTICAL AND DETAIL ORIENTED; THEY STARTED THEIR Firms TO RETAIN CONTROL AND HESITATE TO LOOSEN UP ON THE REINS. "DELEGATING RESPONSIBILITY AND HOLDING OTHER PEOPLE ACCOUNTABLE IS MORE CHALLENGING THAN ACTUALLY JUST DOING IT THEMSELVES," OBSERVES ROB FRANCAIS, CEO OF ASPIRANT IN LOS ANGELES. "THAT PIECE OF THE EVOLUTION IS HARD FROM AN ORGANIZATIONAL PERSPECTIVE."

SEPARATE ROLES?
At some point a founder must decide whether to work primarily as a client adviser or a business manager, or attempt to serve in both capacities. Peggy Ruhlin, CEO of Budros, Ruhlin & Roe, Inc. in Columbus, Ohio, faced this decision 13 years ago when she and her two partners realized they needed a full-time business manager. Her partners were unwilling to hire an outsider who lacked wealth management experience and appealed to Ruhlin to take the job. She declined at first and then reluctantly agreed to try it for two years, with the written agreement that she could return to client service if the new arrangement didn't work out.

The roles can be separated in reverse as well. Advisers can transition out of management and back to working with clients full-time. The four co-founders of Westport, Connecticut–based LLBH Private Wealth Management LLC left Merrill Lynch and launched their firm in October 2008 with roughly $450 million of AUM. They initially shared the business management roles but decided to scale back on those duties by hiring a professional manager as AUM approached $1 billion. In 2013, they hired Jeff Fuhrman as chief operating officer and chief financial officer. His arrival has allowed the original partners to spend less time on management and more time with clients, according to founding partner Jim Pratt-Heaney.

Other advisers argue in favor of combining the business management and client service roles. Peter Mallouk purchased Leawood, Kansas–based Creative Planning, Inc. in 2004. At the time, the company managed $30 million; the firm and its affiliates have grown to include a staff of about 180 and $11 billion of AUM. Mallouk believes that a core reason for the company’s success is that its managers, including him, genuinely understand the business as a result of working directly with clients. Those ongoing client-advisory relationships are vital, he maintains, because they give him and his management team direct insight into clients’ concerns. Removing himself completely from client service would cut off a key source of business intelligence. "Otherwise," he says, "I’m going to get it all secondhand or reading it in magazines or talking to people, and to me, I’m going to spend just as much time doing that and it’s not going to be as valid.”

Most advisers seem to share Mallouk’s opinion. According to a December 2013 Financial Planning Association survey, “The Future of Practice Management,” non-advisory management roles are rare. Only 13% of respondents said their firm’s chief operating officer was a dedicated (i.e., non-adviser) manager; the response for chief financial officers was 12%. The results were not broken out by firm size.
EXPERIENCE REQUIRED?
Mallouk believes that wealth management firms’ leaders must have industry experience to be successful. Others disagree. Tibergien notes that advisory firms have become large, complex entities. The discipline of managing a business is very different from the discipline of managing a client relationship or giving personal and financial advice. Managing is a special and unique capability, and having intimate knowledge of what it takes to advise a client is not a critical skill set for a business manager. In his experience as a consultant to RIAs, Tibergien has found that most financial advisers have limited business management experience, are not naturally equipped to perform that job, and do not enjoy the role. “Having the ability to understand how a service business works, how a closely held business works, and how a growth business works are far more important,” he says.

Fuhrman is an example of a full-time manager who lacked prior wealth management industry experience. He believes that being a newcomer to the industry gives him a fresh perspective that benefits the firm. He sees himself as unencumbered by legacy relationships and legacy thinking and believes he can approach the business as a client might. His lack of experience wasn’t a negative factor in the hiring decision, according to Pratt-Heaney. The founding partners wanted someone who could take over management duties so they could concentrate on clients’ needs; they didn’t want another wealth manager. “We don’t need anybody in the space to tell us how to manage money or how to get clients or how to service clients. We do that extremely well,” says Pratt-Heaney. “What we wanted to do was just have it more professionally managed.”

Steve Janowski worked as a consultant in other industries before becoming chief operating officer of Wetherby Asset Management in San Francisco in 2005. At that time, the firm had slightly under US$1 billion in AUM. Today, it has $3.65 billion in AUM and another $4 billion under advisement. The organization has an office on each US coast, with about 500 clients and 57 employees. He agrees that full-time managers must remain focused on clients’ needs as well as the business, but he believes that the right organizational structure can facilitate both objectives.

Wetherby has three client-service teams, each headed by a senior wealth manager who carries a full client load and is also a shareholder in the firm. When Janowski meets with the firm’s senior wealth managers, he doesn’t tell them how to take care of the clients because he is a step removed. He sees his role instead as asking the right questions to ensure that clients are being taken care of. “Yes, it’s important to have your finger on the pulse of the client, and yes, it’s important to listen to the people and work with the people that do have their fingers on the pulse of the client,” he says. “But does it need to be me? You know, I would say no, and I think the last nine years have probably proven that this model works pretty well.”

STRUCTURES AND PATHS
The different approaches indicate that independent private wealth management firms can succeed with a range of organizational models. Wetherby has five functional areas: client service (which includes the wealth management teams), research, operations, administration, and business development. Other firms have similar structures, according to several sources contacted for this article.

A different model can be found at Budros, Ruhlin & Roe, where the major shareholders do not have any direct client responsibility. They serve instead as in-house experts for the firm’s six client-service teams. One shareholder has extensive tax- and estate-planning experience. Another serves as chief investment officer, and a third helps clients set and prioritize goals. Each shareholder is expected to be a subject-matter expert in his field. “We’re counting on them to make sure that they are always up to date in what’s happening in their particular area that they have responsibility for,” says Ruhlin.

Organizational structure also has implications for employee career paths, although the options are naturally limited by size. At LLBH, the clearest path is on the client side of the business, according to Fuhrman. Entry-level hires progress from client-service associate to support adviser and then to associate adviser and ultimately to lead adviser.

Wetherby provides career paths in all its areas. New employees often start in an entry-level client-service role because that area has the largest department. After two years or so learning the business’s basics, some employees will continue in client services and others may decide to focus on more analytic investment work in the research area. “Most of them will go on into the client-service track,” he explains. “They’ll spend a couple of years as an associate, a couple of years as a senior associate, and ultimately move toward being a wealth manager. On the research side, we do have people that maybe started as a client-ops person; ultimately, they become a research analyst, then a senior research analyst, and given an opportunity or a need in the business, possibly a director of research. [It’s the] same thing on the administrative side.”

EVOLVING BEST PRACTICES
Given the lack of a widely accepted best-practices structure, Janowski advises that the choice of an organizational model should be driven by how the firm wishes to service clients, not vice versa. Even then, he cautions, don’t underestimate the time needed to manage the firm and be willing to adapt over time as needed.

Ed McCarthy is a freelance financial writer in Pascoag, Rhode Island.

KEEP GOING

*“Expanding Horizons,” CFA Institute Magazine (May/June 2014) [www.cfapubs.org]*

*“The Big Lie of Strategic Planning,” summarized in CFA Digest (April 2014) [www.cfapubs.org]*

*“The Future of Wealth Management,” CFA Institute Conference Proceedings Quarterly (January 2014) [www.cfapubs.org]*
Satisfaction Reaction
WHAT REALLY DRIVES JOB SATISFACTION?

By Lori Pizzani

For many people, job satisfaction is an elusive thing. Even trying to define job satisfaction is difficult because the sense of satisfaction consists of many different elements.

“It’s all about attitude and expectations,” says Elayne Savage, a psychotherapist, communications/workplace consultant, coach, and speaker in Berkeley, California. Job satisfaction typically includes feeling respected, trusted, and supported while also being a good listener and team worker, according to Savage.

Being happy and achieving job satisfaction comes down to three main elements, explains Scott Crabtree, chief happiness officer of Happy Brain Science and a speaker, consultant, and coach in Portland, Oregon. First is starting with a good attitude, followed by seeing the bright side because that sets the mood. Finally, you need to find the meaning in what you do, which gives you a more meaningful mindset.

“Can you ask yourself, ‘Why am I doing what I do?’” Crabtree says.

Research suggests that progress toward clear and meaningful goals is an important element in happiness, according to Crabtree. “When you are completely focused on something for 20 minutes or more, you become fully immersed and all else goes away,” he says. “You are completely absorbed and super-happy.” The last theme is being social, such as connecting with coworkers and having warm relationships, because we are all social creatures. “Science shows that even introverts get a boost from social interaction,” Crabtree points out.

“Success is personalized and is about satisfaction and feeling fulfilled and happy,” says Khalid Ghayur, CFA, managing director of Goldman Sachs Asset Management and head of equity for Smart Beta Solutions in Boulder, Colorado. Ghayur is co-author of the book Career Success: Navigating the New Work Environment, which is available online from CFA Institute.

He notes that over the past few decades, the psychological contract driven by loyalty between employers and employees has changed. In the past, an employee promised to be loyal to the employer and vice versa; the job of career management fell squarely to the employer. That loyalty has transitioned into flexibility, and today’s employer can no longer guarantee jobs or security but can provide employees with the tools and skills they need to advance themselves. The pendulum has swung to where employees now must manage their careers.

According to Ghayur, individuals need self-awareness, including an understanding of what drives and motivates them and an understanding of the five or six most important attitudes and behaviors they value, such as treating people with respect, he explains. Employees must also understand what natural “soft” skills they have, which will define them; they also need to understand their weaknesses and what they are truly passionate about. They must gain awareness of their environment and the array of jobs, careers, and corporate cultures that exist so they can align themselves with those traits they see as vital.

OVER THE PAST FEW DECADES, THE PSYCHOLOGICAL CONTRACT DRIVEN BY LOYALTY BETWEEN EMPLOYERS AND EMPLOYEES HAS CHANGED.

“When all of these things fall into place, job satisfaction is the natural outcome,” Ghayur says. “When you are truly passionate about what you do, then it’s not really work. Passion drives many things that make you successful. Over a career, with lots of ups and downs, that passion keeps you going.”

MORE THAN MONEY
For some people, job satisfaction is definitely all about the money, particularly for younger people, according to Savage. Many individuals grew up in families where an abundance of money was the code to live by, which then becomes the model they replicate.

An interesting and useful exercise is to look back and identify what messages we received from our family about job satisfaction, including hints of fears and self-esteem issues. “You can inherit family fears, including attitudes about job satisfaction,” she says. But these don’t have to forever define our futures. Attitudes can be changed once they are identified.

Sometimes, the motivation isn’t money but perhaps something else that brings a sense of great satisfaction. Such people may want to make money, but it is not their...
core career goal. “For many individuals, making a true difference, not just making oodles of money, is what is really important, such as when someone gets great satisfaction from helping clients achieve their goals or providing a sense of financial security for them,” she says.

“A fundamental truth is that not having money can make you miserable, but having money doesn’t make you happy,” says Crabtree. Research has shown that “once your basic needs are met—typically around the $70,000 a year level—extra money doesn’t flip your lid or make you happy.” Job satisfaction goes beyond that.

**FINDING MEANING**
About a year ago, Focus Consulting Group in the Chicago suburb of Lake Grove, Illinois, reached out to ask investment professionals, Where do you find meaning in work? That survey revealed, among other things, that while people have differing views, “most care less about money but more about their legacy,” says Jim Ware, CFA, founder of the firm. Focus found that 20- to 30-year-olds appropriately want to make money whereas 40- to 50-year-olds often shift to lesser-paying jobs, such as working for foundations, endowments, and pensions, because they see it as “doing more worthwhile things even though these don’t pay the most,” he adds.

Most people want to be paid fairly, and pensions, endowments, and foundations can still attract top talent, but the individual focus often shifts to become more about the quality of life, says Focus Consulting partner and managing director Keith Robinson, adding, “It becomes a lifestyle choice.” Focus has most recently been working on a compensation study and understanding what employers need to provide to keep employees happy in their jobs. The study is showing that it’s not about paying the most money. Rather, the top factors of employee satisfaction and commitment are centered on leadership credibility and trust, followed by organizational culture and purpose. The opportunity for growth and development, engaging in challenging and meaningful work, and total compensation are seen as key but not as vital. Relationships with both coworkers and customers, work recognition, and the quality of work/life balance also do factor in, but to a lesser degree, Focus found.

For many financial professionals, job satisfaction is essentially “intellectually driven,” says Hersh Shefrin, the Mario L. Belotti Chair and Professor of Finance at Santa Clara University’s Leavey School of Business. What defines their careers are such things as helping clients identify their long-term financial goals, putting a process in place to work to achieve them, generating above-average returns, or developing a conceptual framework for valuing a security or an investment methodology.

“Financial professionals set goals or reference points, and when gains are above them, satisfaction is achieved, and when not, there is a sense of loss or dissatisfaction,” he says about the financial professionals he has spoken to. Our financial rewards are often the after-effect: “We generate wealth for ourselves when clients are meeting goals.”

**FOCUS ON THE POSITIVES**
Perspective, particularly focusing on the positives and ignoring negatives, can often be an important element that factors into job satisfaction.

**ACCORDING TO ONE STUDY, THE TOP FACTORS OF EMPLOYEE SATISFACTION AND COMMITMENT ARE CENTERED ON LEADERSHIP CREDIBILITY AND TRUST, FOLLOWED BY ORGANIZATIONAL CULTURE AND PURPOSE.**

“One of the biggest problems with job satisfaction is the negative messages we give to ourselves, which can lead to self-rejection and not self-esteem,” says Savage. For example, expectations set too high can lead to a disappointment, which can feel like a rejection. That negative feeling can affect productivity and one’s state of mind.

Learning to ease up on yourself and not judge your actions so harshly is an important element for many, especially perfectionists, who tend to procrastinate, which then causes stress and job dissatisfaction. Experts consulted for this article advise people to remind themselves that they are not perfect and neither is the world around them.

Having a bad boss can sometimes be turned into a positive, even if that boss is the most despicable person in the world, according to Savage. “Find something to like in your boss—a hairstyle or the color of his or her clothes—and then think of this whenever you are speaking to that boss. That single positive thought of, ‘Wow, what a great tie/shoes/necklace’ tends to posture you so that you are showing them respect. In turn, that respect will often be reciprocated.”

Lori Pizzani is an independent financial and business journalist based in Brooklyn, New York.
Do you know the names of the stocks you own? That may seem like a funny question, but simply knowing the names of your holdings puts you at risk of making behaviorally driven decisions, such as acting on emotionally fueled news stories, according to C. Thomas Howard, author of the book *Behavioral Portfolio Management* and CEO and director of research at Athena Investment Services. His “no-name portfolio strategy” has guided his Athena Pure Valuation | Profitability portfolio to a 25% annual return over the past 12 years, including a 67% jump in 2013. Howard, who spoke at the 2014 CFA Institute Annual Conference, is also professor emeritus at the University of Denver’s Reiman School of Finance. In an interview with *CFA Institute Magazine*, he explained why behavioral portfolio management is “the next paradigm” for investment management, the argument for limiting investment process decision making to a few strict criteria, and the importance of “ruthlessly driving emotion out of your decision process.”

What inspired you to write *Behavioral Portfolio Management*?

Behavioral finance is the next paradigm. We are moving away from modern portfolio theory. I think it’s a new way to look at the world. We all hear about cognitive errors. Look at the success of Daniel Kahneman’s *Thinking, Fast and Slow*. How do we work with clients to help them avoid these cognitive errors?

We recognize that virtually every investor makes emotional decisions. There have got to be price distortions. In fact, they’re all over the place. How do you harness those price distortions and build successful portfolios? That was the motivation for the book. This represents 30 years of my research and the research of others, and it really gathered steam when the finance literature, which is empirical literature, turned decidedly against modern portfolio theory.

What’s different about behavioral portfolio management?

Most active equity managers say things like, “We go visit lots of companies. We understand their management. We understand their products, markets, and competitors. We do all the fundamental analysis.” Others say, “We try to value the company, look at the cash flows, look through the financials very carefully. Or we keep track of events, like mergers and takeovers and spin-offs, and that’s how we make money.”

The truth is, they’re uncovering behavioral price distortions. They just do it in different
ways. We go out directly and say, “We’re just trying to identify measurable and persistent behavioral price distortions.” Ultimately, I think all managers would admit that’s the game we’re all playing. We just go at it very differently. When the dust settles a few years from now, everybody’s going to say, “Well, yeah, we were doing behavioral stuff all the time. We just didn’t call it that.”

**You define two groups: emotional crowds and behavioral-data investors.**

Emotional crowds dominate the markets. Anybody who’s spent any time in the stock market knows the markets are irrational. There is absolutely no sign of rationality whatsoever.

In the formal language of finance theory and finance academics, we speak of “return factors.” What are the return factors that drive returns? We know those return factors are the result of some collection of investors making buying and selling decisions. I refer to that collection as “emotional crowds” because they are largely driven by emotion.

Robert Shiller, who won the Nobel Prize in 2013, contended 30 years ago that there’s very little sign of fundamentals in stock returns. He’s done a lot of research since then, and that piece still stands today. Emotional crowds drive the markets.

Behavioral-data investors try to pull themselves away from that emotional price-setting process. We try to identify the resulting distortions and build portfolios on that.

**Is emotion really that dominant in the markets?**

We’re all emotional. We all make emotional decisions. In fact, most people take great pride in that. You’ve heard people say, “I depend on my gut.” But when it comes to investing, it’s damaging. People just go into investing and use the same decision process they use in everything else. That turns out to be a very poor way to make investments.

One example is that investors are constantly bombarded with information. When you’re watching CNBC or one of the other channels, they’re constantly spilling out information. We tend to grab onto those pieces of information disproportionately. We react to those.

Related to that is the availability bias. Whatever’s available to us right now, we make our decision based on that. A variation of that is the availability cascade, which we see all the time in the news. We begin to talk about something, and everywhere you turn, you see it. It begins to dominate our thinking. In the case of financial markets, people talk about the Federal Reserve. If you hear it all the time, it begins to dominate your thinking.

**What’s your investment process?**

We said to ourselves, “Let’s manage portfolios recognizing that we all, left to our own devices, will make these kinds of emotional decisions.” I call it ruthlessly driving emotion out of your decision process. As ruthlessly as I can, I drive everything out of the decision process that is emotionally driven and has nothing to do with my investment process. That’s what we do in terms of managing money.

**What does that mean in practice?**

It means we don’t pay attention to anything—literally. We have five criteria in the “Pure” portfolio. That’s all I pay attention to. Whatever’s happening that day in the news—ignore it completely.

**What are the five criteria?**

One is dividends; we buy stocks that pay dividends. Companies that pay dividends are saying to the market, “We believe we have earnings into the foreseeable future.” It’s a powerful signal. It’s putting your money where your mouth is. In identifying behavioral price distortions, I look for situations where people are putting their money where their mouth is.

Analyst earnings estimates are the second factor. Based on the forward P/E, analysts are saying they believe there’s enough future earnings to justify the current price. Now I have two opinions on the company—management’s opinion and the sell-side analyst’s.

Third, I want companies with as much debt as possible. If I find one with a negative net worth, I’m thrilled. Now, when most people hear that, their lip curls and they say, “That’s bad.” The reason debt is attractive is because the underwriter or the bank worked closely with the company and decided they could make the loan and the firm would repay it. I’ve now got a commitment from three sides—again, people putting their money where their mouth is, saying, “Yes, we believe in this company.” The greater the debt, the better I like it.

Then, I use a price-to-sales ratio. Sales are the least manipulated of accounting measures and have been shown to be one of the best predictors. And I have a minimum sales threshold. Those are my five criteria.

**Aren’t these basic balance sheet metrics rather than distortions?**

They are distortions. Investors tend to underreact to dividends; they don’t realize how powerful a signal it is. The typical response to dividends is a downgrade of growth prospects. It turns out it’s just the absolute opposite of that—the higher the dividend, the higher the return, the higher the growth of the company.

Investors also tend to overreact to debt. If a company has lots of debt, they tend to run away from it. I’m harnessing these particular behavioral mistakes.
What names do you hold in your portfolio?
I don’t know the names of the stocks I own.

Really? Are you serious?
I’m serious.

How does that work on an operational basis?
I have to know them long enough to tell our traders to trade them, but beyond that, I don’t remember the names. The reason is a component of my process. I ruthlessly drive emotion out of my decision process. I make no attempt to remember names any longer than it takes for me to say, “Trade this stock.” I just don’t remember. Now, I do look at them from time to time. They’ll float through my brain, but it’s nothing that I keep track of.

Why should I remember the name of a stock? It’s not part of my process. I believe the name of a stock creates emotional problems. You could wipe out the name and call this stock “123.”

Are you saying you don’t place importance on names, or are you actually saying you don’t remember the names?
I literally don’t know the name. I cannot name the 10 stocks that I currently own.

How do you decide to sell?
I look at my five criteria on a monthly basis. When they fail at one of those five criteria, I sell them. On my screens, the name is on the far left. I look over and say, “OK. I want to sell that stock.” I send it to the traders, and it’s gone. I don’t remember the price that I paid for the stock either. I really don’t know whether my stocks made or lost money. I follow the portfolio—I know it’s going up—but I have no idea which individual stocks are going to make money or lose money.

Again, I’m ruthlessly driving emotion out of my decision process. When I started managing a portfolio, this is exactly what I was trying to do. I’ve done research for years on huge databases and studied different anomalies and how you build portfolios. Not once was the name of the stock important to those studies. This is taking the context of behavioral portfolio management to the extreme.

What’s your turnover like?
We hold stocks one to two years in this portfolio. Once I sell it, I never look at it again, but that’s pretty easy because I don’t remember it in the first place. Don’t waste your time on regret.

The other thing I do to drive the emotions out of the decision process is I never make an investment mistake. I know that sounds arrogant, but at the time I made the decision, that was the best decision I could make. Based on the information, that was a good stock. But in fact, only 60% of my stocks beat their benchmark. The other 40% are not mistakes; they just did not work out. But there was no way to know that at the time I made the initial investment decision.

You don’t read news about the company?
Absolutely not. Well, I don’t remember the name of the stock, so if a story did come up, I wouldn’t know about it anyway.

What about at the time you decide to invest?
Do you read up on the company?
No, I don’t generally know what my companies do.

You don’t look into their operations?
No. Five things—that’s all I look at. The only things you want to put into your investment process are things that help you make better decisions. I don’t want to do anything that helps me feel better. I couldn’t care less if I feel better about my portfolio. If there’s data or something I’ve uncovered that I know is measurable and persistent, I will include it. Otherwise, I ignore everything else.

How did the Pure portfolio come about?
Pure came from my years of teaching and doing research. I took my knowledge and built a portfolio around it. Pure is a proof of concept of behavioral portfolio management. When you push behavioral concepts to the extreme, what happens? This portfolio has generated 25% a year for 12 years. Last year, it generated 67%. It was the number one portfolio in its category in the United States in 2013.

As an academic, I spoke about these ideas for years, and people would say, “Ah, Tom, you’re just an academic. You have no proof of this because you haven’t done it.” Now here I am successfully managing portfolios, so I’m hoping people will cut me a little slack.

You’ve said many industry best practices are actually "emotional catering."
We talk about the markets as the cult of emotion, which means essentially [that] all prices are driven by emotion. Very few fundamentals are reflected in prices. Around that cult of emotion is built an industry that we call the “cult enforcers.” Even if I (as an investor) decide to get out of the cult of emotion, I’ve then got to go up against almost all of the industry practices to do that because the industry has been built around enforcing that cult.

A classic from a legal standpoint is the Prudent Man Rule. That’s a legalizing of the cult of emotion. What’s a prudent man? The “prudent man” is the typical emotional investor.

Modern portfolio theory is part of the problem and not part of the solution, because modern portfolio theory is built around volatility. Volatility is largely emotion. In the short term, obviously, volatility is risk. If I need money in three months, I do have to worry about that. But if I’m building long-horizon wealth, volatility is largely emotion. If I build a portfolio based on volatility, which is, of course, Markowitz’s mean–variance optimization, that’s really short-term emotion optimization. It’s institutionalized.

Every investment professional in the industry talks about volatility, drawdown, upside capture, downside capture, the Sharpe ratio (which is a long-term return to short-term emotion), and tracking error. Almost everything they do is based on modern portfolio theory and has emotion built into it and therefore reinforces the cult of emotion.

Even if I decide as an investor that I’m going to de-emotionalize my process, almost every investment professional I talk to will essentially push me back into the cult of emotion.
because, “Well, you need to worry about volatility.” We see this all the time. It’s really, really a challenge to step away from the cult of emotion.

**How does emotional catering factor with clients?**
Investors create volatility by reacting emotionally to events. When volatility gets high, they get more emotional. The other problem is myopic loss aversion. If you have a manager that lets a client down for a quarter or a year, they may move their money elsewhere. So a client’s emotion has been turned into a business risk for the asset manager.

**EVEN IF I (AS AN INVESTOR) DECIDE TO GET OUT OF THE CULT OF EMOTION, I’VE THEN GOT TO GO UP AGAINST ALMOST ALL OF THE INDUSTRY PRACTICES TO DO THAT BECAUSE THE INDUSTRY HAS BEEN BUILT AROUND ENFORCING THAT CULT.**

**How do clients participate in the cult of emotion?**
Clients say to investment professionals, “Don’t lose any money.” We ask, “Over what period of time?” “Well, over the next quarter, the next year.” This is myopic loss aversion, the cognitive error that investors make. Short-term volatility gets diversified away over the long run, but people simply don’t see it due to their short time frame for making decisions.

In the industry, when people talk about risk, they really mean three things. Number one, there’s probably a fair amount of emotional volatility associated with this investment. Number two, that [emotional volatility] gets translated into business risk for me as a financial professional, because you might take your money and go elsewhere. Number three, there’s some investment risk, but we don’t really know how to measure that. The word “risk” is really primarily emotion. When asset managers say “risk,” it’s actually business risk for them, not investment risk for the client.

**You don’t believe in diversification either, correct?**
There are two situations where diversification makes sense. One, you don’t want to buy one stock or two stocks. You want a reasonable number. I think somewhere around 10; at the most, 20.

The other place where diversification makes sense is when you’re putting asset classes together. If the two asset classes have about the same expected return, then it does make sense to diversify, because now you’ve reduced your volatility, which means you’ve increased long-term effective return. If the asset classes have widely different expected returns, then diversification makes absolutely no sense.

The primary driver of long-horizon wealth is expected returns. Why would you invest in anything but stocks? Why isn’t your portfolio 100% stocks? Do you believe stocks are going to have the highest expected return? By the way, stocks have averaged 10% a year for a long period of time. Bonds have averaged about 6%. The difference between a portfolio that’s 100% stocks and one that is a mixture of stocks and bonds over long periods of time is huge, possibly millions of dollars. Why would I want to buy anything but the highest expected return, asset-wise?

Now, in terms of keeping clients, if I add a few investments that make them more likely to stay in the portfolio when times get rough, then that’s fine. But let’s recognize it for what it is. There are very few wealth-building arguments for diversification. Again, it’s a way of managing the emotions of your clients and keeping them in their seats. We’d much rather have them stay in the portfolio, even if we have to water it down a little bit, than find that they bolt the portfolio when things turn tough.

Managing the emotions of clients is the most important thing a financial adviser does in terms of building long-term wealth—period. It’s not finding the best managers, the most sophisticated managers. It’s keeping clients in their seats.

**How do your clients find you?**
We had two portfolios that were number one on Morningstar last year. One of them was the Pure portfolio, and the other was our Global Tactical ETFs. People are coming out of the woodwork. We now have US$150 million in assets under management. We’re doubling about every year.

We provide our services through advisers, so we’ve developed strong adviser relationships. We have a core of several dozen advisers. We think of ourselves as an intellectual property shop, so we’re not building out a big sales force, wholesalers, and so forth. We’re establishing strategic partnerships—strategic relationships with partners.

**Do your clients realize that you don’t know the names of your investments?**
We don’t deal with direct clients because we deal through advisers. The advisers are our buffer. Advisers provide lots of services, but this one is just absolutely critical. The advisers essentially act as a barrier between me and the client. Our biggest adviser is always kidding me. He knows I don’t remember the names of the stocks I hold, and he says, “I know all the names. I can tell a story about every stock when a client asks a question.”

Clients like stories. For some reason, people want to like the stocks that they own. The only reason to buy a stock is to make money. Stocks are not friends. They’re not family. They’re there to make money. When you don’t think they can make money any longer, you get rid of them.

Nathan Jaye, CFA, is a member of CFA Society San Francisco.
A FAIR EXCHANGE

In the new market structure, can exchanges be trusted with a self-regulatory function?

By Sherree DeCovny

Historically, exchanges had a dual persona. They were member-owned utilities that functioned as trading venues and regulators of their own activities. In the US, this tradition dates back to 1817 when the New York Stock Exchange’s constitution was adopted and the financial responsibility rules and trading conventions were created.

Listing and financial reporting rules were first codified into US federal law in the Exchange Act of 1934, and they have been amended since then. The National Association of Securities Dealers, which is the precursor to the Financial Industry Regulatory Authority (FINRA), was created by the Maloney Act in 1938. That legislation established the concept of a national securities association with mandatory membership and laid the groundwork for self-regulation.

The US Congress has supported self-regulation over many decades, taking the view that self-regulatory organizations (SROs) have the expertise to perform the supervisory, surveillance, rule-making, and enforcement functions much more efficiently and cost effectively than a government bureaucracy could.

As the external environment has changed, however, the self-regulatory model has come under review by the US Securities and Exchange Commission (SEC) and other government regulators worldwide. The markets have become more complex, with increased globalization and the proliferation of electronic communications networks and trading venues. New technologies have sparked public concerns. Moreover, when exchanges became publicly traded, for-profit companies and assumed a fiduciary duty to their shareholders, questions arose about the quality of self-regulation. This conflict of interest has become even more apparent as exchanges have had to compete with trading venues that do not have the same level of regulatory responsibilities.

DIFFERENT FLAVORS OF SROS

Before companies can begin trading their shares on an exchange, they must meet certain initial requirements or listing standards. In the US and Canada, the exchanges set their own standards for listing and continuing to trade a stock, but they are subject to congressional or parliamentary legislation. In the US, for example, listings must comply with the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010. The passage of the JOBS Act in 2012 exempted smaller, emerging companies from some listing standards imposed on larger companies.

FINRA and the Investment Industry Regulatory Organization of Canada (IIROC) have a unique role in the world’s financial markets. Funded by the broker/dealers, they are
independent SROs with regulatory responsibility for the equities markets in the US and Canada, respectively. The exchanges outsource such functions as market surveillance and enforcement to these entities. Oversight for the derivatives markets is done separately by exchanges that list those contracts and other organizations.

By statute, US equities exchanges can outsource certain functions to FINRA, but they cannot delegate their responsibility as SROs. Each exchange has a regulatory committee to oversee FINRA’s activities, and the SEC holds FINRA accountable for fulfilling the functions it serves.

Europe’s financial markets are competitive, like exchanges in the US and Canada, but are generally going down a different route. Supervisory functions are being taken away from the exchanges and given to the European Securities and Markets Authority (ESMA) as the universal regulator.

Niki Beattie, CEO of Market Structure Partners in the UK, points out that in a developing country where there is no competition, the incumbent exchange SRO has the most expertise to enforce rules. But the complexity changes once competition comes into the market. “It just doesn’t seem right to have an exchange setting certain marketwide regulations and enforcing those when in fact it’s got competitors out there,” she says.

Yet each European country is different. The concept of competitive markets is well ingrained in the UK, and the authorities in that country regulate multiple marketplaces. Recently, the government regulator was split into two bodies, with the Prudential Regulatory Authority supervising the banks and the Financial Conduct Authority (FCA) as the primary regulator for the financial markets and the securities listing authority. Other European markets, such as France, Italy, and Spain, have less competition. In those markets, the incumbent exchange is still the primary market (at least conceptually) and is therefore expected to take a greater role in regulating the market.

Australia’s incumbent exchange, ASX, traditionally has had SRO responsibility, including the responsibility to enforce disclosure rules. Now that competition is allowed, regulation is migrating to the primary government regulator, the Australian Securities and Investments Commission (ASIC).

Responsibilities are shifting in many markets, posing a challenge for the industry. “There is a time lag between the regulators understanding what they have to take on and having the experience and the capability to take on that role,” says Beattie. “It’s a bit of a black hole where the exchange isn’t really doing it anymore, but the regulator hasn’t quite got up to speed.”

CONFLICTS OF INTEREST

Exchange SROs always had to balance their regulatory arm and their operational arm. The operational arm wants to attract order flow, but there is a risk that certain members will have undue influence over how the exchange operates. FINRA maintains that it avoids industry capture in the US by requiring that its board

WHEN EXCHANGES BECAME PUBLICLY TRADED, FOR-PROFIT COMPANIES AND ASSUMED A FIDUCIARY DUTY TO THEIR SHAREHOLDERS, QUESTIONS AROSE ABOUT THE QUALITY OF SELF-REGULATION. THIS CONFLICT OF INTEREST HAS BECOME EVEN MORE APPARENT AS EXCHANGES HAVE HAD TO COMPETE WITH TRADING VENUES THAT DO NOT HAVE THE SAME LEVEL OF REGULATORY RESPONSIBILITIES.
Self-Regulation in the Financial Markets
By Jason Voss, CFA

In the aftermath of the global financial crisis, many finance industry commentators have scrutinized the role of regulators in contributing to the crisis. Particular scrutiny has fallen on self-regulatory organizations (SROs). To help shape a better future for the financial industry, CFA Institute published the report Self-Regulation in the Securities Markets: Transitions and New Possibilities (available at www.cfainstitute.org and www.cfapubs.org). The report, which builds on earlier CFA Institute research on self-regulation, concludes, “We believe ... that despite differences in the securities regulatory landscape that existed when they were first created, SROs and the market expertise they offer are now more important than ever. In fact, the ever-evolving complexities of the securities markets argue for more, rather than fewer, uses of SROs, if only to take advantage of their understanding of market practices.”

In support of this conclusion and in the interest of moving the SRO reform agenda forward, CFA Institute recently hosted an event in Washington, DC, under the auspices of the Future of Finance initiative. As part of the event titled “Self-Regulation in the Financial Markets: Exchange Issues, Market Structure, and Investor Protections,” a panel of current and former senior regulators, practitioners, and law professors (including Mary Schapiro, former chair of the US SEC) discussed a range of topics, from security exchange issues and market structure to investor protections, global financial market interconnections, and both the strengths of SROs and areas of needed reform.

All panelists, including those from traditional regulators and the legal profession, felt that SROs are an important part of the global regulatory framework. Still, the panelists identified many ongoing challenges. In opening remarks, for example, Schapiro contended that SROs can be a highly effective enforcer and can complement the role of governments, especially in an environment where traditional regulators are underfunded. However, she argued, this is only true if the following conditions are met: SROs are well-funded; they are technologically advanced; there is government oversight; they are held accountable; they act within their authority; and they are structured to avoid conflicts of interest.

JASON Voss, CFA, is a content director at CFA Institute. This sidebar is an excerpt from a post that originally appeared on the Market Integrity Insights blog. For full details, including summaries of the panel presentations at the event, read the complete post “Self-Regulation in the Financial Markets” (24 June 2014) at http://blogs.cfainstitute.org/marketIntegrity.

consist mostly of public governors, who are not elected by the broker/dealer members.

Over the past 15 years, the SEC has taken disciplinary actions against exchange SROs for failure to discipline or investigate certain activity within their area of responsibility. Examples include unlawful proprietary trading, failure to enforce order-handling rules, failure to implement proper controls for a system outage, or giving improper trading advantage to one member over another.

According to Sayena Mostowfi, senior analyst at Tabb Group, potential conflicts of interest between exchanges, broker/dealers, and investors are not new. Each stakeholder group has always had certain advantages and disadvantages, but conflicts are coming to a head now as the industry evolves and trading becomes more electronic. “You can’t look at one [stakeholder group] in isolation from the other,” she says.

When US exchanges want to introduce or change a rule—whether it has to do with capital requirements, order types, systems, or any other issue—they must file a proposal with the SEC. The proposal is then opened up to the public for comment. During the comment period and approval processes, exchanges’ operations are affected. If they want to make a systems change, for example, their competitors are entitled to provide input on the proposed functionality or even copy it. Alternative trading systems (ATSs) are not required to file changes publicly.

Exchanges are obligated to operate a fair and orderly market, and they cannot discriminate between their members. Broker/dealers are obligated to provide customers the best execution possible across the industry—both on and off exchange. But unless ATSs reach a certain threshold, broker/dealers do not have fair-access requirements and can discriminate between customers by charging different fees or providing a different execution quality. Exchanges have limited liability for such problems as a botched IPO caused by a systems glitch. Broker/dealers are fully liable for an array of faults.

Exchanges in the US collect market data revenue from broker/dealers. The securities information processors (SIPs) consolidate quote and trade data for US stocks. Revenue from the SIPs is divided among all the exchanges through a formula that weights the volume of quotes and trades. FINRA also receives a portion of the income. Canada has a pass-through model for market data. In addition to the distribution fee, market-data fees and the data policies of the contributing marketplaces are passed through to the client.
“The incumbent exchanges often complain that their role as SRO gives them an unfair disadvantage, as they have to incur extra costs in order to fulfill their regulatory function and new competitors do not have to worry about these costs,” says Beattie. “It seems no one is really happy, and the transition path is usually unclear for all parties.”

Yet Mostowfi points to the practical benefits of making changes. “I don’t think you can say, ‘OK, from now on exchanges don’t have any regulatory authority, and broker/dealers have to disclose all of their operations in a public manner,’” she says. “You don’t want to end up in a scenario where you have unintended consequences.”

**SHOULD EXCHANGES BE SROS?**

Roberta Karmel, Centennial Professor of Law at Brooklyn Law School and former SEC commissioner, blames the industry for losing some of its self-regulatory control. Speaking at a CFA Institute conference on SROs, market structure, and investor protections, held in Washington, DC, in June 2014, she noted that fragmentation and the destruction of the exchange model of trading have undermined the SRO system. Moreover, the 2008 meltdown indicates that members did not feel any obligation to the system or the securities industry as a whole. [For further details about the conference and CFA Institute’s engagement with the topic of self-regulatory organizations, see the sidebar “Self-Regulation in the Financial Markets” on page 34.]

“Some of them had to know that some of the developments in the market were going to lead to disaster, but they did nothing to put a stop to it,” she said. “To me, that is what was lost—the sense of obligation to a community that to some extent existed in the old self-regulatory system.”

She pointed out that the US has no choice but to continue with the self-regulatory system that is in place. Change will not come until the SEC becomes a self-funded organization and has a much bigger budget than Congress has allocated and until the SEC merges with the CFTC, providing the latter entity with more resources.

Although Karmel was complimentary about FINRA’s performance, she also argued that the future of exchange SROs must be viewed in light of the fragmented market and the volume of trading that occurs off exchange. “Unless some kind of regulation comes into effect to unify all of these marketplaces, I don’t think it makes that much sense for the exchanges to be self-regulatory organizations,” she said at the conference. “As a practical matter, I don’t know that they really are since so much has been given over to FINRA.”

Given the nature of the business, exchanges likely will have certain public responsibilities, such as upholding market integrity by designing sound trading rules, ensuring transparency, and protecting investors (even if they delegate other activities). But in the near term, the role of exchange SROs and whether they should be SROs at all will continue to be a topic for debate.

Sherree DeCovny is a freelance journalist specializing in finance and technology.
"Putting a price on pollution will motivate technological change and will create investment opportunities," says Richard Sandor

By Nathan Jaye, CFA

If you’re not familiar with environmental assets and finance, you soon will be, according to Richard Sandor, CEO at Environmental Financial Products (ENVIFI), a company specializing in inventing, designing, and developing new financial markets. Sandor, known as the “father of financial futures” and the “father of carbon trading,” founded the Chicago Climate Exchange in 2003 and co-wrote the recent CFA Institute Research Foundation monograph *Environmental Markets: A New Asset Class*. In a recent interview with *CFA Institute Magazine*, he discussed the implications of what he calls “environmental finance,” the underappreciated importance of markets for weather risk, and how embracing new markets will “unleash certain technological change.”
What's your reaction to the Obama administration’s new proposal to cut carbon emissions 30% by 2030? This is what I predict in my book *Good Derivatives*. There were a number of headlines in the *New York Times* recently [saying that], basically, everything is going cap and trade. California and China will lead the way, and new markets for environmental assets will be happening all over. We’ve been saying this for the past four years.

What effect will this have on environmental financial markets? We’re going to see more sustainable investing. The preliminary reports are saying that the government is going to give credit for renewable energy. It is a continuation of the trend that we’ve been seeing for many years. We’re going to see renewable energy credits and credits for wind and solar. This is a perfect example of why people should be interested in environmental markets.

When CFA Institute commissioned us to write our monograph a year and a half ago, they wanted to have a book written for CFA Institute members that would teach them about cap-and-trade markets. The choice of commissioning a book on environmental markets was very, very prescient.

How would you describe environmental assets and environmental finance? Environmental finance is about using financial tools, markets, and financial instruments to achieve environmental objectives.

At ENVIFI, we deal with environmental assets in several different ways. The leading focus is on rights to emit either airborne or water-based pollutants. Environmental assets also include other sorts of weather-based derivatives (such as catastrophe bonds and temperature markets, all of which are the result of weather or natural calamities) and are used to transfer risk from those who have weather risk or catastrophe risk to those who want to include this new asset class in a portfolio.

What is the range of existing environmental markets? Environmental markets range from water markets in Australia to carbon markets in Europe and China to regional greenhouse gas markets in the northeast and mid-Atlantic of the United States to the California cap-and-trade program to such local pollutants as SO₂ (sulfur dioxide) and NOₓ (nitrogen oxide). There are water-quality markets in the Ohio River basin, Pennsylvania, and other areas in the United States. These markets are bubbling up everywhere. There are water-rights markets in Colorado now. They’re in the process of forming, and I think water will be the most important commodity of the 21st century.

In terms of air pollution, the biggest issue is greenhouse gases. The European Union’s market, along with the EU allowances and certified emissions reductions, is the largest market in the world in terms of breadth. Their open interest at times has come near to or approached that of Brent crude oil. With markets like the Regional Greenhouse Gas Initiative in California and seven pilot markets in China, there is a growing recognition that emissions markets have a role in reducing climate change.

How does your work at ENVIFI facilitate these markets? We’re interested in environmental markets and also other areas as well, such as health, education, and places where externalities exist. That’s our business—inventing and structuring new markets.

One of the things we talk about when starting new markets is that education is critical. By that, I mean educating the accountants, educating the lawyers, educating professors, educating journalists, educating regulators, and educating industry. That’s the biggest challenge you face in starting new markets. It’s not only designing them but also the educational challenges and the marketing challenges. You can’t simply invent a new market. You have to develop a complete infrastructure, and that’s what I talk about in my book *Good Derivatives: A Story of Financial and Environmental Innovation*.

What do markets for weather risk and weather catastrophe look like? We believed there was insufficient capital in the insurance and reinsurance sector. Given the magnitude of catastrophes, any single event could cripple the insurance and reinsurance business. Hurricane Sandy in 2012 is the perfect example. Had Sandy hit New York directly or even gone 40 miles in the other direction, it would have caused hundreds of billions of dollars or more in damages. The entire insurance industry has only US$500 billion in capital surplus; any single event can now total hundreds of billions of dollars. There just isn’t enough capacity in the business.

What’s happened in terms of catastrophe funds is that 15% of the reinsurance market is now taken up by catastrophe derivatives. Not so long ago, that number was essentially zero, and I expect it will grow in the future.

Do you find large institutional investors in these assets, or is it more specialty-type shops? It’s been specialty funds in the past. But in catastrophe bonds, for example, we’re seeing larger and larger participation by funds and hedge funds and portfolio managers. They find this a synthetic way to be in the reinsurance business and want an asset class that’s not correlated to other markets. But by and large, anybody who is considering investing in environmental assets—security analysts, portfolio managers—should understand the role of markets in sectors like utilities and others that are sensitive to the impact of fossil fuel use.

This is also true of market participants who are significant users of energy and might be governed by these markets. The CFA Institute Research Foundation monograph is meant to be a reference book for those kinds of individuals and people who are looking toward a world in 10 or 20 years that might be very different—a world where there are more regulatory actions that will limit emissions, both airborne and waterborne, and more financial tools that will deal with weather events, such as catastrophes and severe temperature changes.
These are professional markets more meant for portfolio managers rather than for individual investors. They’re not like gold or other commodities that are well known to the public. I think anybody who’s interested from an individual point of view would be better served by not getting involved unless they’re really very professional and sophisticated.

**What are the primary factors an analyst would consider in valuing environmental assets?**

Investors will look at environmental assets the same way they would look at other industries. But the big factor is, what happens now, given that you have regulation coming from government? Will this go into the courts? Investors will have to be very aware of the politics in order to do any forecasting. They’ll need to study the field like you study social media or solar production of panels. Look at it like any other business—except it’s got a backdrop of increasing laws that require or that are moving industry toward a less carbon-intensive economy.

**Do you encounter skepticism toward environmental assets and trading, or are you seeing people embrace them?**

It’s still in its very early days. It’s like computers were in the early 1980s after Steve Jobs came along. There wasn’t wide-scale adoption. It took 20 years for the web to be born, and I think it’s very important for readers to understand that these are the tools of today and, more importantly, tomorrow. Those people who want to learn about what may become a very big trend are best served by understanding it now and watching reactions.

**What Are Environmental Markets?**

We’ve all heard of cap and trade, but how do cap-and-trade markets work? Where are they located? How large are they?

Environmental markets now cover allowances for a wide range of pollutants. The earliest emissions markets are those for allowances in sulfur dioxide (SO2) and nitrogen oxide (NOx), generated through the burning of coal and resulting in smog and acid rain. The primary markets for SO2 and NOx trading are the Intercontinental Exchange and the Chicago Mercantile Exchange (CME), where utilities, industrial corporations, and investors exchange allowances. Products also exist for trading specific-year emissions, known as vintages.

The largest category of environmental markets are cap-and-trade markets for greenhouses gases, such as carbon dioxide (CO2), most famously reflected in the Kyoto Protocol of 1997. The largest of the greenhouse gas programs is the EU Trading Emissions Scheme, with a market value upwards of US$170 billion. In the United States, the Regional Greenhouse Gas Initiative (begun in 2003) and the California cap-and-trade program AB 32 exist as regional programs. China and India are also beginning their own trading markets.

Markets for trading of water assets may have the biggest future of all. Water assets divide into three categories: water quantity assets (the most common), water quality assets, and water temperature assets, which regulate riparian water temperature in the western United States. Examples of programs for water trading include Australia Water Trading (water quantity allowances), with a market value of more than US$1.5 billion, as well as water quality trading in the Chesapeake Bay nutrient trading program. Trading in water temperature credits began in 2008 in Oregon.

Catastrophic and weather event assets manage risks from extreme weather events, such as hurricanes and earthquakes. Weather derivatives, including index-based futures, hurricane futures, and options contracts on weather events, trade on the CME and in a US$12 billion global market. Global trading in catastrophe bonds, initiated in the mid 1990s, had a market cap of more than US$15.6 billion as of 2012.

A final category is renewable energy and energy-efficient assets. These represent technological innovations in electricity, where “clean” power has become a commodity. Renewable energy credits—also known as green tags or green certificates—represent the power generated from renewable energy sources and are sold separately from the electricity itself.

**Are these markets working better than people realize?**

I think so. If we look at Europe, the data have been focused in the wrong direction. Most data look at the price of emissions, and that’s not really the objective of these markets. It’s not to price emissions high or low. It’s to reduce carbon in the air, and in that regard, the EU has been extraordinarily successful. It had a goal of reducing emissions by 8%, and it actually reduced them by 17% over the first phase of the Kyoto Protocol. All of the articles focus on the price of allowances, not the success of the program in reducing emissions.

I do think that, particularly in the United States, the acceptance of markets is almost directly proportional to the distance from Washington, DC. Go a little [distance] away and you have the Regional Greenhouse Gas Initiative (in the northeastern United States and eastern Canada), which is successful. I think California will lead the way in the United States, and I would suggest that people study California’s markets and also study China. In California, it’s doing very well by all accounts and achieving its objectives. European markets are very successful, and even the People’s Republic of China has emerging regional pilot markets. India, for that matter, has something called the Perform, Achieve, and Trade (PAT) program, which is one that trades renewable energy certificates. Or look at US states, 29 of which have renewable portfolio standards.

I think the mistake we often make is to look at the headlines and federal policy while the action is really going on at the state level, at the provincial level in Canada, or in regional trade pacts, like the EU, China, and India, which are embracing tradable emissions rights.

You’ve worked with China on new markets. How does China approach environmental trading, compared with Western countries?
I’ve lectured throughout China and helped form the first climate exchange in China, the Tianjin Climate Exchange. There is a tremendous interest—whether it is at Peking University (where I lectured), Fudan University, or in various other universities throughout China—by the young people who believe that pollution is a critical problem in China and are looking to market-based tools for solutions.

My book Good Derivatives came out in a Chinese version. We’re publishing an expanded version of the CFA Institute monograph, more textbook oriented, by World Scientific Publishing in collaboration with CFA Institute. A Chinese-language version is also in the works. For the young people, I think there’s a lot of interest in China in the work we’re doing.

You’re excited about India as well. What’s happening there?
Yes, they have the PAT (Perform, Achieve, and Trade) program. They just started, and in the first quarter, they traded just under US$400 million in renewable energy credits. There’s a commitment to it. I would expect that this will continue to grow. If you’ve been to China or India, the pollution is so evident.

These programs are all modeled on the acid rain program in the United States. In the 1980s, there were parts of the Atlantic states that looked like Beijing. Pittsburgh and Gary, Indiana, were very polluted areas. We were emitting about 18 million tons of CO₂. Under the cap-and-trade program (the Clean Air Act) for acid rain, that’s down to 3 million tons. The argument by naysayers at that time was that electricity prices would go up. It would kill US competitiveness, and it wouldn’t achieve its goals.

In fact, the US Environmental Protection Agency (EPA) estimated that the entire program cost US$1 billion to US$3 billion in a US$16 trillion economy, and the reductions alone in medical costs annually achieved US$123 billion reduction in costs associated with lung disease. By the EPA’s estimates, or in independent studies that were quoted, we’re saving 30,000 to 40,000 lives a year. The success of the acid rain program really began the whole trend in the world about the efficacy of cap-and-trade, and that is lost in the history. It’s important to show how potent a market can be in addressing a very severe problem of local pollution.

What have you learned from structuring trading markets? Does this help you build better markets?
Each version gets better. The acid rain program was about version 2.0, and I think we’re up to about 4.0 now. I think we’ve learned an awful lot about monitoring, verifications, what to do, and what not to do. You get things wrong, and then you change them. Markets are organic. They get better and better. Financial innovation does as well. I’ve learned from my failures and things that don’t work.

It’s no different from technological change. Financial innovation is the same general sort of process. The first versions never look like the 10th version. People get more familiar with the concept. You get a sophisticated set of regulators and government officials, and I’m convinced that at some point, people will be looking at climate change as a result of these markets the same way they look at acid rain. What happened with that acid rain? Acid rain was going to kill the United States, and [when] you go to teach at a university, nobody even remembers it anymore. Ask a freshman or even a graduate student. They don’t remember that there were smog problems in the United States.

What kind of derivatives do we have in these markets? They range from everything like catastrophe bonds to futures and options and spot market rights to emit. They really span a lot of investment classes. They’re also embedded in equities in certain specialties, such as wastewater treatment and companies that specialize in desalination. You can get exchange-traded funds in water. You really have a whole series of ways for investors who are convinced of the argument and, depending on what their preference is, buy into the scarcity of air and water.

What’s next for environmental markets?
We’re now having widespread drought in the western part of the United States. California, New Mexico, and Arizona are having raging fires. It is my hope and belief that our leaders in these areas will embrace markets, and if they embrace markets, it’s going to unleash certain technological change.

Once you price pollution, it affects technology. You look at start-ups. In the case of water, you have to look at desalination. Where does it stand? Are there opportunities? Who are the makers of equipment that deals with wastewater treatment and with low-flush toilets? Lots of things can be done in the conservation area.

Once you understand or buy into the fact that air and water are the most important commodities in the world and they’re finite in supply, then putting a price on pollution will motivate technological change and will create investment opportunities for those people that buy into the premise that these are finite commodities.

Nathan Jaye, CFA, is a member of CFA Society San Francisco.
A monumental thing happened this past June in the US Supreme Court. Integrity and confidence in capital markets received a favorable lift from the highest legal authority in the land. In the case *Halliburton Co. v. Erica P. John Fund, Inc.*, the court upheld a long-standing legal doctrine allowing shareholders to rely on the financial and other material disclosures made by public companies and file a claim of fraud when those disclosures turn out to be bogus. The conclusion sounds like a no brainer, but the legal complexity of this 14-year-old case and its threat to investor protection made the ruling anything but simple.

Integrity and trust in securities markets are at the heart of the advocacy work we do at CFA Institute. Of all the things affecting those values, the veracity of information filed by public companies, particularly the required financial and other material operating information filed annually and quarterly, is vital. The information from these sources is disseminated to market participants worldwide and used by investors as part and parcel of pricing securities. Such information is the foundation of an efficient market. Indeed, much of the CFA Program curriculum is intended to ground charterholders in the expert use of financial and other information filed by public companies.

Accordingly, a purposeful distortion or concealment of such information ought to have severe consequences for offending companies. Without getting lost in the legal complexity of decades-old legal doctrine or providing an in-depth legal treatise, I want to stress that this case may be one of the seminal rulings solidifying investor protections. It is instructive for all of us who use financial information to see just how fragile investor rights concerning that information can be. Seldom do you see the debate carried out in such high legal fashion.

Three fundamental concepts are important here. First, investors clearly rely on the public disclosures filed by public issuers. By law, such disclosure must not be false or misleading.

Second, if such disclosures turn out to be false and misleading, investors in the company stock are presumed to have relied on the erroneous filings, whether or not each such investor has read those filings cover to cover or is even aware of the false statements. This principle is generally known as the “fraud on the market” doctrine, and it goes back to the *Basic Inc. v. Levinson* case of nearly three decades ago. The doctrine allows investors to collectively assert fraud claims against the issuer without having to individually demonstrate reliance on all filings and specific misrepresentations. In effect, the company breaches its duty and defrauds all investors by filing the bogus information.

Third, the defendant company always has the ability to rebut the presumption of fraud on the market and thereby block investor claims by introducing evidence that any false information did not alter or otherwise affect the market price of its stock. This point is a key check and balance in preventing frivolous law suits.

The three-part legal dance is played out constantly in cases alleging fraud on the market but seldom finds its way to the lofty corridors of the US Supreme Court, which is why this case is so pivotal. Lawyers arguing against the doctrine came within a breath of removing a monumental protection for investors and markets.

The result of the case confirms two important things for the proper policing and sanctioning of bad actors in our markets. First, the court ruled that securities fraud defendants can offer evidence relating to the alleged price impact of misstatements or false information early in the proceedings to certify a class action, in which plaintiffs try to establish a case on behalf of a broad class of investors. Importantly, that ruling will create another important check and balance on frivolous claims and at an earlier stage than in the past. The real victory is one for investors, however, because the Supreme Court was unwilling to overturn a 30-year legal precedent.

At least in the US courts, the efficient market hypothesis is alive and well. Legal observers and CFA charterholders can now consider how future plaintiffs might demonstrate that prices reflect public information.

At CFA Institute, we track global policy and legal developments affecting members and engage with regulators on important concerns. In this connection, we note that in the United States, there is a new regulatory initiative to examine the rules about just what information needs to be disclosed by public companies. The SEC staff has recommended a broad review of key disclosure rules, Regulations S-K and S-X, which means that pretty much anything that is disclosed in current annual and quarterly filings is subject to a fresh look. In the European Union, the European Parliament adopted the directive on disclosure of nonfinancial and diversity information in April of this year.

Follow the Market Integrity Insights blog: http://blogs.cfainstitute.org/marketintegrity
Follow us on Twitter: @MarketIntegrity

Kurt N. Schacht, JD, CFA, is managing director of Standards and Financial Market Integrity at CFA Institute.
Gauging Investor Attitudes about Credit Ratings

By Jim Allen, CFA

With the passage of time, it was likely that investors would eventually forgive the credit-rating agencies for their mortgage market missteps—but not forget the problems they created. Given the financial and reputational losses that cut across a wide swath of the global financial landscape, forgetting was certainly too much to expect. But whether the market would ever again find any use for the ratings these firms create was always a key question.

What has developed since the crisis is an uneasy truce, according to a survey of CFA Institute members. Targeting fixed-income investors globally at the end of May, the survey found that 62% believe the rating agencies continue to receive pressure about their ratings from issuers. And that means that investors have become more cautious about how much they rely on such ratings, as 64% said.

That is a marked change from the pre-2007 era, when at the insistence of legislators and regulators, investors were required to look to the rating agencies for guidance on whether a security was worthy of their interest—that is, whether the security was “investment grade.” Indeed, the special inspector general for the US Troubled Asset Relief Program (TARP) found 54 instances of laws and regulations requiring the use of credit ratings in everything from maintaining to whether a particular type of investment fund could buy a particular type of security to whether a company qualified for federal housing programs.

This overreliance on ratings undermined the forces that might have prevented the rating agencies’ startling fall from grace. There was a market for their ratings, regardless of how flawed they were, because governments had so mandated. The US Dodd–Frank Act of 2010 placed heavy emphasis on removing those mandates, as did the European Union and other markets throughout the world to one degree or another. Getting rid of those mandates was the biggest factor in restoring trust in the rating agencies, according to an admittedly small plurality of survey respondents (26%). European respondents placed greater faith in the increased regulation of rating agencies (23%) as the primary factor in bolstering investor trust in the sector.

In the United States, other reforms included increased transparency about ratings performance and methodologies and tighter internal controls. It also meant creation of the Office of Credit Ratings within the Securities and Exchange Commission. But these additional reforms would do little to improve the quality of the firms’ ratings. And although the reforms were worthwhile—strong internal controls should have been standard fare well before 2007—they also would necessarily increase the cost of participation for new entrants or small firms in the market. This result had the effect of mitigating the benefits of removing the mandates by making it harder for start-ups with better-quality ratings and different business models to compete in the market.

For survey respondents, how rating agencies make money remains a concern, though not an insurmountable one. Globally, 52% of members said that the biggest unfinished regulatory reform is taking on the issuer-pays model, but an even greater percentage (60%) said that all rating agency business models are conflicted and the best way to deal with them is to increase transparency and competition in the sector so that investors can make informed decisions.

Inherent in these data is the further recognition that an investor-pays model would not provide a panacea. The Standard & Poor’s downgrade of US sovereign debt ratings in 2011 is a case in point. The US government, which did not pay S&P for its ratings, exerted significant pressure not only on S&P but also on the other rating agencies not to make the move. S&P followed through on its downgrade, but Moody’s did not follow suit.

Despite the distrust, credit ratings still serve a useful purpose. Large firms tend to use them as one data point among many to compare with their internal evaluations. Small firms have great need for the ratings, if not the full-blown analyses, given their more limited resources. And ratings still have the ability to move the markets. But these days, it seems that most investors use the ratings with some trepidation.

All of which goes to show that the road to perdition is short, whereas the road to redemption is incalculably long and winding. Put another way, it doesn’t take long to ruin a reputation developed over decades, but it can take decades to recover trust. Given the responses from CFA Institute members, there is certainly a willingness to forgive but not necessarily to forget.

Jim Allen, CFA, is head, capital markets policy, Americas, at CFA Institute.
Managing Conflicts of Interest

By Christian Takushi and Christina Rulfs, CFA

At a time when the public views the financial industry with distrust, there is much talk about ethics. At a recent seminar sponsored by CFA Society Switzerland on managing conflicts of interest that investment professionals might face during their careers, London Business School professor Robert Jenkins, FSIP, discussed moving from teaching a code of ethics to putting it into practice. And investment adviser Hans-Peter Rohrer shared how he has addressed conflicts of interest in his own business.

To get the discussion started, Jenkins asked participants to rank financial industry stakeholders on the basis of how they are currently ranked in importance by investment professionals and how they ought to be ranked. Although participants agreed that customers should rank first, in practice they often rank well behind financial industry executives, shareholders, and employees. Jenkins suggested ways industry leaders could put clients first without jeopardizing long-term goals, stressing that placing customers’ interests first need not mean putting shareholders last. He pointed out that to serve all stakeholders well, the time horizon for measuring profitability must be longer and employee incentives need to be aligned accordingly.

Jenkins highlighted the importance of not only adhering to the CFA Institute Code of Ethics and Standards of Professional Conduct but also sharing it (as well as the Asset Manager Code of Professional Conduct) with employers. Initiating this dialogue presents an opportunity for investment professionals to show their commitment to doing business ethically and to open a discussion with management about what this means in their firms.

Hans-Peter Rohrer discussed how, in dealing with customers, the profitability of financial firms is often given more weight than client objectives. Rohrer, who has held management positions at several banks in Switzerland and Liechtenstein, shared his personal journey that led him from morally compromising behavior toward clients to putting customers first. He described how one conflict of interest led to another and how he eventually sought help to turn his business around. Rather than dreading phone calls from customers, he keeps his promises to clients, carries out their investment strategies as intended, and builds a relationship based on trust.

Making such a change is not easy, and investment practitioners may encounter many obstacles in trying to realign their business practices in order to deal with conflicts of interest. Members of the audience pointed out that employees often do not have the power to change the business model of their firm and may be penalized for raising concerns about potential conflicts of interest with management. One participant described trying to discuss CFA Institute professional and ethical standards several times with management to no avail. This reality is encountered by some investment professionals, and not all of them have the option of moving to another employer where their concerns about ethics might be taken more seriously.

This observation brought the discussion back to the central theme of the seminar: What are some constructive and practical ways to deal with conflicts of interest that practitioners are likely to face in their careers? If customers do not rank at the top of the list of stakeholders, what can individuals in the industry do to change that situation? Although participants did not have any easy answers to these questions, they agreed that starting a dialogue in a forum like the CFA Society Switzerland seminar is a first step. For example, many were motivated to go back to their employers and continue the discussion by exploring ways to move customers up in the stakeholder rankings and to better align employee incentives.

One of the objectives of the event was to raise awareness and encourage practitioners to share concerns and seek help if needed. Rohrer sought help from a CFA Institute volunteer in addressing his conflicts of interest and turned his business around. The volunteer who helped Rohrer had previously sought advice from a CFA Institute board member on a delicate business decision. Taking such action requires a conscious effort to develop trusting relationships and get feedback. What can practitioners do to encourage and support ethical behavior among their colleagues and help them deal with conflicts of interest? Participants acknowledged the potential cost of behaving ethically, such as not getting a bonus or a promotion or perhaps even being laid off.

Behaving ethically demands a clear and conscious individual choice, but it often also requires help and support from colleagues. To that end, CFA Society Switzerland is exploring the possibility of opening a hotline that would enable people to share their concerns about ethical dilemmas and conflicts of interest in their workplaces. The hotline would allow experienced practitioners to act as a sounding board for their colleagues in need of an independent and supportive perspective.

Christian Takushi is deputy director and strategist investment manager—emerging markets at BCV Asset Management in Switzerland, and Christina Rulfs, CFA, is director of society advocacy engagement at CFA Institute.
SUSTAINING THE ECONOMIC GROWTH MOMENTUM

Written off as the "sick man of Asia," the Philippines is back on the investment map. With sound economic fundamentals, an energetic young population, and strong investment sentiment, the Philippines seems poised for takeoff.

Hear from top government policymakers, business leaders, economists, investors, and many others at the Philippines Investment Conference—proudly co-hosted by CFA Institute, CFA Society Philippines, and the Department of Finance of the Republic of the Philippines.

EARLY-BIRD OFFER
Register by 22 September 2014 and save USD 30

For more information and to register, visit http://cfa.is/2014pic
GIPS Standards Undergo Strategic Review

Following a two-year review and discussions with key stakeholders, the Global Investment Performance Standards Executive Committee is undergoing an organizational restructuring aimed at promoting greater efficiency and effectiveness in the development and promulgation of the Global Investment Performance Standards (GIPS®).

The voluntary GIPS standards are based on the fundamental principles of full disclosure and fair representation of investment performance. Global standardization of investment performance reporting gives investors around the world the additional transparency they need to compare and evaluate investment managers.

“We initiated the strategic review to ensure that the organization is structured efficiently and effectively for the future,” states Jonathan Boersma, CFA, executive director of the GIPS standards. “We need to make sure we are supporting the industry from a technical perspective while maintaining robust stakeholder representation and, importantly, being good stewards of the resources afforded to us.”

The strategic review process yielded a new mission statement and identified specific goals that give direction and purpose to the revised governance structure:

Promote ethics and integrity and instill trust through the use of the Global Investment Performance Standards by achieving universal demand for compliance by asset owners, adoption by asset managers, and support from regulators for the ultimate benefit of the global investment community.

The GIPS organizational restructuring reflects the duty to manage resources effectively and responsibly, and this ongoing duty is highlighted among the goals for the revised GIPS governance and operating structure:

• Maintain the integrity of the GIPS standards.
• Support the advancement of the mission.
• Keep the GIPS standards relevant to the current issues of the global asset management industry.
• Be inclusive rather than exclusive and allow for broader stakeholder engagement.
• Support increased promotion and awareness activities.
• Reduce the time to market for content (such as guidance and interpretations) without sacrificing quality.
• Use available resources efficiently.

Key elements of the restructuring include the following:

• A new Executive Committee will be structured to function as a board that focuses on strategy, vision, and the promotion of the GIPS standards. This committee will target high-level influencers rather than technical experts.

• A Technical Committee will be created to oversee technical issues, interpretations, and guidance.

• Regional Investment Performance Subcommittees will transition to Regional Technical Subcommittees that will provide insight on regional issues that warrant development and/or clarification and will foster Country Sponsor involvement and engagement on a regional level.

• Country Sponsors will be required to be inclusive and welcome other organizations/stakeholders that are committed to advancing the mission of the GIPS standards.

This strategic realignment of governance and resources positions the GIPS standards to continue their global expansion. Partnerships with key industry organizations in 37 countries have provided the foundation for direct participation and insight into local markets and have contributed significantly to the promotion and development of the Standards for the past 20 years. During these years, the investment industry has expanded in emerging markets and developing countries. CFA Institute, in conjunction with the GIPS Executive Committee, continually strives to maintain the strategic vision and to ensure that key industry participants are engaged in the development and promotion of the GIPS standards.

The new governance and operating structure of the GIPS standards will provide the framework for the efficient use of resources and the ability to nimbly address technical issues in the diverse investment industry and reduce the time to market with guidance and interpretations to evolve and maintain the Standards as a relevant industry resource. The separation of strategic and technical oversight will focus resources on these two key areas and result in more robust promotion and development of the GIPS standards as they continue to be recognized as the “gold standard” of global investment performance standards.
Ethics Education and Engagement

By Dorothy C. Kelly, CFA

The vast majority of the work of the CFA Institute Professional Conduct Program is focused on diligent investigations and fair process, but in recent years, staff members have been increasing outreach efforts to engage and educate members, societies, university partners, and others in the areas of the CFA Institute disciplinary process and the Professional Conduct Program in general. Through these articles and the CFA Institute website, we’ve reached out to our stakeholders to inform them about the disciplinary process and how a strong disciplinary program protects the reputation and integrity of the CFA Institute membership, examinations, and designations.

Several years ago, a simple request by a member of the Disciplinary Review Committee (DRC) revealed a previously unrecognized opportunity to contribute to the organization’s mission. Following a mock disciplinary panel based on well-publicized events in 2011, Matthew Andrade, CFA, requested permission to use the DRC training materials to train his internal staff. “In our business, employees encounter these types of situations every day,” explained Andrade, who is now chair of the DRC.

Thanks to Andrade’s request, staff soon realized that they could leverage the resources devoted to maintaining a fair disciplinary process and develop derivative products that would benefit a much broader audience in furtherance of the mission of the organization. Recognizing that the materials used for mock disciplinary panels are not suitable for most other applications, staff set out to distill the research and original training materials into a user-friendly format designed for ethics and education.

At about the same time, faculty at CFA Program Partner universities, which agree to include the CFA Institute Code of Ethics and Standards of Professional Conduct as well as other topics from the CFA curriculum in their degree programs, were finding it challenging to find appropriate ethics material for use in the classroom. In a survey of Program Partners, more than 50% of respondents reported that they found integrating ethics into their curriculum quite challenging (29%) or somewhat difficult (25%). The biggest challenge in providing ethics education, according to 39% of respondents, was resources—including teaching staff.

A potential solution became clear: Distill DRC training materials into ethics case studies that could be used by CFA Program Partners to educate students on the Code and Standards and develop teaching notes to accompany the case studies. If desirable, faculty could invite local society members to lead the case discussions.

During the development and review process, it became obvious that CFA Program Partners were not the only audience interested in ethics case studies. Societies expressed interest in ethics case studies as a way for members to earn continuing education credits in the area of Standards, Ethics, and Regulations (SER); as a tool for employer outreach; and as a program offering during the local kick-off event of the Global Research Challenge.

CFA Institute published its first such ethics case study, titled “Buying Lubrizol,” in April 2014. In July, staff invited CFA charterholders grading Level III examinations to read the case and participate in group discussions of the case study. Approximately 140 charterholders attended one of the four ethics events, which featured lively conversations about the Code and Standards.

Feedback has been positive. One participant said, “SER credits are hard to get and are often only obtained through very dry sessions. The interactive nature of this session made it interesting but also ensures that much more information is retained.” Another commented, “The case study discussion was a highly enriching experience for me.” Finally, one participant wrote that “the case study was a perfect complement to the Code and Standards.”

Staff is encouraged that more than 57% of respondents planned to share the case study with colleagues, more than 18% planned to share the case study with their member societies, and 24% planned to share it with their students. CFA Institute invites and encourages its members, candidates, member societies, Program Partners, employers, and others to read and review “Buying Lubrizol,” which is freely available on the CFA Institute website, and to share their thoughts on this new ethics resource.

Although the case study is available free of charge, it is copyrighted material, and members and others are reminded that if they are aware of potential violations of the Code and Standards by a member or candidate, they should contact Professional_Conduct@cfainstitute.org.

Members seeking guidance in applying the Code and Standards to their professional activities should contact ethics@cfainstitute.org.
to abide by international copyright law. Readers can easily share the case study with colleagues via hyperlink, which is not copyrighted and allows CFA Institute to measure usage. Individuals and organizations interested in using or distributing the case study for educational, corporate, or general use may request reprint permission by completing a copyright permission form, available on the CFA Institute website.

Member societies interested in using the Lubrizol case for educational or outreach purposes may want to translate the eight-page case study into the local language to share with employers, universities, and others in their regions. On receipt of a completed copyright permission form, CFA Institute will gladly provide permission for member societies to translate the copyrighted material into the local language.

Based on the strong interest in ethics case studies, CFA Institute recently entered an agreement with Darden Business Publishing, which publishes and distributes case studies for the Darden School of Business at the University of Virginia. Long-time members will recall that Darden, which is a CFA Program Partner and is recognized globally for its strong ethics program, was the birthplace of the original Institute of Chartered Financial Analysts (ICFA) and was its home from 1961 until 1978. The new agreement, to co-produce and co-brand ethics case studies, will allow CFA Institute and Darden to once again join forces—this time, to produce high-quality ethics case studies for distribution to a wide audience of educational organizations.

That’s leveraging resources.

Dorothy C. Kelly, CFA, is director of training and outreach for the CFA Institute Professional Conduct Program.

**DISCIPLINARY NOTICES**

**RESIGNATIONS**

Effective 18 June 2014, Keith M. Summers (Canada), a charterholder member, Permanently Resigned his membership in CFA Institute and in any member societies and his right to use the CFA designation, in the course of an investigation of an industry-related matter by the Professional Conduct Program.

Effective 13 May 2014, Richard J. Godfrey (US), a lapsed charterholder member, Permanently Resigned his membership in CFA Institute and in any member societies and his right to use the CFA designation, in the course of an investigation of an industry-related matter by the Professional Conduct Program.

---

**GET THE INSIDER’S VIEW.**

Introducing Industry Guides—a new CFA Institute publication series written by and for CFA Institute members.

Each guide is focused on providing a brief but comprehensive examination of a specific industry, including an overview of its structure, its primary economic drivers, and practical guidance for conducting effective valuation and analysis. Browse and download current titles at [www.cfapubs.org](http://www.cfapubs.org) or at [www.amazon.com](http://www.amazon.com).

Want to give back to the profession by sharing your experience as an Industry Guide author? Learn more at [www.cfainstitute.org/community/volunteer](http://www.cfainstitute.org/community/volunteer).
The Rise and Fall of the Ticker-Tape Empire

By Ralph Wanger, CFA

In ancient Rome, when a Roman general won a war, he would return to Rome with his army and a few wagons full of captured enemy officers. He would receive a “triumph,” a big parade through Rome where the crowd could admire the general in his beautiful chariot and his impressive army and watch the enemy captives get executed. In the 1920s, New York City held triumphs for such heroes as Charles Lindbergh and Babe Ruth. It would have been way cool if the triumphal parade honoring the New York Yankees’ triumph included the losing Brooklyn Dodgers in chains, but that proved infeasible, so they had a ticker-tape parade instead. Photos of those parades show vast quantities of yellowish paper floating like confetti to the streets below. I suppose many CFA Institute members have never seen ticker tape, but it was a key step in the development of the modern stock market.

The New York Stock Exchange began in 1792 under the famous buttonwood tree of Wall Street. (I have never heard of any other tree called a buttonwood tree except for that single specimen, but perhaps there were a whole bunch of them. I do not think the early stock traders spent much time worrying about forestry.) In those days, trading was limited to government bonds because there were very few corporations large enough to issue shares. Canal companies and railroads were high-tech start-ups in the 1840s, but even then, trading equities would have been confined to a few speculators in Manhattan. The disruptive technology in the 1850s was the telegraph, which linked the rest of the country to Wall Street. Telegraphic technology included the printing telegraph in 1846. In 1864, the stock ticker printed out stock trades on a long narrow roll of paper, which allowed brokerage offices to be formed around the country. Lively young clerks would take the trade data from the ticker tape and write the latest prices on a big black board in the front of the room. Many a titan of finance began his career as a humble “chalk boy.” Every brokerage office had to get rid of big piles of used ticker tape every day, so a parade down the street gave everyone the opportunity to chop the used ticker tape into confetti and throw it out the windows. (Back then, office windows could be opened.)

The stock ticker had occasional improvements to speed it up, but it was basically the same when I started in 1960. The ticker tape was spooled on a narrow pipe and had a 15-minute lag from the time of a trade to its printing on the tape, even when business was quiet. On a busy day, the tape could easily trail way behind the action on the floor. My rough calculation suggests that a stock ticker could handle about 6 million shares a day. I remember at the end of May 1962, a six-month bear market ended in a selling climax. Volume ballooned to unheard-of levels, and the stock ticker had no possibility of keeping up. The lag went to 10 minutes, then 30 minutes, one hour, and eventually three hours behind trades. The NYSE put up a “flash prices” list of current prices of a few market leaders, which helped a little. Folks in my office could see that this was a historic day. After the close, we decided to break out the medicinal brandy from the first aid kit and bet on how long the ticker would run. It was three hours after the close. When you can’t get information about what’s happening on a volatile day, it is a very unnerving experience. The volume that broke down the system was—drum roll!—28 million shares.

The solution was telephone technology to deliver stock prices through a wider pipe, displaying on a CRT (cathode ray tube) monitor rather than on a ticker tape. This improvement allowed us to track current prices on the stock we were interested in. The company that made it work was Quotron, founded in 1961. Within five years, almost every financial firm had a Quotron system, which included a massive server feeding individual terminals throughout the office. It was a marvel compared with the ticker tape. No more changing rolls of paper tape and replacing the ink. Because Quotron was profitable, had a dominant market share, and already had equipment in everyone’s office, it should have been a slam dunk for Quotron to lock up the entire financial industry by upgrading the Quotron terminal to a PC and adding news feeds. The company muffed it.

Citicorp bought Quotron in 1986, when Quotron had placed 100,000 terminals and had a 60% market share. Under Citicorp’s skilled professional management, Quotron was quickly driven out of business by Bloomberg, which had been founded in 1981. Will Bloomberg hold its dominance in the internet world?

This is as clear as any example you would want as to how to convert first-mover advantage into catastrophe. It happens a lot. The Wright brothers were not able to build a successful airplane company. The early discount store leaders, such as Korvette’s and Interstate Department Stores, were swallowed up by Walmart, a late entry into the business. The history of disruptive technology is instructive. No triumph lasts forever.

Ralph Wanger, CFA, is a trustee of Columbia Acorn Trust.
CLARITY IS EVERYTHING.

Whether you call it smart beta, advanced beta or something else ...

... You can rely on STOXX for research-driven index ideas that are unambiguous.

From the STOXX smart-beta suite:

<table>
<thead>
<tr>
<th>Key figures ¹)</th>
<th>STOXX Global 1800 Minimum Variance</th>
<th>STOXX Global 1800 Minimum Variance Unconstrained</th>
<th>STOXX Global Strong Quality 50</th>
<th>STOXX Global Strong Balance Sheet</th>
<th>STOXX Global Strong Balance Sheet Equal Weight</th>
<th>STOXX Global 1800</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return (annualized)</td>
<td>6.0%</td>
<td>5.9%</td>
<td>5.6%</td>
<td>6.9%</td>
<td>7.4%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Volatility (annualized)</td>
<td>14.4%</td>
<td>11.9%</td>
<td>23.6%</td>
<td>17.8%</td>
<td>18.7%</td>
<td>20.1%</td>
</tr>
<tr>
<td>Maximum drawdown</td>
<td>43.5%</td>
<td>31.9%</td>
<td>51.0%</td>
<td>47.7%</td>
<td>51.2%</td>
<td>58.2%</td>
</tr>
<tr>
<td>Sharpe ratio</td>
<td>0.43</td>
<td>0.48</td>
<td>0.32</td>
<td>0.43</td>
<td>0.44</td>
<td>0.20</td>
</tr>
</tbody>
</table>

¹) STOXX data from Sep. 24, 2007 to May 21, 2014. LIBOR used as riskless asset to calculate Sharpe ratio. All indices are in USD Gross Return version.

For research papers and more information visit www.stoxx.com/smartbeta or scan the QR Code.

STOXX is a part of Deutsche Börse and SIX

STOXX® Indices are protected through intellectual property rights. STOXX is a registered trademark. The use of the STOXX® Indices for financial products or for other purposes requires a license from STOXX. STOXX does not make any warranties or representations, express or implied, with respect to the timeliness, sequence, accuracy, completeness, currentness, merchantability, quality or fitness for any particular purpose of its index data. STOXX is not providing investment advice through the publication of the STOXX® Indices or in connection therewith. In particular, the inclusion of a company in an index, its weighting, or the exclusion of a company from an index, does not in any way reflect an opinion of STOXX on the merits of that company. Financial instruments based on the STOXX® Indices are in no way sponsored, endorsed, sold or promoted by STOXX. Contacts: Europe, HQ Zurich: +41 58 399 5300, The Americas, New York: +1 212 669 6426, Asia/Pacific, Hong Kong: +852 6307 9316.
Why become an independent Advisor on Interactive Brokers platform?

- Freedom and flexibility to run your own business.
- No contract.
- Keep 100% of your fees.
- Minimal start up and overhead costs.
- Full White Branding capability with customized statements.
- State-of-the-art trading platform with automated allocation of stocks, options, futures, bonds, CFDs or forex to subaccounts.

- Generate Higher Returns:
  - Lower commissions, no ticket charges; no minimums; and no technology, software, platform, or reporting fees.
  - Better executions. We do not sell or trade against your orders.
  - Low interest rates, and higher loan values on portfolio margin accounts over $100K.

- Model Portfolios, Option Analytics and Algos.

- Automated calculation, billing and withdrawal of management and performance fees.

- Manage clients’ accounts wherever they come from* and wherever they want to trade on over 100 exchanges around the world.

- Solid financials with $5 billion equity¹, S&P rating: A-

To find out more, contact an IB representative by calling toll free 855-861-6414 or by visiting: ibkr.com/cfa

Interactive Brokers
for Institutions

stocks • options • futures • forex • bonds — on over 100 markets worldwide from one account

Interactive Brokers LLC - member NYSE, FINRA, SIPC. Supporting documentation for any claims and statistical information will be provided upon request. * Subject to registration requirements (US only). [¹] Includes Interactive Brokers Group and its affiliates.
GET AHEAD OF FUTURE RISK

PORTFOLIO & RISK ANALYTICS
What if you could monitor the future predicted volatility of your portfolio, narrow the risk down to the factor level, and then see how each holding contributes to the overall portfolio risk? You can. Right now.

The Bloomberg Professional® service puts the industry’s most powerful suite of global, multi-asset portfolio and risk tools at your fingertips.

For a comprehensive demo email us at portsolution@bloomberg.net or visit bloomberg.com/portfolio-risk.