Is shadow banking a threat to the system?
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By Nathan Jaye, CFA
WHY BUY A SINGLE STOCK WHEN YOU CAN INVEST IN THE ENTIRE SECTOR?

Technology Sector SPDR ETF
Top Ten Holdings*

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Symbol</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Apple</td>
<td>AAPL</td>
<td>17.64%</td>
</tr>
<tr>
<td>2 Microsoft</td>
<td>MSFT</td>
<td>9.65%</td>
</tr>
<tr>
<td>3 Verizon Communications</td>
<td>VZ</td>
<td>5.10%</td>
</tr>
<tr>
<td>4 AT&amp;T</td>
<td>T</td>
<td>4.35%</td>
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<td>5 Facebook</td>
<td>FB</td>
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<tr>
<td>6 Intl Business Machines</td>
<td>IBM</td>
<td>3.81%</td>
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<tr>
<td>7 Google A</td>
<td>GOOGL</td>
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<td>8 Google C</td>
<td>GOOG</td>
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<td>9 Cisco Systems</td>
<td>CSCO</td>
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<tr>
<td>10 Oracle</td>
<td>ORCL</td>
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</tbody>
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* Components and weightings as of 4/30/15. Please see website for daily updates. Holdings subject to change.

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• Undiluted exposure to a specific sector of the S&P 500
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Intelligence Delivered

Managing downside risks has never been more important—or more difficult—in a global multi-asset class portfolio. FactSet’s Multi-Asset Class risk model uses a simulation-based approach to help you manage risk across different asset types and classes, giving you a full picture of risk distribution.
Growing toward the Sun

“I make manifest a shadow of / the blessed kingdom sealed upon my brain.”—Dante Alighieri, Paradise (translated by Anthony Esolen)

In writing his epic poem The Divine Comedy, the great Italian poet Dante aspired to describe the light of ultimate truth (heaven) in positive terms, but he knew that his mortal limitations were inescapable. Again and again, he has to render light in terms of shadows.

In the first canticle, Inferno, he begins with the opposite problem: trying to bring darkness to light. With the Roman poet Virgil as his guide, he descends into “that dark verge”—hell. Peering into the abyss, he writes, “So dark it was and deep and bleared with mist, / that though I fixed my gaze upon the bottom / I still could not discern a single thing.” An unlikely group of modern people might be able to relate to how Dante felt: regulators trying to measure the scope and scale of shadow banking and its potential threat to the financial system (“Shadow Casting,” 24).

The souls Dante meets in hell appear to him only as shades. During earthly life, evil ways dissolved any true virtue in these people. At one point, when Dante is forced to pass over condemned souls lying in mud, he steps on them and is shocked when his foot presses down on “what seemed their persons, but was emptiness.” Likewise, things are not always what they appear where the duties of best execution are involved, and portfolio managers must watch their step to avoid pitfalls, warns Sophia Lee, CFA (“Four Dangerous Myths about Best Execution,” 13).

In addition to their lethal pride, the damned also were damaged by a kind of cowardice—fear of suffering for truth by doing good. Dante himself experiences it. At one point, Virgil rebukes him, saying “your spirit has been bruised by cowardice, / Which many a time so weighs a man’s heart down / it turns him from a glorious enterprise— / as shadows fool the horse that shies away.”

Muster ing courage for a greater purpose is why Paul Smith, CFA, calls on CFA Institute members to use their influence for good. “Let’s amplify our impact by personally engaging with investment management industry leaders in our communities to develop market professionalism,” he writes (In Focus, 6). Such efforts can take many forms. For example, Don Chance, CFA, has found that the unheralded work of writing for the CFA Program curriculum “allows me to influence a tremendous number of professionals” (CFA Institute News, 10). Danae Ringelmann, CFA, got involved with startups because “I realized the system was broken and that the people who had good ideas didn’t have the power to make them happen” (Career Connection, 16). In India, Punita Kumar-Sinha, CFA, started hosting a TV show “to bring more financial literacy to the Indian market” (“In the Passing Lane,” 38).

These aspirations would be for naught without professional competence and knowledge. As Ralph Wanger, CFA, writes, “Communication skills are sterile without something to communicate” (Chapter 10, 48). In Dante’s Inferno, many of the damned still deceive themselves and others with sterile excuses. They often sound more like victims than perpetrators. In contrast, although the poet gets lost in “wild darkness,” he finds the right track by being honest about his inner shadows and seeking the light. The ultimate goal of human existence, as Dante eventually learns, is nothing less than absolute truth. Or as he puts it in the third canticle, Paradise, “What now we hold by faith will then be clear, / seen without proof, / self-evident and known, / like the first principles of human thought.”

Roger Mitchell, Managing Editor (roger.mitchell@cfainstitute.org)

Did you know that CPAs can now earn 36.5 CPE credits under NASBA’s continuing education program for completing CFA Institute’s Claritas Investment Certificate?

Learn more at www.cfainstitute.org/nasbacpe
Investment firms worldwide have an overwhelming vested interest in adopting the highest standards of professionalism, technical expertise, and client service to ensure their own success. Yet, so many firms have not taken steps to demonstrate adherence to the high standards that clients expect. I believe that we—as professionals—each have a responsibility to encourage our employers to reach for those highest standards of practice.

Investors have the right to be served by ethical professionals who act as stewards of their savings. They also deserve an underlying investment environment that is ethical, fair, and transparent. As professionals, we have a duty to exercise discipline and ensure that the industry we serve nurtures a culture of ethical behavior, investor protection, and market integrity.

CFA Institute and its more than 128,000 members are in a unique position to help firms meet high standards and improve not only their performance but also (by extension) their standing in society. We have more influence than we think we do.

Currently, CFA charterholders are employed at more than 31,000 firms worldwide. That’s a huge number! Our members’ reputations as investment professionals are tied to the reputations of the firms that employ them. We need to effect change from the inside out. This means building deeper relationships with senior leaders of investment firms as part of our pursuit to build professionalism, raise standards, and prove the value of the investment profession. For example, only 1,100 of the firms at which we work have adopted our Asset Manager Code of Professional Conduct. What are the other 30,000 firms doing? And what are we doing—as professionals and as employees—to promote our codes and standards?

To do this effectively, we need to understand our firms’ often complex global agendas and the issues and industry challenges they face. We can assist them in establishing the firm cultures they wish to create and in meeting each firm’s needs for professional development and training. By providing this support, we will play an important role in helping them serve their clients.

We have a particularly great opportunity to impact the development of the profession and our industry in emerging markets. In Asia-Pacific markets, for example, the battle for financial talent is extremely competitive. In China, local governments offer attractive packages for finance professionals to relocate to emerging financial centers. Educating local firms about the value that CFA charterholders bring is important, not only in China but in all markets. We must also advocate for our members to be recognized for their qualifications and help them advance to the highest levels of their firms. Our penetration rate in China is still low, but the market there offers great opportunity to change this situation. Educating and increasing local employers’ awareness of our brand, the value of CFA charterholders, and the values we stand for will help us achieve greater influence.

We can also focus on countries that are fast developing but which today have only a handful of CFA charterholders, places such as Brazil, Bangladesh, and Nigeria. If these countries are to thrive, they are in desperate need of a skilled professional base for their financial markets. Talent development has to catch up, and we have a responsibility to play our part to the fullest.

The beauty of emerging markets is that governments and firms are often keen to adopt international best practices, recognizing that it will be to their benefit if they want to compete for international capital. Our promotion of the Asset Manager Code and the Global Investment Performance Standards (GIPS®) is beginning to bear fruit in the developing world. Early this year, we saw the first insurance-owned asset management company in China claim compliance with the GIPS standards, and the State Bank of India and Union Bank of the Philippines-Trust and Investment Services Group have claimed compliance with the Asset Manager Code.

Financial institutions understand that our standards will help them improve their competitiveness as well as ensure that their employees are aware of their duties and responsibilities and who therefore are trustworthy professionals. We are seeing increased interest in our codes and standards not only among industry practitioners but also among regulators. Such interest has prompted us to translate the Asset Manager Code into many local languages, such as Chinese, French, and Bahasa Indonesian, among others, to help asset managers better understand and adopt the Code. The 2010 edition of the GIPS standards is also available in Korean, Japanese, German, Spanish, and Russian.

Let’s amplify our impact by personally engaging with investment management industry leaders in our communities to develop market professionalism. If each of us acts with energy and purpose, we can make a difference.

Paul Smith, CFA, is president and CEO of CFA Institute.
London Recalling

By Will Goodhart

CFA Society United Kingdom recently had a party to mark the occasion of its 60th anniversary. Much has remained the same; for instance, we still worry about finding venues for events, the pace of member growth, our finances, and how best to cooperate with other societies and organisations. But much has also changed. Having begun as the Society of Investment Analysts, we’re now on our fourth identity, although we all hope and expect that we won’t be changing our name again for some time. Our size has also changed. At the end of its first year, the society had 175 members. Today, we have more than 11,000.

But what has not changed is that we are still engaged with building a better investment profession by developing the investment professionals of tomorrow, supporting the investment professionals of today, and explaining the value of our profession to regulators, policymakers, and the public. We have the platform to support this activity because of the hard work that has been done on the society’s behalf in the past. More than 150 individuals have served on the society’s board, contributing more than 900 cumulative years of service. When you add in the contribution of our numerous volunteers, it isn’t hard to see how the society has achieved so much.

While we should feel a sense of satisfaction and pride in CFA Society UK’s past achievements, we should not doubt that there’s much more still to do. As CFA Institute’s new CEO and President Paul Smith, CFA, noted at the opening of the recent 68th CFA Institute Annual Conference in Frankfurt, Germany, we haven’t yet convinced society of the value that investment management provides and are not yet regarded as a true profession. The challenges are many. We need to hone our message and be heard. We need to maintain our relevance in the face of changing technology, regulation, and practice. We need to better reflect the society that we seek to serve, and we need to do a better job explaining and arguing for our value to society at large.

Achieving these goals will be difficult and time consuming, but as was the case 60 years ago, we have the resources at hand with which to achieve them. We have a common purpose, and we have members with skills, energy, and experience. In the past, our members were counted in the hundreds, but today, they can be counted in the thousands.

Will Goodhart is chief executive of CFA Society United Kingdom.
Enhancing the Value of the CFA Charter

By Thomas Ma, CFA

In Asia Pacific’s rapidly developing financial markets, countries are battling to attract top talent. This demand bodes well for our charterholders and candidates, but it would benefit them even more if the CFA charter and our exams also helped them meet regulatory requirements to enable them to seize career opportunities across the region. In fact, the CFA Institute Regulatory and Program Recognition (RPR) team is tasked with achieving precisely this goal.

National regulators have varying requirements for those who want to work as investment professionals in their respective markets. These requirements may be fulfilled by our education programs. The RPR team works to achieve recognition of the CFA Institute examination portfolio by working with regulators and other professional organizations around the world. Recognition can lead to waivers from regulatory requirements, university requirements, and/or professional certifications.

Our work benefits from the involvement of our local societies and members, who play a vital role in bridging the gap between CFA Institute and national regulators and other key stakeholders. For example, together with CFA Society Malaysia, we worked closely with the Securities Commission Malaysia to obtain waivers from four Malaysian licensing examinations in 2014.

So how does the RPR team provide value to members? There are four major types of recognition:

1. **Regulatory recognition** (waivers from regulatory licensing or qualification examinations). For example, the New York Stock Exchange exempts those who have passed both CFA Level 1 and Part I of the NYSE Supervisory Analysts Qualification Exam (series 16) from taking Part II of this two-part exam.

2. **Benchmarking and accreditation** (documentation on the qualification level of CFA Institute programs). For example, UK NARIC has benchmarked the CFA charter as comparable to a master’s degree.

3. **Certification program recognition** (waivers granted by other designations that recognize CFA Institute programs as satisfying the requirements of their own programs). For example, the Professional Risk Manager designation waives CFA charterholders from two of the four exams required to earn the PRM.

4. **Educational recognition** (waivers on university courses or entrance requirements). For example, the University of California, Berkeley exempts successful Level III CFA candidates from the financial accounting and finance classes in its MBA program.

These four types of waivers and other recognitions give clear benefits to our members. Regulatory waivers mean that those who have passed our exams do not have to demonstrate professional competence a second time.

At the same time, regulators have an incentive to recognize our programs because doing so makes their financial markets more attractive to investment professionals with globally recognized credentials.

In addition, we have observed that more local regulators are looking for ways to integrate themselves into the global regulatory system. This trend implies greater reciprocity with the rest of the world and provides more opportunities for our members to develop their careers in these countries.

Currently, regulatory bodies in 29 countries and territories around the world formally recognize our programs with waivers from regulatory licensing and qualification exams. Out of this list, 11 of them are from Asia Pacific: Australia (Australian Securities and Investment Commission), Hong Kong (Hong Kong Securities and Futures Commission), Indonesia (Indonesia Capital Market and Financial Institution Supervisory Agency), Malaysia (Securities Commission Malaysia), New Zealand (Financial Markets Authority), Philippines (Securities and Exchange Commission), Singapore (Monetary Authority of Singapore), Sri Lanka (Securities and Exchange Commission of Sri Lanka), Taiwan (Securities and Investment Trust), Thailand (Bank of Thailand), and Vietnam (State Securities Commission).

(For details on the status of recognition in each country, please visit our website at www.cfainstitute.org/ethics/recognition/regulator/Pages/index.aspx.)

Given the clear benefits and importance of recognitions and waivers, the RPR team is actively looking for ways to expand our global recognition footprint for our members.

In the wake of the 2008 financial crisis, the world’s regulators have been constructing a maze of new rules and regulations. At the same time, regulators in many countries and territories may be confused by competing professional designations and could benefit from greater awareness of the rigor inherent in the CFA Institute program qualifications (in connection with local requirements). In many countries and territories, CFA societies and members are the best sources of our potential opportunities, as they are closest to the local financial markets and regulations. The waivers and other recognitions matter to our members as a way to leverage the professional competence established in CFA Institute programs while keeping our designations from becoming lost in the crowd.

If you have any suggestions on how we can help you in your country, please do not hesitate to contact us at recognition@cfainstitute.org.

Thomas Ma, CFA, is the director of Regulatory and Program Recognition in Asia Pacific at CFA Institute.
SUMMARY SUSPENSION
On 9 February 2015, CFA Institute imposed a Summary Suspension on Yimin Ge (US), a lapsed charterholder member, automatically suspending her membership and right to use the CFA designation. Because she did not request a review, the summary suspension became a Revocation on 20 March 2015.

On 27 October 2014, the Financial Industry Regulatory Authority (FINRA) barred Ge from association with any FINRA member in any capacity. FINRA determined that between 2011 and 2013, Ge entered into an agreement with counterparties at other financial institutions to engage in prearranged trading. These prearranged transactions artificially influenced the natural forces of supply and demand in the market for the relevant securities.

CENSURE
Effective 13 April 2015, CFA Institute imposed a Censure on a charterholder member. A Hearing Panel found that the member violated Standards I(A)–Knowledge of the Law and VI(A)–Disclosure of Conflicts of the CFA Institute Code of Ethics and Standards of Professional Conduct (2005).

Specifically, while working as a sell-side research analyst, the member and his wife engaged in personal trading in preferred stock and bonds issued by the same company for which he issued research reports regarding the common stock during the prohibited period beginning 30 days before and ending five days after the publication of the reports, in violation of NASD Conduct Rule 2711(g)(2) and FINRA Rule 2010. The analyst also failed to disclose his and his wife's financial interests in the related securities of two companies that were the subjects of his research reports. This failure to disclose violated NASD Conduct Rule 2711(h)(1)(A) and FINRA Rule 2010.

The Hearing Panel found that the member failed to understand and comply with the rules pertaining to his work as a research analyst and failed to disclose the actual or potential conflicts of interest posed by his and his wife’s ownership of the related securities of companies that were the subject of his research reports about the common stock.

CENSURE
On 19 February 2015, a Review Panel affirmed CFA Institute’s imposition of a Censure upon Reid C. Weaver, CFA (US), a charterholder member. CFA Institute found that Weaver violated Standards II(D)–Misconduct and IV(A)–Loyalty of the CFA Institute Code of Ethics and Standards of Professional Conduct (2005).

While working as a research analyst and operations manager at IMS Capital Management (IMS) in 2010, Weaver violated his duty to his employer by working with two coworkers to set up a competing investment firm. He improperly contacted the firm's clients and worked to set up a competing office during business hours while working at IMS.

PCP Volunteers Needed!
The CFA Institute Professional Conduct Program (PCP) is looking for members to serve as PCP Liaisons. This position is designed to increase member communication with the PCP and provide a way for members to promote the integrity of the CFA Institute membership, CFA charter, and examination program in their own communities. Liaisons provide the PCP resources to

- monitor local media,
- understand local regulatory issues,
- provide outlets for ethics training, and
- serve as a foundation for other PCP outreach as ethics ambassadors.

For more information and/or application materials, please contact Stephanie Gibbons at stephanie.gibbons@cfainstitute.org.

ARE YOU ACTIVELY MANAGING YOUR CAREER, OR JUST LETTING IT HAPPEN?
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Get started with practical tools and resources designed to help you reach your potential, including:

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Download your free copy of the Career Success e-book from the interactive companion website today:
www.cfainstitute.org/careersuccess.
Practicing investment professionals play a critical role in helping to shape the curricula of CFA Institute education programs. Through their participation in practice analysis and as authors, reviewers, and question writers for the CFA®, CIPM®, and Claritas® Programs, they help ensure that the curriculum for each program remains relevant in a rapidly evolving global financial landscape.

Mike Edleson, CFA, served as a writer for the CFA Program curriculum. Edleson is the chief risk officer at the University of Chicago. With fellow charterholder Don Chance, CFA, Edleson co-wrote Introduction to Risk Management for the CFA Program Level I curriculum.

“After a career spent helping in the formation of this relatively new area [risk management], writing that chapter for the CFA curriculum was a great opportunity to share a lifetime of experience and help shape practice for the next generation of investment professionals,” Edleson says.

Chance is the James C. Flores Endowed Chair of MBA Studies and a professor of finance at Louisiana State University, as well as a consultant for Omega Risk Advisors. He is the primary writer and adviser for the CFA Program’s derivatives and risk management material.

“It helps me stay connected with the real world of investments, and I also feel that with the size of the program it allows me to influence a tremendous number of professionals,” Chance says.

Jeanne Murphy, CFA, director of curriculum projects at CFA Institute, appreciates the valuable partnership illustrated in the curriculum development process. “The collaboration between Mike Edleson and Don Chance is a perfect example of the effort entailed in developing study materials for the candidates,” she says.

According to Edleson, writing for a curriculum is an intense and lengthy process. “Once we began writing, there were 16 CFA Institute staff and charterholders involved in getting from first draft to final product … it’s a fairly involved process, and every effort is made to create a first-rate reading that’s accessible and informative to the candidates,” he says.

Gabriela Clivio, CFA, manager of business valuation at Deloitte in Santiago, Chile, volunteers as a CFA Program curriculum reviewer and works to ensure that curriculum readings reflect global practices and are understandable to candidates who are nonnative English speakers.

“As a charterholder from Chile, my viewpoint as an industry practitioner from the emerging markets is a valuable one,” she says.
The CFA and CIPM Program curricula would not be possible without the help of the more than 380 practitioners and academics from 25 countries around the globe who contributed. We would like to recognize the investment professionals who served as authors and reviewers.

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Hounds of Zeus versus the Research Challenge

By Dave Alluisi

“Beware: / The sharp-beaked hounds of Zeus that do not bark, / The Gryphons...”—Aeschylus, “Prometheus Bound”

The CFA Institute Research Challenge has crowned a new global champion: Canisius College of Buffalo, New York. The ninth annual competition, which ended on 17 April in Atlanta, Georgia, culminated a series of local competitions that saw over 4,000 students from more than 865 universities in 70 countries participate. The winning team, handpicked from among Canisius’s student-helmed Golden Griffin Fund by two professors from the college’s department of economics and finance, consisted of Carl Larsson, Stephen Miller, Kevin Monheim, Ryan Zimmer, and team captain Matt Coad.

Teams are sponsored by local CFA Institute member societies or groups formed from among thousands of experienced volunteers. The team benefited directly from the mentorship of one such society member, Steven A. Gattuso, president of CFA Society Buffalo. “He was extremely essential,” says Monheim. “Without his guidance and questions, we would have not finished with the report we did.”

The team was also quick to note the contribution of their faculty adviser, Dr. Richard Wall. “Dr. Wall is five for five in [western New York] regional finals,” says Miller. “His comments and advice (more like brutal honesty) are what caused us to, two days before the report was due, scrap everything and start again.”

“The success our program has is not confined to us five but rather includes the faculty, administration, professors, and other students who pushed us to succeed,” adds Miller.

The CFA Institute Research Challenge promotes best practices in equity research while giving students an opportunity to learn from both industry leaders and peers from other top business schools around the world. Preparation for the competition involves hands-on mentoring and hours of intensive training in financial analysis as each team analyzes a different publicly traded company, drafts a report, and presents to a panel of investment industry experts. Points are awarded on the strength of the investment case, each team’s poise, and participants’ ability to field questions from the judges. The Canisius College team defended their report on Sovran Self Storage, Inc., to a panel that included Ashby Watts, CFA (managing director at Mirador Advisors), Rex Macey (head of investment risk at Wilmington Trust Investment Advisors), Gautam Dhingra, CFA (founder, portfolio manager, and CEO at High Pointe Capital Management), Syarifa Galeb, CFA (US utilities and midstream energy equity research associate at Bloomberg Intelligence).

The reports that are presented to the panel are researched over several hundred hours in addition to the students’ other commitments. Based on these reports, select teams are invited to present and defend their “buy,” “sell,” or “hold” recommendations to the panel.

Local competitions ran from July 2014 to March 2015, advancing winners to one of three regionals hosted by CFA Institute: Asia Pacific, held in Manila, Philippines, on 12 March; EMEA, held in Amsterdam, Netherlands, on 2 April; and the Americas, held in Atlanta on 16 April. The final competition included teams from Ateneo de Manila University (representing CFA Society Philippines), Kyiv National Economic University (representing CFA Society Ukraine), University of Florida (representing CFA member societies in Florida), and Canisius College (representing CFA Society Buffalo and CFA Society Rochester).

Preparation of the report was mostly completed during Canisius’s winter break, which provided certain challenges for the team. “We wrote the majority of the report while multiple members of the team were either in Boston or Sweden and the rest of us were home in Buffalo,” says Coad.

Despite having to adapt to these challenges, however, both Coad and Monheim discovered “a passion for equity research.” According to them, the competition helped them discover their future careers.

For more information on how to participate in future competitions, please email researchchallenge@cfainstitute.org or visit www.cfainstitute.org/researchchallenge for rules, eligibility requirements, and competition dates. Additional information, including the latest updates and photos from past competitions, can be found on Facebook at www.facebook.com/globalirc.

Dave Alluisi is associate editor of CFA Institute Magazine.
Four Dangerous Myths about Best Execution
COMMON MISCONCEPTIONS LEAD MANY MANAGERS ASTRAY

By Sophia Lee, CFA

For the first time in a long time, equity market structure has been a hot topic of debate and interest, reaching audiences outside of the financial markets. Critics of the current system often point to its unnecessary complexity, which creates potential for abuse that can hurt the investor experience. However, investors ideally ought to be able to take comfort in their asset managers’ duty of best execution, a fiduciary obligation that affords investors some measure of protection and assurance. Unfortunately, best execution is often invoked but rarely understood and frequently misinterpreted. As a result, four key myths about best execution have become widely believed. With a clearer understanding of the facts behind the myths, investors can (hopefully) rely on best execution for what it is intended to provide: a clear, unambiguous threshold for client service.

Myth #1. Choosing a broker who charges the lowest commission satisfies best execution.

When portfolio managers send orders to buy or sell securities to their brokers or directly to particular venues, they owe a duty of best execution to their clients. There is a common misperception that a portfolio manager’s only obligation when it comes to best execution is merely selecting a broker with the lowest commission cost. In fact, however, this belief is misguided. This duty requires that the portfolio manager use reasonable diligence to assess the quality of executions achieved at each venue. In addition to assessing the quality of a broker’s execution, a portfolio manager should recognize and consider the potential conflicts of interest the manager faces in directing client orders to a particular broker. The SEC recommends that investment advisers evaluate whether they are choosing a particular broker/dealer because of the client’s best interest or for other motivations.

Numerous cases have been brought against investment advisers for selecting brokers for conflicted reasons. In July 2013, the SEC settled a case against two investment advisers (Goelzer Investment Management and A.R. Schmeidler & Co.) for potential conflicts of interest because the fund managers allegedly put their personal interests ahead of those of the investors in three ways: (1) failing to compare the services its in-house brokerage division offered with those available at other brokerage firms, (2) failing to properly seek best execution of trades for certain advisory clients, and (3) failing to implement policies and procedures to ensure that the fund manager sought best execution as represented in its Form ADV. In 2013, the SEC undertook an administrative action against the investment adviser Fry Hensley & Company for allegedly failing to disclose three things to its clients: inflated commissions, markups, and markdowns charged by its affiliated broker/dealer. The firm subsequently agreed to a cease and desist order.

Downstream from portfolio managers, the brokers exercising discretion that they choose have both a fiduciary obligation and a regulatory obligation to seek the best execution reasonably available for their customers’ orders. According to FINRA (Financial Industry Regulatory Authority) Rule 5310, brokers must use reasonable diligence to ascertain the best market for their customers’ orders and obtain the best price available at submission while also considering other factors, such as the character of the market for the security, the size and type of transaction, the number of markets checked, the accessibility of the quotation, and the terms and conditions of the order that resulted in the transaction. The SEC has further stated that some of the factors a broker must consider when seeking best execution of customers’ orders include “the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood that the trade will be executed.” (For further details, see “Best Execution” at www.sec.gov/answers/bestex.htm.)
Myth #2. Venue choice isn’t a best-execution consideration.

A portfolio manager must evaluate best execution as much more than simply finding the best price or lowest explicit costs. Today, fragmentation of equity markets has given investors many venue choices, including almost a dozen exchanges and more than 40 dark pools. These venues can vary greatly, with differences in available liquidity, transparency of operations and pricing, average trade size, implicit costs from market impact and information leakage, the amount of price improvement, the types of participants, the character of the liquidity, the opportunities to interact with natural order flow, and the extent of structural or latency arbitrage opportunities enabled by the venue. All portfolio managers should define what best execution means to the specific funds that they manage, including qualitative and quantitative measures of execution quality.

Regardless of which factors the portfolio manager deems most important, the quality of execution must always be viewed from the customer’s perspective, not from the firm’s point of view. The portfolio manager—as a fiduciary with respect to clients’ accounts—has an obligation to ensure that trades are executed in a manner that is optimal under the particular circumstances and to achieve the best result for the client in terms of both explicit and implicit costs. This obligation comes with an independent duty to conduct analysis of the quality of the executions achieved by the brokers. Factors that should be analyzed include the explicit commissions, the market impact costs, the opportunity costs of orders that are not filled, and whether the fill rates in the particular securities are satisfactory.

Investors may also seek best execution by trading in dark pools. One benefit of trading in dark pools is anonymity. An institution participating in a dark pool can trade without signaling to other participants that the institution is trying to establish or unwind a position. Institutional investors, such as investment advisers, tend to place even more weight on trading in an environment that not only provides anonymity but also creates as little information leakage as possible about their large trades, because opportunistic market participants with access to such information can shift a stock’s price to the detriment of the institution’s trade.

Low counterparty risk is another important factor to consider. The nature of the participants, liquidity, operations, and trading rules of a given dark pool combine to create a spectrum of liquidity and information leakage outcomes.

As such, how a given venue works and who is trading on such a venue are important considerations for managers, and they need understanding and transparency in these areas. According to RBC Global Asset Management research published in 2010, “Traders should also consider execution capabilities such as liquidity, timeliness, clearance, settlement and responsiveness, as well as the overall financial solvency and risk associated with counterparties.” (The full RBC report, “Best Execution: Defining Best Execution in an Increasingly Complex Trading Environment,” is available at us.rbcgam.com.)

A hot-button issue these days is whether a conflict of interest exists for the venue receiving the institutional order, either in connection with the venue’s own proprietary order flow or that of the venue’s largest customers. In fact, FINRA, which regulates broker/dealers, is looking closely at best execution in the context of order routing. Part of FINRA’s focus is on conflicts of interest. Not only broker/dealers but also portfolio managers should analyze the venues where the trades were executed, the appropriateness of strategies used by the brokers (i.e., whether their algorithms and routers prioritize speed or whether the execution fees paid by brokers have an impact on their routing decisions), the performance of routers in liquidity capture, and information signaling. Portfolio managers should also consider the type of funds they are managing when selecting brokers. For example, perhaps a bulge-bracket broker is appropriate for an active fund, but specific instructions are more appropriate for less active funds.

Myth #3. Portfolio managers have no say with respect to venue choice.

Fiduciaries act as agents for their principals under the law of agency. In the case of a broker, it owes a fiduciary duty to its clients, both retail and institutional, and also must comply with SEC and FINRA rules, including FINRA Rule 5310, which (together with its supplementary material) addresses a broker’s best execution obligations. The rule generally provides that a broker must use “reasonable diligence to ascertain the best market for the subject security” and sets forth a list of non-exclusive considerations that may be considered in determining whether a broker has used “reasonable diligence.” The supplementary material to the rule addresses customer instructions regarding order handling and states:

“If a member receives an unsolicited instruction from a customer to route that customer’s order to a particular market for execution, the member is not required to make a best execution determination beyond the customer’s specific instruction. Members are, however, still required to process that customer’s order promptly and in accordance with the terms of the order.” (Emphasis added.)

Thus, portfolio managers also have the ability to direct orders to particular venues, and brokers following specific routing instructions to a particular market will be deemed to meet their best execution obligations by complying. In fact, some asset managers deem execution venue as the key factor in meeting their duties of best execution. For example, consider how RBC Global Asset Management defined its approach to best execution in its 2010 “Best Execution” paper: “The determinative factor in best execution is not necessarily the most favorable price point or lowest commission cost, but whether the transaction represents the best quantitative and qualitative execution for the client account… Determination should be given to the proper execution venue; direct order
routing, ECNs, algorithms or alternative trading systems (ATS), such as dark liquidity pools, crossing networks and aggregators.”

New venues and new technology must be considered in the best execution analysis. Therefore, the more portfolio managers understand about each venue, the better they can make informed decisions about best execution and establish the most appropriate best execution policies for their funds. For example, considerations that should be evaluated include the order types offered by each venue, the toxicity of the venue, and book depth. Other factors, such as speed, trading strategies, and routing strategies, are also important when selecting brokers.

In 2014, the New York attorney general brought a case against Barclays Capital alleging that Barclays made false and misleading statements about its “Barclays LX” dark pool. When Barclays requested that the case be dismissed, New York Supreme Court Justice Shirley Werner Kornreich issued a ruling that stated, “Given the reality of how modern securities trading actually occurs—that is, how trading decisions are really made—the notion that the decision about where to execute a trade is not an ‘investment decision’ is unpersuasive because the choice of trading platform can have a significant impact on the outcome of the trade.” Investors that were allegedly harmed in the Barclays case chose to send their orders to the Barclays dark pool because of the advertised characteristics of that venue, and Kornreich further stated that “their decision to trade in the Dark Pool is very much an investment decision.” (For complex legal reasons, Kornreich ruled that Barclays’ motion to dismiss was “granted in part and denied in part,” allowing the attorney general to proceed with some of the complaint.)

Myth #4. Mutual fund directors are too far removed to have a say in best execution.

Another checkpoint on the duty of best executions lies with mutual fund directors, who similarly have a responsibility to oversee (at the fund level) the performance of the selected brokers (via transaction-cost analysis and other reports), analyze the trading data, discuss the data with the portfolio manager, and act on such information. SEC rules (in particular, Rule 605 and Rule 606) require broker/dealers to provide quarterly reports on routing of customer orders and require markets to supply monthly reports on execution quality. Although these reports could use some modernization and more stringent disclosure obligations, the directors should also take advantage of this data. The directors can help to determine how the adviser is monitoring the broker and whether the adviser is holding the broker accountable for execution results. Moreover, directors are in the best position to assess the potential conflicts of interest of individual brokers and should ask questions such as: How many of the orders are sent by the brokers to their own dark pools? What is the composition of the participants in these dark pools? Can participants opt out of interacting with certain types of order flow or counterparties? And what logic is used by the broker’s smart-order router?

Brokers, portfolio managers, and mutual fund directors each play a role in obtaining best execution for their investors (on whose behalf they are acting) and should use the necessary vigor to consider the factors important to those clients when shaping their best execution policies. With the right approach, investors can be assured that their interests are protected by the fiduciary duty of best execution. But if the common myths outlined in this article prevail, the result may be more prescriptive regulations. Establishing clear criteria for best execution is a critical step toward avoiding confusion as asset managers adopt prudent policies and procedures to meet their fiduciary obligations.

Sophia Lee, CFA, is general counsel for IEX Group in New York City.

LETTERS

DISRUPTIVE TRENDS

The recent set of articles published in CFA Institute Magazine on disruptive trends in asset management gave good coverage on the disruptive trends taking shape and how traditional asset managers should evolve. It is truly astonishing to see how the trends in digitization of data, wide availability of communication infrastructure, and network impact are leading to the entry of disruptive new players. After recently reading The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies by Erik Brynjolfsson and Andrew McAfee, it was really great to see that CFA Institute Magazine has given prominence to these developments taking shape.

Chanakya Dissanayake, CFA
Sri Lanka


Correction for July/August Issue

The article about practice analysis in the May/June issue (“Keeping Pace with Change”) incorrectly identified the employer of author Andrew Tanzer, CFA. Tanzer is a senior research analyst and investment writer in the investment strategy group of Gerstein Fisher in McLean, Virginia.
"A World of Opportunities"
WHAT LEADS SOME CHARTERHOLDERS TO PURSUE CAREER PATHS WORKING WITH STARTUPS?

By Sherree DeCovny

Most CFA charterholders migrate toward careers in investment banking and asset management, yet those with an entrepreneurial flair can apply their knowledge and skills to reap big rewards in startups. For several CFA charterholders, pursuing this unconventional career path appears to have paid off. Their personal stories demonstrate the versatility of the skill set developed through the CFA Program and the ability of trained investment professionals to add value in a variety of ways, including their influence on ethical culture.

EMPOWERING GOOD IDEAS
Before co-founding the Indiegogo crowdfunding platform in 2008, Danae Ringelmann, CFA, worked as an investment banking analyst, did a stint in a private bank, and then worked in equity research. One of her passions was volunteering to help filmmakers and theater producers raise money for independent projects, but she soon realized that small businesses always struggle to gain access to traditional capital.

“Ideas were going unborn every day, unless you were lucky enough to know somebody in the system. I realized the system was broken and that the people who had good ideas didn’t have the power to make them happen,” she says. “That inefficiency was a huge opportunity. If we could close that gap, then we could make finance at this level more efficient and fair.”

Indiegogo’s vision was to democratize investing by connecting companies that need to raise capital with people who want to invest over the internet. The company created a model to circumvent SEC laws that deemed such deals public offerings. Meanwhile, the company became part of the movement to pass the JOBS Act and petitioned the SEC to change the crowdfunding laws to reflect the times.

Today, Indiegogo is an incubation and market-testing platform—even for large organizations that have invested heavily in R&D. Moreover, it is becoming a pipeline for traditional investors, such as banks and venture capitalists.

Working on Wall Street and going through the CFA Program gave Ringelmann a clear understanding of how the financial system works and what needs improvement. It also gave her the confidence to leave finance and start a new type of company with the goal of bringing equal opportunity to entrepreneurs and investors alike.

On reflection, Ringelmann says she was impressed by the ethics component of the CFA Program. Financial professionals are driven by setting goals and achieving results, but the process is as important as the outcome. The best companies, financial analysts, and investors hold themselves to a high ethical standard.

“In the startup world, it’s easy to cut corners and do whatever it takes to get early results and start achieving milestones,” she says. “But that sets patterns and a culture that ends up backfiring eventually.”

She also notes that financial and accounting skills are often missing from the founding team of a company. CFA charterholders can contribute their knowledge of profit and loss, cash management, forecasting, and budgeting—all things that could make or break the company.

DESIGNING YOUR OWN CAREER PATH
Donald Wyse, CFA, chief investment officer and managing director at ASQ Consulting, was already an engineer and a patent agent when he decided to pursue his CFA charter to gain more exposure to finance. He started his career at a top North American construction contractor and then left to help expand his family’s salvage business. Later, he was hired to lead a forensic group, recruited to direct multiple turnarounds in the construction industry, and ultimately appointed to head internally financed investment programs in the infrastructure space.

After passing all three levels of the CFA exam, Wyse teamed up with his co-founders to start ASQ Consulting, which offers professional services in various areas—including dispute resolution, transactions, business strategy, and litigation finance—across multiple industries.

“The timing was appropriate because we had a core group of people we trusted who could work with us,” he says. “We were at the right point in our lives where we could take the financial risk to build something great.”

Many CFA charterholders go to work for large banks or investment funds that have an established career track. If they take certain steps in the first few years, they will probably be on a defined career path for advancement, such as the progression from partner to senior partner and then managing partner.

“When you go to a startup, you have a clean slate,” he says. “Assuming that you’ve picked a startup that is associated with your interest, you get to figure out and implement what you want your path to look like.”
SHAPING CULTURES
CFA charterholders have proved that they can self-learn, stay disciplined, master many different products and concepts, and get work done. They can also wear many hats, which is important in a startup organization.

Dan Field, CFA, chief operating officer of WeConvene, started his career at a super-regional bank in the Asia-Pacific region as a financial analyst, doing equity-style research as a way to drive new business. After 18 months, he moved to India, where he spent two and a half years replicating that model and building a team of analysts. During that time, he enrolled in the CFA Program.

“It was something that my staff were doing, and being the senior person in the room, I wanted to make sure that I was keeping up,” he says. “I also wasn’t sure what I was going to do next because my career path was unconventional in the bank, and I wanted to give myself options.”

Field was then transferred to Hong Kong, where he worked for the bank for another nine months. But he did not enjoy going from running his own little startup within a big organization in India to being an individual contributor on the floor within a culture that did not suit him. He was frustrated by the risk aversion, slow decision making, and his inability to influence the culture of the workplace. He left the bank determined to work on a small, high-performing team at a startup where he could help create and shape the business.

About a year after leaving the bank, Field landed his job at WeConvene, a new company that helps both buy-side and sell-side firms facilitate corporate access and analyst meetings. In his current role, he is responsible for executing the CEO’s vision and running the operations. Although he is not in finance per se, understanding financial statements, cash flow, and profitability comes in handy.

“The CFA charter has a lot of credibility, so it was very valuable during the interview process,” he says. “The industry knows what’s involved in getting the qualification, how painful it is, and that many people have to have it. It has given me a lot of confidence in dealing with people who have a finance background.”

APPLYING SKILLS IN DIVERSE WAYS
Expansive Ventures invests in early-stage companies that do not yet have revenue. Jon Soberg, co-founder and managing partner, uses his CFA skill set when looking at strategy, setting up the investment fund, and talking with investors. Venture capitalists build portfolios. They look at portfolio construction from the perspective of what is happening at the companies they are investing in, industry trends, potential risks, and valuations.

“It’s not unlike investing in public markets in terms of trying to figure out where the trends are and your right entry points,” he says. “Ownership stakes are a big deal. Should I be investing in 50 companies, or should I be investing in 20? How concentrated do I want the portfolio to be?”

KEEP GOING

*“Signals from Silicon Valley,” Enterprising Investor (13 March 2015) [blogs.cfainstitute.org/investor]*

*“Best of 2014: Career Insights,” Enterprising Investor (26 December 2014) [blogs.cfainstitute.org/investor]*

*“Social Network Analysis (SNA) and Start-Ups: An Interview with Murat Ünal,” Enterprising Investor (3 December 2014) [blogs.cfainstitute.org/investor]*

It’s not unlike investing in public markets in terms of trying to figure out where the trends are and your right entry points, he says. “Ownership stakes are a big deal. Should I be investing in 50 companies, or should I be investing in 20? How concentrated do I want the portfolio to be?” When I’m talking to investors, they speak that language.” Soberg works with many financial technology startups. He thinks CFA charterholders can bring significant value to these companies as they grow.

Startups can be an exciting place to work, depending on one’s risk tolerance and interests. These days, it is easier to get a startup off the ground. Companies can build products much faster and cheaper than before. Servers and software are available as an online service, and companies can deploy them as needed. In addition, they can gauge market interest quickly.

“That opens up a world of opportunities to people,” says Soberg. “For a CFA charterholder, the assumption is you’re going into investment management. But you could take your financial skills and apply them in whatever industry or at whatever-stage company you want to, and it could be a very exciting career.”

MAKING THE TRANSITION
Ringelmann would like to see more CFA charterholders get into the startup pool, but as she says, “It’s always better to date before you get married.”

Go to technology and new-business meet-ups to see whether any ideas resonate and perhaps offer your financial expertise for a few months. If you like working with the team and you are adding value, then roles may open up naturally. To get your own idea off the ground, talk with potential customers and test your proposition in your spare time until you know whether the idea will work and quitting your day job is viable.

Working for a large company has many benefits, including a steady paycheck and such resources as administrative support and an ample supply of office equipment. In startups, these resources may be unavailable.

“A lot of people in the industry talk about how they’d love to do something similar to what I’ve done but find themselves unable to do it for a range of reasons,” says Field. “The longer you spend in the finance industry, the harder it is to walk away from the paycheck. But the people who are prepared to take that risk almost always find that the money works out. In the long term, they end up back where they started, if not better.”

Sherree DeCovny is a freelance journalist specializing in finance and technology.
Assurance Policies

IS THE US AFFORDABLE CARE ACT BOLSTERING INSURERS’ STOCKS?

By Sherree DeCovny

The Affordable Care Act (ACA) fundamentally changed the way health care is paid for in the United States. Not everyone benefits directly from the law but, so far, the group of winners clearly includes large, publicly listed health insurance companies, such as Aetna, Anthem, Cigna, Humana, and UnitedHealth Group. Their stock prices are rising, which is a surprising change from the negative expectations of a few years ago.

To understand why investors are rewarding these stocks, it helps to understand the ACA’s basic outline. The act was created to provide health insurance to individuals who were previously unable to obtain it. Another goal was to control the overall cost of health care by migrating from a fee-for-service system to a value-based payment system. The idea was to ration care by removing incentives to provide certain services and focusing on those that are effective and produce the best outcomes for patients. The ACA encourages accountable care organizations (ACOs)—groups of doctors, hospitals, and other health care providers—to come together voluntarily to give coordinated care to patients.

To this end, 17 state-run public exchanges and one federal exchange were established to provide a liquid, transparent market for insurance. Medicaid coverage was expanded to cover more individuals, and a significant amount of that program’s administration was handed to the private sector. The law also allows individuals under the age of 26 to be covered under their parents’ health insurance policy.

Traditionally, insurance policies were underwritten on the basis of individual policyholders’ medical history, and less healthy people were charged higher premiums. There were also gender-specific rates. Now, insurers cannot discriminate on the basis of gender or deny coverage for pre-existing conditions, and lifetime maximums on the policies have been eliminated. The rate for the oldest age can be only three times higher than the rate charged for the youngest age for any given plan. Importantly, ACA-compliant policies contain an essential health benefits package. In the past, insurers were not required to offer these benefits, and indeed, some people did not need or want them.

Insurance policies are now subject to a minimum medical loss ratio (MLR). For individuals and small groups, insurers must spend 80% of the premium dollars they collect from policyholders on health care services. The ratio is 85% for large groups. Losses in one sector cannot be used to offset profits in another.

Financing for the ACA has come partially from taxes and fees imposed on insurers. For example, they now have to pay a nondeductible industry fee, which effectively has been passed on to customers. Funding also comes from reductions in reimbursements to Medicare Advantage plans and Medicare providers.

INSURING THE INSURERS

By the end of 2014, more than 10 million uninsured adults gained health coverage as a result of the ACA. In reality, they had little choice but to purchase health insurance, because if they did not, they would be required to pay a steep tax penalty.

Because of the lack of reliable claims data for these new customers, the government included protections to mitigate, though not eliminate, the potential losses. The three key provisions are risk corridors, reinsurance, and risk-adjustment programs, also known as the three Rs of health care reform.

The risk corridor mechanism, effective from 2014 through 2016, protects insurers as they set rates for non-underwritten, guaranteed-issue plans. If their loss ratio is above a certain point, they get paid by the program, and if their loss ratio is below a certain point, they pay into the program.

Some analysts believe the risk corridor mechanism will be retained beyond its expiration date. “If they take away the risk corridors, which they probably won’t, you’re going to see fewer insurers participating on the exchanges, which decreases competition and potentially increases the costs of premiums,” notes Steven Halper, senior vice president for equity research at FBR Capital Markets, where he specializes in health care IT, managed care, and pharmaceutical services.

The reinsurance program, also effective from 2014 through 2016, is applied at the customer level and reimburses insurers for a portion of a customer’s claims when those claims are high. All plans (individual, small-group, large-group, and self-funded) pay a monthly premium into the program, which is funded by industry fees.

The risk-adjustment program is permanent and pertains only to individual and small-group plans. Claims are analyzed on a state and market level. Plans with riskier-than-average policyholders receive payments, and plans with less risky policyholders pay into the program.
PRODUCT AND PRICE
When the ACA initially took effect in 2014, insurers limited their participation to markets where they had significant commercial or Medicare exposure, extensive networks of doctors and hospitals, and a strong sense of the costs.

“Nobody was jumping in with both feet because they wanted to see how the rules would shake out and how enrollment would go,” says Joe France, a managing director and senior equity research analyst at Cantor Fitzgerald. “The expectations were fairly modest, and for the most part, the results were too.”

But the scenario has changed in 2015. Generally, insurers are charging higher premiums, especially for individual policyholders, and policyholders have to pick up a much larger share of their health care expenses under the new plans. The profit potential led UnitedHealth Group, for example, to increase the number of states in which it participates from 4 to 23.

The US Department of Health and Human Services created an actuarial value calculator to determine what percentage of coverage small-group plan benefits provide. This percentage determines the tiers of coverage for plans sold on and off a public health insurance marketplace. The tiers have been marketed with precious metals themes to signify how “rich” the coverage is. “Bronze” plans cover 60% of the full actuarial value of the plan’s benefits; “Silver” plans, 70%; “Gold” plans, 80%; and “Platinum” plans, 90%.

The ACA defines an “affordable” premium as being less than 9.5% of an employee’s wages, and the federal government subsidizes individuals who would have to pay more than this for insurance. The catch is that many individuals do not qualify for these subsidies, and the increased premiums have forced them to downgrade to policies with high deductibles and out-of-pocket maximums.

According to the Kaiser Family Foundation, average annual deductibles for 2015 Bronze plans are about $5,372 per individual in network—about five times what the average person with employer-based individual coverage would pay. The deductibles could be double that amount for a family. Average deductibles for Silver plans are about three times higher than those for employer plans. Individuals also have to pay much larger out-of-pocket maximums and co-pays compared with employer plans.

IMPACT ON PERFORMANCE
Analysts and investors are monitoring insurers’ revenues, earnings, operating costs, and cash flows to assess the impact of health care reform on company performance. Results so far have been positive.

Aetna ended 2014 with about 560,000 on-exchange members, exceeding its projections for enrollment and profitability in this new program. Moreover, the company anticipates ending the first quarter of 2015 with about 1.1 million members, including up to 800,000 on-exchange members.

On a conference call in February 2015, Shawn Guertin, Aetna’s chief financial officer (CFO), noted that the commercial medical benefit ratio (MBR) was 80.2% for the full year of 2014. Aetna recorded $338 million in incremental reinsurance recoverable and additional net payables for the risk adjusters of $230 million. Aetna did not record any risk-corridor receivables; in certain geographic areas, however, it recorded a modest risk-corridor payable, whereas its current projections indicate it will be required to contribute to this program. Had Aetna accrued a risk-corridor receivable on 31 December, the full-year 2014 commercial MBR would have been about 20 bps lower.

Anthem ended 2014 with 37.5 million members, having added more than 1.8 million members over the year, representing growth of 5.2% compared with year-end 2013. Public exchange enrollment stood at 707,000 members.

Regarding the three Rs, Anthem President and CEO Joe Swedish said on a conference call in January 2015 that Anthem continues to book reinsurance as appropriate. The company has recorded a net payable for risk adjusters and is in a net-neutral position on risk corridors.

Anthem forecasted operating revenues to grow about 7%–8% in 2015, with roughly 2% membership growth across the business. It expects the minimum MLR to be 83% plus or minus 30 bps in 2015, consistent with 2014 levels.

Wayne DeVeydt, Anthem’s CFO, added, “2015 MLRs will be favorably impacted by the increase in health insurer fee, which impacts operating revenue and G&A [general and administrative] expense. We also currently expect our tax rate to be in the range of 43.5%–45.5% for the year, reflecting a significantly higher health insurer fee in 2015, which is nondeductible for tax purposes.”

Cigna offered coverage on state-run public health insurance exchanges in five states in 2014, and it expanded its public exchange participation to include three more states in 2015. The company recognized $238 million in operating expenses for the industry tax in 2014, increasing its effective tax rate on a consolidated basis to 36.6%.

For its insured business, the tax-deductible reinsurance fee was about $110 million in 2014, and Cigna incorporated the fees into its targeted pricing actions. Cigna recorded receivables related to the risk mitigation programs of about $200 million after tax in 2014.

Humana offers plans on public exchanges in 15 states. Its individual commercial medical membership increased 91.3% to 1,148,100, reflecting new sales, both on and off exchange, of ACA-compliant plans.

For 2014, the three R provisions affected the timing of Humana’s operating cash flows; it booked a receivable of $679 million in 2014 to be collected in 2015.

THE ATTRACTION OF THIS BUSINESS IN PART IS THAT MILLIONS OF PEOPLE DON’T HAVE INSURANCE. IF YOU WOULD BRING ALL OF THOSE INDIVIDUALS INTO THE HEALTH CARE SYSTEM, THAT’S SUBSTANTIAL UNIT GROWTH.
“We now have more color around the mix of our membership distribution among the metal tiers and by age range,” Brian Kane, Humana’s CFO, said on a conference call in February 2015. “Having evaluated that data, we are comfortable lowering our projection for full-year accruals for the three Rs by approximately $50 million at the midpoint.”

He added that the company’s pricing strategy for 2015 includes lowering reliance on the three Rs, and Humana is on track to at least break even in 2015. With regard to the risk corridors, Humana believes that the 2014 $51 million net receivable that it disclosed in February 2015 is collectible. Further, 2014 amounts must first be satisfied before subsequent years’ amounts are paid. The risk corridor receivable that Humana is forecasting for 2015 is insignificant.

According to its 10-K, Humana paid an industry fee of $562 million in 2014, which increased its effective income tax rate to about 47.2% compared with 35.9% in 2013. In 2015, the fee increases by 41% for the entire industry, and assuming no change in its market share, Humana expects its fee to increase by that amount.

Finally, UnitedHealth Group reported that the ACA negatively impacted full-year net earnings by $1 billion, or about $1 per share. The 2014 consolidated medical care ratio decreased 60 bps year over year to 80.9%, reflecting the premium impact of ACA fees. This was partially offset by adding more than 1.3 million customers in its public and senior sector business.

Meaningful improvements in productivity and operating efficiency in 2014 were more than offset by 120 bps of ACA fees and taxes and the growing mix of health care services business. The operating cost ratio increased 80 bps to 16.6%. The full-year 2014 tax rate of 41.8% increased 540 bps year over year owing to ACA taxes.

HIGHER STOCK PRICES
When the ACA was passed in 2010, investors interpreted the law as being negative for insurers because they were afraid it would erode their commercial customer business. That negative scenario has not happened, and the insurers’ “bread and butter” remains intact. The insurers have gained millions of new customers through the exchanges, although the profitability of these enrollees is uncertain. As the market settles, insurers are adjusting their plans’ benefits and pricing to increase profitability. In addition, health care costs recently have come in lower than expected. Insurers are also leveraging their selling, general, and administrative costs. Their fixed costs are not growing significantly, but they are generating far more revenue from new customers.

According to France, many insurers have targeted operating profit margins in the range of 3%–5%. Margins in Medicare are believed to be in the 4%–5% range, and commercial margins might be twice that. “The attraction of this business in part is that millions of people don’t have insurance,” he says. “If you would bring all of those individuals into the health care system, that’s substantial unit growth. And even though the margins are lower, the volume would be so big that they can make money.”

Other aspects of health care reform that are not necessarily tied to the ACA are also attractive for the insurance industry. Certain populations, such as dual eligibles (those eligible for Medicare and Medicaid) and elderly, blind, disabled, and long-term care patients, cost more money than the average individual insured on the exchange or through Medicaid. Managing those patients, a largely unmanaged population today, is a huge opportunity. Smaller players, such as Centene, Molina, and WellCare, are expanding into these areas in pursuit of growth.

But none of this is to say that insurers face no challenges ahead.

“From my perspective, the overall operating environment for many of these firms is going to be more pressured, and they’re going to face more headwind as we move forward,” says Vishnu Lekraj, senior analyst for health care and institutional equity research at Morningstar. “It’s a lower-profit environment, the ability for them to underwrite has been restricted somewhat, and the competition between the insurance companies has increased dramatically.”

He points out, however, that if the large, diversified companies underwrite carefully, they should be able to navigate the higher-pressured environment better than the smaller, regional carriers.

Another variable is politics. In March 2015, the Supreme Court heard a case to determine whether the US Constitution allows states that do not have insurance exchanges to provide federal subsidies to policyholders. The ruling will likely be delivered in late June or early July.

“That’s going to be a key issue in 2015 that will put some operational uncertainty into the minds of investors,” warns Lekraj. “It won’t derail the whole plan because they’ll most likely find a way to work around an unfavorable ruling, but [an adverse ruling] will definitely put a wrench into how the public exchanges are run moving forward.”

In the eyes of supporters, the ACA was motivated by the good intentions of providing better health care and the theory that a healthier population will lead to a stronger economy. While it is too early to say whether this vision will be realized, recent trends suggest that it could lead to a healthy bottom line for insurers.

Sherree DeCovny is a freelance writer specializing in finance and technology.
Thank you for renewing your CFA Institute and CFA society memberships.

We look forward to serving you with exclusive career, content, and community resources to help you advance professionally—for the benefit of investors globally.
Independent wealth management firms can face two simultaneous challenges: retaining quality employees and planning for succession as founders approach retirement. For some firms, sharing ownership with employees solves both problems. Proponents of employee ownership claim that, in addition to clarifying succession plans, equity sharing improves employee morale and performance as staff takes ownership of its duties. That improved performance can boost productivity, leading to greater profitability and a self-sustaining virtuous cycle. Critics point out that employees who are passed over for equity might leave the firm or become disgruntled sub-performers. Also, adding owners can complicate management decisions.

**MOTIVATIONS FOR SHARING OWNERSHIP**
Determining the reasons for sharing ownership is the first step, says Gabriel Garcia, head of relationship management at Pershing Advisor Solutions in Jersey City, New Jersey. It’s not always the right solution, and there are risks. Smaller advisory firms in particular seem to be staying away from the arrangement. Garcia notes that the advisory industry is still transitioning from micro-sized firms to much larger organizations; the discussion about employee ownership becomes more necessary as firms grow to 40 employees and beyond. Schwab Advisor Services’ “2014 RIA Benchmarking Study” confirms that the topic is more relevant for larger businesses. Among firms with more than $1 billion in assets under management, the study reports, “twice as many professional staff hold equity compared with firms with $250 million to $500 million in assets. This is something growth firms are addressing in their lifecycle as they surpass $500 million in assets. These firms create opportunities for employees to become owner-operators, giving them clear career paths and cultivating the next generation of leadership.”

Retaining ownership in a small firm versus sharing it makes economic sense, says Glenn Kautt, principal with Savant Capital’s McLean, Virginia office. “If you do the simple math on what is the best and highest net present value for you and your company, it’s for you to basically die at the desk,” he explains. “If they have a successful small business, it’s high margin, high cash flow, and when they sell it, cash flow after tax, after investment generally drops to about 20 to 25 cents on the dollar. So no one in their right mind, if they’re healthy and working hard and enjoying what they do, would ever leave their business. They just won’t do it.”

Among those advisers seeking to develop succession plans, however, equity sharing can facilitate ownership transfers. Establishing valuation procedures, financing mechanisms, and equity-transfer policies can help senior partners realize a value for their shares and exit the business more easily. That process becomes smoother as the firm grows, according to Garcia. “If you have more owners in the business, that certainly makes succession less of an event and more of a normal course of business,” he says. “So, if you have [multiple] owners, the ability to bring other partners into the organization is simpler and there’s a mechanism for that to happen and a process for that to happen.”

Kautt’s experiences with ownership transfers support Garcia’s observations. In 1999, he purchased for cash the Monitor Group, a wealth management business whose owner wished to retire but had been unable to find a buyer. Over the next 10 years, the firm grew to about $500 million in assets under management. Kautt wanted to formalize his own exit strategy, but a planned buyout from another adviser fell through at the last minute. He subsequently combined his firm with Savant Capital in Rockford, Illinois, in June 2012. The new firm now has assets under management exceeding $4 billion and 20 shareholders, a size that has allowed both Kautt and the firm’s chairman to plan their eventual respective retirements.

**EQUITY STRUCTURES**
The methods for distributing equity vary. At Parthenon LLC in Louisville, Kentucky, the founders decided to share equity with all employees from the firm’s start in 1999, according to President Todd Lowe, CFA. All shares vest immediately, including non-operating membership interests, and employees do not pay for their stakes. It’s an unusually generous arrangement, but Lowe reports that it works. “Undeniably, it’s a positive for morale and for behavior,” he says. “When a staffer is talking to a client, knowing that client’s revenues are what keep our firm operating and paying the bills, I think it puts that client in a brighter light and a more positive light. It’s wonderful to be able to hire somebody and give them a piece of equity that, hopefully, by the time they leave will be well into the six-figure valuation, which is our goal with … even an entry-level administrative person.”
In contrast to Parthenon’s approach, Garcia believes there should always be “some consideration and exchange for tangible equity in a business, and that doesn’t necessarily have to be cash.” Using an employee’s long tenure as a possible consideration for reward is an example of a non-cash arrangement. Awarding “phantom” equity is another option that allows employees to participate in the organization’s wealth creation without the risks of equity ownership.

Total Alignment Wealth Advisors in New York City uses a phantom stock arrangement, according to managing member Robert Hayden. He and two other advisers own vested shares; another 12 or so employees have stock that vests if the firm is sold for a value beyond a certain amount. Although immediate vesting with risk of forfeiture provides more of an incentive than delayed vesting, Hayden believes the arrangement helps bind employees to the organization more closely.

Savant Capital issues both voting and nonvoting shares; otherwise, the two types of shares are valued identically. To make the nonvoting shares more attractive, the firm has a redemption plan to ensure liquidity if the shareholders decide to sell, regardless of the sale’s circumstances. The redemption plan involves both cash and a note payable over a period of time. “Everyone that becomes a shareholder now doesn’t have to wonder, I’ve got this piece of paper, [but] will I ever get any money back?” Kautt says. “The company’s operating agreement says you, as a nonvoting liquidity shareholder, will be cashed out; your estate will be cashed out; your heirs will be cashed out—whatever—no matter what the circumstances are. So, that makes it pretty much a good deal.”

The different ways in which these firms use equity structures highlight what Garcia considers a vital distinction between compensation and ownership reward versus ownership and governance. He believes an owner should be compensated by salary or incentive for work as an employee of the firm, but ownership should be rewarded through the firm’s profits. Thus, in his view, the two compensation methods should be mutually exclusive propositions. Governance and ownership should also be distinct, especially in firms with 10 or more owners at various ownership levels. Otherwise, it can be very difficult to reach decisions when every owner has an equal vote and right to participate in every decision.

THE DOWNSIDE OF NOT SHARING

The advisers cited in this article strongly believe that failing to share equity with key employees in some capacity can damage a firm’s long-term prospects. Hayden feels that a lack of ownership can lead employees to feel detached from the organization; the resulting lack of incentive and loyalty can lead to less than a full effort. Kautt says that a failure to share equity can lead to “palace revolt” among the firm’s potential future leaders, who will seek ownership opportunities elsewhere. Equity distribution also benefits clients, he believes: “If you wish to be responsible, if you wish to be professionally ethical, if you wish to be a fiduciary, if you feel that you have a moral responsibility to your stakeholders—you can quote me on all of that—then you must plan for continuity, and the way you do that is to develop an equity plan and share it with the key individuals.”

Ed McCarthy is a freelance finance writer in Pascoag, Rhode Island.
Misnamed and misunderstood, shadow banking has a highly visible (and vital) function, but does it also pose a systemic threat?

By Maha Khan Phillips

Should the financial industry be worried about potential growth in shadow banking? Unease at the prospect would hardly be surprising. The shadow banking system played a significant part in the subprime crisis, and regulators around the world have been warning of the systemic risks posed by the sector for many years.
In April 2015, the International Monetary Fund (IMF) called—and not for the first time—for greater oversight of the institution-level risks, ”warned the IMF, identifying several key risks to which investors and regulators should be paying better attention.

Quoting the IMF’s unofficial motto that “complacency must be avoided,” former US Treasury Secretary Robert Rubin also issued warnings in a speech given in March 2015 at the Federal Reserve Bank of Atlanta. Pointing out that much had been done to strengthen the prudential regulation and supervision of the sector, he said more still would have to be done in the future. “We must remain vigilant for changes in the system that increase systematic [i.e., systemic] risk, and we should make appropriate changes to regulation and structure of regulation as necessary,” Rubin declared.

But the fundamental question about shadow banking’s potential threat remains a matter of debate. Does shadow banking pose risks to the financial system? The answer is a complicated one. The Financial Stability Board (FSB), the international body that monitors and makes recommendations about the global financial system, has defined shadow banking as “credit intermediation involving entities and activities outside the regular banking system.” In its “Global Shadow Banking Monitoring Report 2013,” the FSB stated, “Intermediating credit through non-bank channels can have important advantages and contributes to the financing of the real economy, but such channels can also become a source of systematic risk, especially when they are structured to perform bank-like functions, and when their interconnectedness with the regular banking system is strong. Therefore, appropriate monitoring of shadow banking helps mitigate the build-up of such systematic risks.”

So, by this definition, whether systemic risks are properly monitored plays a critical part. Some industry participants argue that regulators are being overzealous and that their efforts add more risk to the system, while others contend that regulators are not being zealous enough.

**ASSET MANAGERS STEP UP**

Part of the shadow banking world is already heavily regulated. The shadow banking industry includes money market funds, securities lending activities, repurchase agreements, securitisation, collateralised or secured finance, and hedge funds. According to the FSB, growth in non-bank financial intermediation grew by $5 trillion in 2013, reaching $75 trillion. This figure includes most of the asset management industry in its entirety, even though much of that industry is already regulated.

Europe’s asset managers looked after €19 trillion in assets under management as of the end of 2014, up 9% from the year before, according to the European Fund and Asset Management Association (EFAMA). Those asset managers are increasingly stepping into the space that banks once occupied.

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**The Future of "Parallel Banking"?**

For proponents of lighter regulation of the sector, it doesn’t help that the term shadow banking itself suggests something murky or sinister. "Post the financial crisis, shadow banking was seen as being a contributory factor to the problems the market had at the time," explains Rhodri Preece, CFA, head of capital markets policy (EMEA) at CFA Institute. "The name itself, coined around 2007, draws parallels with opaque, complex, and lightly regulated financing activities. We saw that in securitisation vehicles linked to subprime mortgages and systemic leverage and in the general lack of transparency in the system."

While the sector has moved on from the subprime crisis, the terminology has remained the same. "It is generally accepted that shadow banking is not a bad thing," comments Sidika Ulker, director at the Association for Financial Markets in Europe (AFME), the body which represents global and European banks and other significant capital market players. "It is just an unfortunate use of the term. It was used, and then it stuck. It incorporates a lot of things, and all it refers to are the sectors of the financial industry which are not regulated."

In a June 2012 green paper, one of the world’s largest asset managers, BlackRock, asserted that the term shadow banking was pejorative and belied the positive contribution that these activities made. "This reflects the fact that the debate has largely been viewed through the lens of banking supervision and the prudential regulatory tool kit," stated the green paper. "It also ignores the fact that many ‘shadow banking’ entities and activities are already highly regulated by securities legislation."

BlackRock wanted the European Commission to use the term shadow banking to refer only to certain off-balance-sheet structured finance entities sponsored by banks, noting that "This would appropriately focus regulatory attention on the area which gave rise to some of the greatest systemic issues during the financial crisis of 2007 and 2008." Furthermore, it recommended an alternative label, market finance, be used to refer to the broader set of activities (such as money market funds, securities lending, repurchase agreements, asset-backed commercial paper, and hedge funds) often included in the shadow banking discussion.

AFME has suggested that the term parallel banking might be a more suitable description because it "does not imply that these activities are somehow hidden."

Either way, proponents of shadow banking agree that a name change would go a long way toward assuaging fears.
Changes in the banking sector are driving the shift. “Under Basel III, banks have to repair their broken balance sheets,” says Amin Rajan, CEO of CREATE-Research, an independent global forecasting centre in London. “Hence, they’re off-loading a lot of loans off their balance sheets. They have started to de-leverage in a significant way. This is opening up opportunities for specialist credit managers. They provide different kinds of debt. This covers senior loans and mezzanine finance, which is what banks used to provide. But it also covers distressed debt. As a result, we are seeing quite a lot of interest expressed by institutional investors in this alternative form of credit.”

KPMG, the financial services firm, has also said that the shrinking banking sector presents opportunities for asset managers. In its 2014 report “Evolving Investment Management Regulation,” the firm argued that the next five to ten years hold enormous potential for the asset management industry. “Regulators have followed through on their promise to restrict trading and private funds within banks, which has led to trillions of assets being spun off,” stated Tom Brown, global head of investment management at KPMG, in a press release on the report. “As talented traders have less access to bank balance sheets, we will increasingly see them migrate toward the asset management continuum, which is another positive for the industry.” [Editor’s Note: For more on megatrends shaping the future of asset management, see the interview with Tom Brown (“A View to the Future”) in the March/April issue of CFA Institute Magazine, which is available at www.cfapubs.org and the Enterprising Investor blog (blogs.cfainstitute.org/investor).]

And asset managers are stepping into the space in different ways. One is through direct lending. For example, M&G Direct Lending finances British companies in the £50 million to £500 million range. In 2014, the firm recorded a total private financing deal flow of £4.9 billion. More than £400 million was lent directly to medium-sized companies over the year. Examples include UK Breweries Hall and Woodhouse and Café Nero (Europe’s largest independent coffeehouse group). M&G also has £5 billion invested in real estate–based finance, with over £2 billion being invested between long-lease property and commercial mortgages in 2014 alone. It has also provided more than £400 million of lending to UK housing associations last year.

**PEER-TO-PEER**

Another way asset managers are getting involved is through peer-to-peer lending. In May 2014, UK hedge fund manager Marshall Wace launched a £200 million peer-to-peer lending investment trust listed in London. The trust was marketed predominately to institutional investors seeking high-yielding investments, with a small part offered to retail investors on demand.

“In asset management, you are starting to see private equity vehicles and hedge funds engaging in direct loan provisions to SMEs (small and medium-sized entities),” says Preece. “Asset managers are also operating retail-oriented funds that utilise the private placement markets. So, there is a lot of scope for the asset management industry to directly step into the loan provision space.”

But increased regulation might start to bite, according to Charles Muller, investment management regulatory partner at KPMG. “Shadow banking is viewed as the next big battleground, and greater transparency and consumer protection are the key objectives of regulators,” he says. “There will be increased pressure on data and reporting, with both investors and regulators requiring more meaningful communication from businesses.”

BlackRock has warned that banks and investment managers have different business models and manage certain risks in different ways, which regulators need to take into account. “These differences should be acknowledged when it comes to crafting regulation for market finance activities and entities,” argues its 2012 green paper on shadow banking. “The inappropriate application of macro prudential tools, such as capital requirements, to market finance activities and entities, is potentially fraught with unintended consequences.”

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**Plunge in Market Finance (Shadow Banking) Overshoots (1967–2014)**

Note: The CFS definition of market finance includes: money market funds, repurchase agreements, and commercial paper.

Source: Based on data from the US Federal Reserve, Bloomberg LP, and the Center for Financial Stability.
Robert Mellor, partner in asset management for PricewaterhouseCoopers, also argues that the risk models of banks and asset managers are completely different. “Asset managers are a very different proposition [from] banks. Pre-crisis, the banks were lending against their own balance sheets, often in a highly leveraged way with a view of making gains for the bank itself. The asset management model is completely different. It is a pool of institutional investor capital which is put into a separate legal fund structure that is completely separate from the manager. The manager has a clear fiduciary duty towards the investors, and there is a board of directors which represents the investors and holds the manager to account.”

That arrangement means that managers have a completely different alignment of interests with the investors, according to Mellor. For one thing, managers have to prove to their investors that they have invested wisely. “The investors undertake their own due diligence over the manager and the risk management processes in place. The managers may receive some element of performance reward, but it is once the investors have had their return.”

Whether the asset management sector will be subject to more regulation remains to be seen, as Preece points out. “The asset management sector is already heavily regulated,” he says. “The big unknown is whether global policymakers will consider whether asset managers will pose any systemic risk. That’s the big question mark over the industry, and we’ll see how that plays out.”

**SYSTEMIC RISK AND REGULATION**

Regulators are beginning to realise that shadow banking is now part of a solution to sluggish financial markets. “I would like to highlight that I see many benefits to a viable and well-functioning shadow banking system,” said Pentti Hakkarainen, deputy governor of the Bank of Finland, in a recent speech. “Shadow banking is a modern, sophisticated, and complementary way to share risks efficiently. It is also an alternative way to allocate resources in the economy outside the regular banking sector, upon which we here in Europe are particularly dependent.”

Hakkarainen warned, however, that investors should understand that shadow banking activities would not be supported and guaranteed by governments. “As some risks are likely to shift to the shadow banking system due to the tighter regulation in the regular banking sector, risk concentrations may very well be built up in the shadow banking system. There is an externality that calls for regulation.”

Part of the scrutiny follows on from the proposed Capital Markets Union (CMU) in Europe, which would enable investors from around the continent to invest more easily in companies wishing to raise capital. According to the European Commission, the CMU will explore ways of reducing fragmentation in financial markets, diversifying financing sources, strengthening cross-border capital flows, and improving access to finance for business, particularly SMEs.

The CMU is one of the reasons why regulators are rethinking the merits of shadow banking. “I would place this in the context of the Capital Markets Union that is now being planned in Europe. From their perspective, shadow banking is not part of the problem but the solution being pushed by the European Union,” says Matthias Thiemann, professor at Goethe University.

But Thiemann argues that the correct approach is not about rules so much as processes. “In the end, the question is, Do we have the right processes in place that are capable of piercing the legal whale that smart legal engineers design in order to circumvent banking regulation?” Noting that regulators get “cues” that help with their decision making, he adds, “Right now, the cues they are getting in Europe are that we need shadow banking for growth and innovation. I think the danger with these cues is that they are not balanced well.”

Thiemann has argued in the past that shadow banking has benefited from the structural separation of global and national financial regulators. When the Basel Accords opened up a “global” market for banking services across many countries, they set a regulatory global minimum, and national regulators resisted imposing heavier regulations because they wanted to protect the competitiveness of their markets. In his 2013 paper “In the Shadow of Basel: How Competitive Politics Bred the Crisis,” Thiemann writes, “Although it was known to the international regulatory community since 1999 that regulatory arbitrage was rampant in the securitisation business, modest national regulators were waiting for the new Basel Accord to come into force, rather than taking decisive steps nationally beforehand. The problem of coordinating the constantanous introduction of national rules closing the regulatory loopholes in a global market prevented regulatory action, as national authorities supported the competitiveness of national banks.”

**RESTRICTIVE REGULATION**

Others argue that regulation is going too far. Lawrence Goodman, president of the Center for Financial Stability (CFS), a New York–based think tank, argues that there are very significant liquidity concerns in the market and that regulation will make it worse. “Many authorities are working from the perspective that shadow banking was the driving force behind the crisis and, therefore, regulators need to get a grip on it and integrate it into the regulatory apparatus. My perspective, reinforced by CFS data, is that we have overshoot. A shrivelling of shadow banking is severely hampering economic activity.”

According to the CFS, this shrivelling of liquidity puts markets and economies at risk for “excessive amplification of minor shocks and a resultant major loss of confidence.” Evidence of such amplification occurred in 2014. On 15 October, the deepest and most liquid market in the world, the US Treasury market, was hit by a six-standard-deviation move that happened over the span of less than two hours. Statistically, according to the CFS, such a move ought to happen only once in 506,797,346 days.
THE FOCUS HAS SHIFTED FROM SYSTEMIC RISKS TO THE ROLE THAT SHADOW BANKING CAN PLAY IN SOLVING THE LACK OF ACCESS TO CAPITAL IN THE EUROZONE.

Shadow banking, which the CFS refers to as market finance, is down a stunning 46% in real terms since its peak in March 2008 (see chart on page 26). According to a statement released by the firm, “This phenomenon starves the financial markets from needed liquidity and is detrimental to future growth by exposing the economy to potentially unnecessary shocks. In fact, the reduction of available market finance shows no sign of abating, with a series of successive drops from the beginning of the crisis to the latest CFS monetary data available through January 2015.”

Regulators and other industry participants need to move past the 2008 view of shadow banking, according to Goodman. “Shadow banking and regulatory arbitrage enabled the financial crisis to be deeper than it might have been in the absence of a more actively regulated sector, but it really was only one of many components contributing to the crisis,” he says. “Central bank liquidity creation was an equal, if not more important, driver of risk-seeking behaviour. Yet, today, there is a vigorous effort to regulate shadow banking and pull it into the fold.”

NEW REGULATION
And more regulation is in the cards. In November 2011, the FSB was tasked by G20 leaders, alongside other international standard-setting bodies, to come up with recommendations to strengthen oversight for shadow banking. The FSB and other bodies have identified five areas, or “work streams,” to focus on. The first work stream (led by the Basel Committee) deals with the interactions of banks with shadow banking entities. The second work stream (led by IOSCO) is concentrating on money market funds. The third work stream (led by the FSB) is evaluating other shadow banking activities. The fourth (led by IOSCO) is examining securitisation. Finally, the fifth work stream (led by the FSB) is looking at securities lending and repo markets.

“The securities financing lending [work stream] is a big one, and it is about introducing greater transparency,” says Ulker of AFME. “From our perspective, these transactions are vital to the movement of collateral in the system, and the FSB has to recognise this. We absolutely support the need for transparency, but anything beyond that needs to be contemplated carefully so that we don’t have collateral flow constraints.”

CFA INSTITUTE PERSPECTIVE
CFA Institute’s global study (see sidebar, right) on alternative channels for capital from shadow banking proposes its own policy recommendations, which have particular relevance for Europe and the Capital Markets Union initiative. In terms of securitisation, policy initiatives should focus on increasing standardisation and simplification of issuance structures, as well as improving transparency via initial and ongoing disclosures to investors. Standardisation of legal frameworks across markets would also improve the ease and certainty of enforcing ownership rights and creditor protections.

In terms of securities financing transactions and collateral, the report suggests that a robust framework surrounding the reuse of collateral is needed to mitigate the build-up of excessive leverage and to prevent associated financial stability risks. Key elements include greater transparency for securities financing transactions via reporting transaction data to trade repositories and to investors.

“The focus has shifted from systemic risks to the role that shadow banking can play in solving the lack of access to capital in the eurozone,” says Preece. “But safeguards are needed. It’s about making sure that the right policies are in place.”

Maha Khan Phillips is a financial writer in London and author of the novel Beautiful from This Angle.
Research on how Federal Reserve policy influences financial markets provides key findings for "astute" investors

By Nathan Jaye, CFA

Everyone knows that Federal Reserve policy has an effect on security returns. But did you know that small value stocks returned nearly 40% more during periods of expansive monetary policy than during periods of restrictive policy? That's the kind of data uncovered by three charterholders—Robert Johnson, CFA, Gerald Jensen, CFA, and Luis Garcia-Feijoo, CFA—in research leading to their book Invest with the Fed, published in March 2015 by McGraw-Hill. In this interview with CFA Institute Magazine, Johnson, president and CEO of the American College of Financial Services and former deputy CEO and senior managing director at CFA Institute, discusses the trio's Fed research (covering the period from 1966 through 2013). Highlights include a foundational model for classifying Fed monetary periods, how monetary policy affects investment style and individual sector returns, and strategy recommendations for maximizing returns when Fed policy is expansive or restrictive.

What was your impulse in writing this book?
Well, it wasn't an impulse. My co-authors and I, particularly Gerry Jensen, have been researching Fed policy and capital market returns for over a quarter of a century. The genesis was when I ran a private wealth management firm. I was convinced from my own experience that Fed policy had a major impact on market returns.

Being the trained academic that I was, I wanted to systematically research that. Gerry and I were amazed at the results from the very start. We have made this area a major focus of our research and have published our findings in both academic and practitioner journals.

We've distilled our academic research into a format for the astute investor. This certainly isn't a book aimed at the novice investor. This is aimed at the serious, shrewd investor—both individual and institutional.

How has the association held up over the period of your research?
It varies, and again, it isn't a one-to-one correspondence. For instance, equity markets perform best in expansive Fed monetary periods. They perform less well in indeterminate monetary periods, and they perform the worst in restrictive periods. Now again, that's on average. Just
because the Fed is adopting an expansive stance, returns won't necessarily be higher in every period. But on average, there's a very strong association, and it's been remarkably consistent across nearly 50 years.

**How much should an investor's portfolio consider Fed policy?**

I think investors ignore Fed policy at their own peril. I believe it’s a factor that investors definitely should consider. And it should be one of the biggest factors they consider because of the strong association between Fed policy and security returns. You simply can't ignore the wealth of evidence that we find in the book.

I think that most investors intuitively realize that there is a strong association between Fed actions and market returns. But most investors have not systematically examined it, nor do they realize the extent of the relationships. In other words, I don’t think it’s news that when Fed policy is expansive, markets have done better. I do think it is news to look at how pronounced the differences are and how pervasive the effects are across stock, bond, real estate, commodity, and global markets.

**What are indicators of Fed policy?**

We look at what the Fed does, rather than what the Fed says. If you look at the media, they are very focused on nuances in Fed language. For example, what could certain statements mean for future actions? We don't pay attention to that. Additionally, it’s hard to analyze what the Fed is saying. If you're trying to outguess what the Fed is going to do, that’s a loser's game to me—a difficult one to win. So in the book, what we look at is what the Fed has actually done.

**How do you classify Fed monetary policy?**

We classify monetary policy in a very simple manner—in a manner that the lay investor can follow. Our scheme is not based on any judgment or intuition. It's simply based on what's happened to two interest rates. We look at the Fed discount rate, and we look at the monthly average federal funds rate (as opposed to the federal funds target rate).

The data on these rates are available on the Federal Reserve Bank of St. Louis website. To classify monetary policy, we look at the last directional change in each of these rates. What was the last directional change in the discount rate? What was the last directional change in the monthly federal funds rate? Our research has shown that it's the direction of interest rates that is more highly associated with market returns, rather than the level of interest rates. Many investors are focused on the fact that interest rates are at historic lows. But what we found in the past is that, regardless of the level of interest rates, it's the direction of interest rates that has a greater influence.

**What are your three classifications?**

Changes in the discount rate signal a broad Fed policy intention—what we call stance. Changes in the federal funds rate show Fed actions in the short-term market—what we call stringency. Combining these two indicators gives us three possible classifications of monetary policy: expansive, restrictive, or indeterminate.

If the Fed raises the discount rate, that signals a restrictive policy stance. If the market-determined federal fund rate rises, that signals greater constraint in the stringency of Fed policy in the market for short-term financing. When both factors signal tight policy, the monetary condition classification is restrictive.

On the other hand, if the Fed lowers the discount rate, that signals an expansive policy stance. And if the market-determined federal fund rate also falls, that reinforces the stringency of the Fed's policy in the market for short-term financing. When the two factors combine to signal easy policy, we classify that as an expansive monetary period.

When the two rates are moving in different directions—say, the discount rate is decreasing while the federal funds rate is increasing, or vice versa—we term that an indeterminate monetary policy. Again, it doesn't involve any judgment on the part of the investor. It's just what it is. The point is that even a simple classification model can result in dramatically different returns. The reader of *CFA Institute Magazine* is likely to be a very sophisticated investor. If investors are able to improve on our basic classification model (for instance, correctly anticipating Fed moves) or modify our approach a little, they likely could capture much higher returns than we report in the book.

**How should investors prepare for a policy shift?**

Psychologically, investors should prepare themselves for lower returns in the equity markets when the Fed is restrictive and should expect higher returns on average when the Fed is expansive. It's an element of behavioral finance that's fueled by all the Fed watching that's going on, this myopic media focus on the Fed.

Would we suggest that you pull out of equities and put all your money into commodities during restrictive environments (because we've found commodities perform very well in restrictive Fed environments)? Of course not. But you may want to tilt your asset allocations—that is, have a slightly higher equity exposure during expansive periods and a slightly higher commodities exposure during restrictive periods.

**How does monetary policy affect investment style?**

We found that monetary policy has a large influence on returns to the two most widely followed investment styles—size and value. The small-firm effect (that small stocks perform better than large stocks) is largely concentrated in expansive monetary environments. That is, small stocks don't do very well in indeterminate and restrictive environments; however, small stocks do exceedingly well in expansive environments.

The same thing is true for the value effect. In the book, we present findings for one particular kind of value multiple, price-to-sales. You can look at other common value metrics—P/E and price-to-book, for instance—and the results are very similar. In the book, for purposes of exposition, we simply show price-to-sales. The price-to-sales effect is very
pronounced in expansive environments (that is, firms with a low price-to-sales ratio perform well in expansive environments), and there isn’t much of a price-to-sales effect in restrictive environments.

Both the size and value effects are concentrated in expansive monetary environments. So if you’re an investor and you have a small-stock bias, expansive periods are when that small-stock bias really manifests itself.

Are investors aware of these effects?
I don’t think that even professional investors are fully aware of those effects. I certainly believe that amateur investors have little understanding of the return patterns. I believe most investors think that, in general, stocks do better in expansive periods and worse in restrictive periods. But I don’t believe that even professional investors understand the magnitude of the patterns. For instance, we document that small value firms returned 44% annually during expansive periods, as opposed to only 4.8% annually in restrictive periods. I don’t think investors realize the patterns are that pronounced.

How often is the Fed expansive?
The Fed has adopted an expansive, an indeterminate, and a restrictive monetary environment about a third of the time each. In other words, from January 1966 to December 2013, which is the length of time that the bulk of the research in the book covers, the Fed policy was expansive 172 months. Fed policy was in an indeterminate classification 209 months and was restrictive 195 months. There are 576 months in the sample overall, so the results aren’t driven by a small sample size.

What’s the effect of Fed policy on sectors?
There are some substantial differences in returns across stock market sectors. For instance, you find extremely high returns in retail, apparel, autos, and construction in expansive periods. And if you think about it, that makes sense. Those are the kinds of sectors that are going to be most affected by consumer discretionary spending. When are you going to buy a new car or suit or renovate your home? Those are likely to occur when you have more discretionary income. When times are tough, you might forgo these kinds of purchases.

So you find much lower returns in those same sectors during restrictive periods. Returns in the retail and apparel sectors in restrictive periods are 1.68% and 2.30% annually—incredibly low. The differences between returns in expansive and restrictive periods are dramatic in those sectors that are most reliant on consumers having disposable income.

Some sectors perform relatively well in restrictive time periods—utilities, for instance. Utilities have a 7.80% annual return in restrictive periods and a 9.36% return in expansive periods. This makes intuitive sense. People still need electricity when money is tighter. Now, they may use less electricity, or conserve a little bit, but they still use it.

In other words, it makes economic sense. The same holds for energy. Returns to the energy sector are about the same across expansive, indeterminate, and restrictive periods. People may not buy a new car, but they’re still going to drive their car and they are still going to heat their homes. It’s the same with food. The food sector performs pretty well in a restrictive environment. Defensive sectors tend to do pretty well in restrictive Fed monetary environments, and cyclical firms tend to do well in expansive environments and poorly in restrictive environments.

You found relationships on global investing that I hadn’t expected.
We hadn’t expected some of those either. There’s good news and bad news here for the domestic US investor. The bad news is that global financial markets tend to be very highly correlated. When the US markets are doing well, the world developed markets tend to do very well. So there isn’t a great deal of diversification from a return standpoint by investing in global equities during restrictive monetary periods.

The good news, however, is that you find the exact opposite pattern with emerging markets and particularly frontier markets (I would note that due to data constraints, the time period we utilized for emerging and frontier markets is shorter than the US sample). Emerging and frontier markets have tended to do better when the Fed is restrictive rather than when the Fed is expansive. It isn’t every time period, but in the past, on average, that’s the case.

What’s the reason for that?
I can’t give you a definitive reason. Our conjecture is that in the past the developed market central banks tended to have highly coordinated policies. That is, the developed markets tend to be more interrelated both economically and in terms of their central bank policies. Emerging and frontier markets are not so interrelated. They’re more independent. Also, many of the emerging and frontier markets are commodity based, and commodities tend to do well during restrictive monetary periods.

So look to developing markets in restrictive times?
Warren Buffett has been quoted as saying, “Be fearful when others are greedy, and be greedy when others are fearful.” Well, when the Fed is raising interest rates and people are fearful about the US markets, they translate that fear into developing markets. In other words, that’s the hardest time to sell somebody on the fact that the US market may not be a great place to be invested and the developing markets may be a better investment. People think, “Oh my gosh, I want to be more conservative and avoid emerging markets instead of taking a more aggressive approach.”

What did you find about Scandinavian countries?
The Scandinavian countries are a fascinating case study.
Denmark, Norway, and Sweden had performance that was remarkably good across all US monetary policy periods. What makes them special? They certainly aren’t as integrated into the European Union. None of those countries use the euro as their currency. Each country exercises its own monetary policy independently and isn’t tied to the European Central Bank.

They also tend to have much less public debt as a percentage of GDP than many of the other developed markets, they’re not developing countries, and they have a very high savings rate. I think the Scandinavian countries’ performance looks pretty good and especially when other markets may not be performing well.

**What about hedge funds?**

You know, hedge fund data are notoriously dirty data. Only some funds report, and funds frequently go out of business. These issues create all kinds of biases in hedge fund numbers. What we did in the book was look at hedge fund strategies that involve taking long and short positions to capitalize on common trading strategies.

Our basic finding was that when Fed policy was expansive, the performance of hedge fund strategies tended to be exceptional, but the common hedge fund strategies performed poorly when Fed policy was indeterminate or restrictive.

Hedge funds are selling people on the fact that they could provide a reasonable return across all environments. What we find is that with respect to monetary policy, that’s simply not the case. The common hedge fund strategies perform very well during expansive Fed environments and perform poorly during restrictive environments, and there’s no good news in that.

**What strategies do you recommend based on your research?**

An astute investor should change his or her tactical asset allocation weightings based on Fed policy considerations. Again, I wouldn’t recommend completely moving out of stocks when the Fed is restrictive or completely moving into commodities when the Fed is restrictive. But I would recommend lessening stock allocations when the Fed is being restrictive and increasing commodity allocations.

Let’s say you’re 60% equities, 20% bonds, and 20% other alternatives, including commodities. Your equity exposure may go down to 40% during restrictive time periods. And I wouldn’t go to 100% when the Fed is expansive, but around the edges, I would make changes. In terms of asset classes, when the Fed is expansive, small value is very attractive as [are] past performance losers.

When the Fed is restrictive, energy and utilities, along with food, are the sectors that I would be focused on. So it isn’t just asset allocation changes I would make—it’s within the particular buckets. For example, the equity bucket may see a migration from small value stocks in expansive periods to a higher weight on energy and utilities during restrictive periods.

By the way, it’s much easier to do this now than it would have been in the past. Now an investor can use ETFs to effect these portfolio changes. There are ETFs that literally mirror all of these asset classes and sectors and many of the strategies that are discussed in the book.

**Can you describe what you call expanded rotation?**

There’s equity rotation and expanded rotation. Equity rotation is changing the mix within the equity bucket. Expanded rotation is about asset allocation changes—tactical asset allocation changes where you’re changing the size of the bucket. Or you may want to increase your equity exposure in total. You can make changes within the bucket and changes to the size of the bucket.

**Will these effects continue to hold in the future?**

People have asked me that question before. Do we think these patterns are going to continue through time? Unless people’s behaviors change through time, I don’t know why these patterns wouldn’t continue in the future. Will they be as pronounced as they have been in the past? Who knows? But directionally, I would expect them to continue.

One of the biggest reasons is that people’s behavior doesn’t change that much. From an individual investor’s standpoint, a lot of the behavioral finance biases that people exhibit are pretty constant through time, and I think that behavioral finance can drive some of these results. For those CFA charterholders who earned their designation many years ago, I believe it is worth your time to study the literature on behavioral finance.

**Is it notable that all three authors are CFA charterholders?**

There’s a real CFA flavor to this book. All three authors are CFA charterholders, as well as each having a PhD. I call myself a *pracademic*—that is, part practitioner and part academic. I never wanted to research anything to simply communicate with other academics. I always wanted to research relationships that practitioners are interested in. The reason for the book was that Gerry, Luis, and I all have that practitioner bias: we want to research things that people on the front lines, people out there investing, are concerned with.

We’re not necessarily interested in simply theoretical relationships but are interested in very practical relationships. The other thing is we’re all three very good friends, and it gave us a good excuse to work together.

Nathan Jaye, CFA, is a speaker on intelligence and member of CFA Society San Francisco.
In January 2015, Pensioenfonds Zorg en Welzijn (PFZW), the €88 billion healthcare and social welfare scheme in the Netherlands, announced that it would no longer be investing in hedge funds either, switching its 2.7% target allocation to equities. It cited the high costs involved and the high remuneration of the sector among its reasons.

The alternatives sector isn't the only sector where fees are coming under scrutiny. Institutional and retail fund managers are also coming under pressure to justify their models. The UK’s Railpen Investments, which manages £20 billion in assets, told the Financial Times that, while it typically paid around £70 million a year in upfront, disclosed fees, it had calculated that the additional underlying fees it was paying were multiples of that number ranging from 300% and 400%. “What we are getting billed is far less than what is being siphoned off underneath,” Chris Hitchen, Railpen’s chief executive, was quoted as saying. “I don’t think many people have done the analysis. I would think that most people in our position would not be aware of what they are paying.”

As a result, Railpen decided it wanted “fewer” and “deeper” relationships with its managers.

Such public scrutiny has led Andrew Clare, professor of asset management at Cass Business School in London, to suggest that transformations are ahead. “I think there is a wind of change blowing around,” he says. “There is an increasing focus on fund manager fees and the value that investors are getting from managers.”

When the California Public Employees Retirement System (CalPERS) announced in 2014 that it was pulling out of its entire $4 billion hedge fund programme, the decision came as surprise to many. But the pension plan had decided that hedge funds were proving too expensive a proposition given their high costs and spate of lacklustre returns. Although the move raised the eyebrows of many observers, many pension funds in Europe were not surprised. Some were in the process of doing the same thing as they focused more on the true costs of investment management.

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SYMMETRIC FEES
Clare and his colleagues conducted a study last year that concluded that the most widespread fee structure used in institutional asset
THE INDUSTRY IS CONFIDENT ABOUT ITS ABILITIES, BUT WHEN YOU SAY, 'LET'S SHARE SOME OF THE DOWNSIDE,' IT IS A DIFFERENT MATTER.

management—that of a fixed-fee model—is actually the least appropriate for investors. The study, titled “Heads We Win, Tails You Lose: Why Don’t More Fund Managers Offer Symmetric Performance Fees?” (available at papers.ssrn.com), compared how the financial well-being of investors and managers was affected by three alternative fee structures: a fixed-fee structure (a fee that is fixed in proportion to assets under management), an asymmetric-fee structure (a base fee that is fixed as a proportion of assets under management, plus a performance fee where the manager earns a portion of upside performance), and a symmetric-fee structure (a performance-based fee that is symmetric, meaning that investors and managers share both the upside and the downside of performance).

Using Monte Carlo statistical techniques, the academics simulated the performance of thousands of fund managers with varying degrees of skill, using a benchmark return matched on the FTSE-100. At the end of the period, they calculated the average financial well-being of investors and fund managers, as derived from manager performance under the three fee structures. They concluded that a clear mismatch existed between the best interests of investors and the interests of managers. No single structure simultaneously maximised both the investors’ and the managers’ satisfaction. The fixed-rate fee, which is most prevalent in the UK, definitely favoured the manager rather than the investor.

“The problem in the fund management world is that it is largely a fixed fee or nothing,” says Clare. “There are so many thousands of funds out there and hundreds of fund management companies. And not one is offering a symmetric-based fee structure. Given our results, it is surprising that nobody has tried to satisfy the demand from investors for a symmetric-based fee. The industry is confident about its abilities, but when you say, ‘Let’s share some of the downside,’ it is a different matter,” argues Clare.

NEW MODELS

Managers are beginning to explore new models. Star fund manager Neil Woodford left Invesco Perpetual in London in 2013 and set up shop on his own at Woodford Investment Management. The firm charges a fixed, low, all-in fee for its flagship Woodford Equity Income Fund. Its new fund, the Patient Capital Trust, will charge an exceptionally low annual fee to cover costs, which will not exceed 0.35% per year. Instead, it will have a 15% performance charge on any returns over an annual 10% hurdle rate.

Similarly, Orbis Investments, which sponsored the Cass Business School report, says it believes its fee structure is unique in the industry. The firm uses a performance-based fee structure for all of its funds, and its “Refundable Reserve Fee” (RRF) share classes charge a performance fee based on relative performance (which is refunded in the event of underperformance, making it a symmetrical structure). The firm offers two Refundable Reserve Fee share classes to direct institutional investors: a “Core RRF” and a “Zero Base RRF.” The Core RRF, available to clients who invest $20 million, has a base fee that starts at 0.45% per annum and a sharing ratio of 25%. The Zero Base RRF, available to clients who invest $100 million, has no base fee and a sharing ratio of 33%.

“We believe that we should add value for clients,” explains Matthew Spencer, director at Orbis. “If we add value, then we should be rewarded. If we don’t, then we shouldn’t be rewarded. If we underperform, we pay fees back. It is a way for us to hang our hat on performance.” He points to the obvious flaws of the flat-fee model traditionally employed by the industry: “One of the biggest problems I have with the flat-fee structure is that it does implicitly incentivise asset gathering. The temptation to gather assets is there for all managers, but at least if you have a performance structure, you start to ask, ‘At what point does our size start to impact our performance?’”

Dan Brocklebank, another director in the firm, points out that the structure allows them flexibility in their investment approach. “We end up with the part of the market that a lot of people wouldn’t touch, because we invest with contrarian names,” he says. “But with this fee structure, and the fact that you return money when you are underperforming, that creates a lot of goodwill.”

The Orbis fee structure is complicated and will take investors some time to understand. But there is no question that investors welcome this type of approach. It is a conversation that the Netherlands’ PFZW has also been having with its asset managers. “In 2014, PFZW started the ‘bonus–malus’ discussion with asset managers and via the media,” says Peter Borgdorff, managing director at PFZW. “Our statement was that it is fine to pay a performance fee when asset managers are over-performing, but then it would be fair for asset managers to pay back a ‘malus’ when they are underperforming.”

PFZW is no longer paying performance fees to its pension fund service provider, PGGM. But it has not agreed on a penalty, or “malus,” with other asset managers yet. “This takes time,” says Borgdorff. “But the fact that we focus on this puts pressure on bonuses.”

Borgdorff also points out that the pressure would be greater if more parties entered into the discussion. But collaboration between pension funds and other parties who purchase investment management services is difficult because it can be seen as combined market manipulation. “The practice
in the financial world, especially in long-term private investment, is still very much focused on performance fees,” he says. “The discussion about a penalty/malus is now used by us to put pressure on the fee and remuneration policies in the financial sector.”

**ASSET MANAGEMENT CHANGES**

More data suggest that asset managers are rethinking their approach. According to a January 2015 study by bfinance, an independent financial services consultancy, almost a third (32%) of active managers are ready to make a trade-off on fees. The bfinance study proposes a fee structure with an outperformance element requiring managers to outperform their benchmark index by a minimum of 2% before a performance fee sets in. Three years ago, asset managers did not show this readiness to trade on fees.

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<th>Investment Management Fees Prior to Negotiation</th>
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Notes: Figures show the average and median fees demanded by management companies (prior to negotiation) in the main asset classes on initial quotation. For comparison purposes, mandate sizes differ according to asset class, but €100 million was used as the standard for most and €25 million as the standard in some alternatives assets. According to the bfinance study, a 20% rebate can be obtained with proper negotiation.

in stone. Rebates achieved through negotiation represented on average 20% off the initially quoted price.

REGULATORY CHANGES

Regulatory changes are also making a difference, particularly on the retail side of the business. The European directive MiFID II, which became law in June 2014 and must be implemented by investment professionals by January 2017, makes it clear that investment firms must provide aggregated details on costs and charges.

The directive states, “The information about all costs and charges, including costs and charges in connection with the investment service and the financial instrument, which are not caused by the occurrence of underlying market risk, shall be aggregated to allow the client to understand the overall cost, as well as the cumulative effect on return of the investment, and where the client so requests, an itemised breakdown shall be provided. Where applicable, such information shall be provided to the client on a regular basis, at least annually, during the life of the investment.”

Another important development in 2014 from the European Parliament and the Council of the EU was an agreement on the proposed regulation of key information documents (KIDs) for packaged retail investment products (PRIPs). PRIPs are products that contain an element of wrapping or packaging that is applied to the underlying investment, whether it is a bond, equity, or other asset. They allow retail investors to combine exposures to multiple underlying assets and are designed to deliver capital accumulation over the medium and long term.

CFA Institute has published a report on PRIPs looking at costs, among other things. Titled Packaged Retail Investment Products: Investor Disclosure Considerations for a Key Information Document, the report contains 14 recommendations that address the scope of PRIPs regulation. According to the report, costs should be disclosed under a standard label and location within the KID, but content of cost disclosures could embody a small degree of flexibility beyond common components, such as entry fees, exit fees, ongoing charges, performance fees, transfer fees, and any penalties or other administrative charges. Cost disclosures should include a statement, where relevant, specifying in percentage terms the total amount the product manufacturer or sponsor pays for distribution arrangements (inducements, which are prohibited in the Netherlands and the UK but permissible elsewhere in Europe). For life insurance products, there should be a table illustrating the effect of costs in monetary terms over predefined time horizons. Costs disclosures for structure products should include a narrative explanation of the total costs included within the amount paid for the product.

Some industry practitioners believe that asset managers are not paying enough attention to the regulation.

“Asset managers will have to take the disclosure of fees and charges more seriously than before,” notes Gina Miller, co-founder of SCM Direct and the True and Fair Campaign, which lobbies for greater transparency in investment management. “MiFID II will require every asset manager to disclose all their costs in one aggregated number. What really is shocking to me is that asset managers haven’t even realised that this watershed moment is around the corner. There is also regulation within PRIPs and the Shareholder Rights Directive. So that is three EU directives which will dramatically change fund managers’ disclosure of their costs.”

In the UK, the Financial Services Consumer Panel (FSCP) has warned that little progress has been made on costs. Many fund managers themselves don’t know the real extent of fees and costs that they pass on to investors, it warned. A survey by consultancy Lane Clark & Peacock showed that around two-thirds of investment managers could not provide information on transaction costs. “Retail investors are particularly badly placed,” stated the FSCP. “They lack the market clout of institutional investors and may also be exposed to risks of which they are unaware, not least as a result of the practice of combining institutional and retail funds for investment purposes.”

CONTROVERSY

The Investment Association (IA), which represents more than 200 UK managers with more than £5 trillion in client assets, published its own paper on fees in February 2015. Titled Meaningful Disclosure of Costs and Charges (www.theinvestmentassociation.org), the summary report sets out to differentiate between product charges and transaction costs and argues that both need to be disclosed separately rather than being compiled into one aggregate figure. Managers can publish a single “pounds and pence” figure for the management fees they charge, but estimated transaction costs are a very different type of expense because the total amount paid will depend on portfolio turnover. The IA believes that there should be a distinction between future disclosure ahead of any product sale and historic disclosure at the end of an accounting period. Implicit and explicit costs are differentiated as well, and the IA argues that the two should not be combined.

The association will submit evidence to the Financial Conduct Authority and Department for Work and Pensions in the UK as regulators build a framework for transparency. But the approach is not without its critics.

“The IA’s proposing a per unit cost that means investors will have to work out what that means for them,” says Miller. “It’s like saying, ‘This is how much one air mile costs,”
but you have to work out how many miles you have flown.’ They are also arguing that transaction costs should not be included because it is not a 100% known number, because you don’t know what a fund manager will do in the future. Our view is that if you smooth the last three years, it is a good predictor of what will happen and so much more accurate than present cost disclosure.”

**CLOSET INDEXING**

SCM Direct also estimates that 36% of UK funds are closet trackers and could have cost investors as much as £3.8 billion over the last six years. This is also an area that is seeing increased regulatory scrutiny. Norway’s regulatory body, Finanstilsynet, is investigating whether Norwegian equity funds that are marketed and priced as actively managed funds are actually active in nature. The regulator has highlighted a DNB Asset Management fund that, over the last five years, has diverged considerably from what investors were led to expect, performing very closely to its benchmark.

“Active managers need to show that they are active. It makes no sense to invest in them if they are closet indexers or benchmark huggers. They need to have conviction and have a view and take calculated risks,” argues Günther Schiendl, chief investment officer of Austria’s VBV-Pensionskasse. He believes his own country has a good track record in transparency: “In the case of costs, we have incentivised our key internal asset managers to carry out cost optimisations on external investment vehicles on a regular basis.”

But Hilko de Brouwer, president of CFA Society Netherlands, believes that it is important to remember that many active managers provide value, even at times when passive funds are performing strongly. “If you think of the more illiquid and inefficient markets, such as property, infrastructure, private equity, and maybe even hedge funds, these are markets where it is really hard to do things passively. Even in the equity space, if you have a certain belief or a value bias or a certain opinion, it makes sense that you would have a specific active manager catering to that, instead of just buying the index.”

And Rick Di Mascio, founder and chief executive of Inalytics, a firm that provides transaction-cost analysis to pension funds, argues that the industry has moved on from the closet indexers argument. “We simply don’t see them in the 944 institutional portfolios that we cover. For example, the global equity managers in our database have, on average, 51 stocks in their portfolios, out of a potential universe of several thousands. Admittedly, ours is a group of elite managers, but it represents the competitive end of the industry and the portfolios that are typically held by large, sophisticated institutional investors.”

One thing is clear: the debate around fee structures is only just beginning. As regulation begins to take shape and investors become more demanding, fund managers will have to look at their models and ensure that they are truly providing value.

Maha Khan Phillips is a financial writer based in London and author of the novel **Beautiful from this Angle**.
Expectations have been high since Prime Minister Narendra Modi took office in May 2014, but what is actually happening in India? Punita Kumar-Sinha, CFA, knows as well as anyone. The founder and managing partner of Pacific Paradigm Advisors and former CIO of Blackstone Asia Advisors has been investing in Indian and emerging markets for more than 25 years. In addition to serving on the boards of select Indian companies, Kumar-Sinha also hosts an annual investment television series on ET Now, one of India’s leading business news channels. In a wide-ranging discussion with CFA Institute Magazine, Kumar-Sinha explains why she expects India to accelerate ahead of China over the next decade, the progress of economic and financial reforms initiated by the new Indian government, her insights on investing in India, and the challenges facing women in the investment industry.

How fast is the Indian economy growing?
I think this year—or in 2016—India is going to overtake China in real GDP growth. For the last ten years or so, China grew at about 9.9%, followed by India at 7% to 7.4%. But I think China is slowing down and India’s growth is picking up. Of the large Asian economies, India probably will be the fastest growing over the next decade. Definitely, India has all the elements necessary to overtake China’s growth in 2015 or 2016.

One ancillary benefit of higher economic and profit growth is going to be significantly enhanced “corporate social responsibility” (CSR) spending since India is one of the few countries that mandates that 2% of corporate profits be spent on CSR projects. These CSR projects are already resulting in many innovative poverty alleviation schemes and would lead to more widespread growth than in the past.

What impact are Indian policy issues having on equity markets?
When the new Modi government came to power in 2014, there was a lot of expectation that things would turn around very quickly. But given India’s deep-rooted problems, nobody can solve these overnight, so patience is required.
In the long run, I think expectations will be met—and hopefully exceeded—because the government is very committed to doing right by the economy. They are undertaking a lot of policy initiatives that are perhaps not being fully noticed. The impact of some of these is going to be felt not immediately but over the medium term.

One is revamping the entire public sector banking system. The banking system, particularly in the banks owned by the government, has a lot of bad loans. So the government is setting up a Bank Board Bureau, and allowing professional management to be appointed—to run the banks like a board-managed company rather than being run by the government itself. That should hopefully address a lot of the issues facing the banking sector.

Another initiative is a national investment fund for infrastructure. The government is going to allocate about $3 billion a year and also raise funds from the private sector, both domestically and globally, to invest in infrastructure. So we could see significant money pouring into infrastructure.

A third one is conducting the auctions of national resources in a transparent manner. The government has auctioned off coal resources and telecom spectrum. That gives the government cash and should likely increase transparency for the companies invested in those sectors. Hopefully, the power sector, which has been plagued by problems, will now start seeing more investment because fuel supply agreements are now finally in place and important transmission lines are being built to ensure that the national network is operating.

There are many, many such initiatives. Another is implementing a single nationwide goods and services tax (GST). It’s scheduled for 2016. That will help rationalize a lot of indirect taxation issues for producers. In general, the government is committed to making it easy to do business in India. I think all these reform measures will surely stimulate the economy and improve the performance of the corporate sector as well.

**How will doing business in India become easier?**

“Ease of Doing Business” is an index created by the World Bank. Countries are ranked from 1 to 189. In 2014, India was ranked at 142 out of 189. Basically, this means when new foreign companies come to India or companies in India set up businesses, there’s so much bureaucracy that things take a very long time.

The new government is trying to improve India’s ranking significantly by reducing bureaucracy and coming up with a single-window clearance for projects (instead of going through many different agencies). For instance, in late April, many government services for entrepreneurs were made available online. The government recently launched a G2B eBiz portal with an objective of eliminating needless procedures and integrating the use of technology. In the long run, several central government services will be integrated on the eBiz platform.

A lot of resources are going into “Ease of Doing Business,” and the prime minister has said that India should be in the top 50. The government wants to develop India’s manufacturing hub, so they really need to make “Ease of Doing Business” much better. When Prime Minister Modi was the chief minister of Gujarat, he brought a lot of investment there. Now, he’s trying to replicate that for the nation.

**How are Indian companies priced in your opinion?**

From a very short-term perspective, because the earnings growth hasn’t picked up and has perhaps disappointed in some cases, one would say that valuations are just about fair. If you take a long-term view, I think earnings will definitely be picking up over the next year or two (some positive data points are already emerging). So, from that long-term perspective, there is still value in the Indian market.

**How can foreign investors best access Indian markets?**

Institutional investors can invest directly in Indian stock markets by applying for a license with the regulator, which is not that cumbersome anymore. This is the foreign portfolio investment (FPI) route, which is what most investors prefer to do. If not, they can also invest in ADRs, but those are only a handful of names. To get access, you have to really get the license to invest locally.

Also, anyone can buy Indian mutual funds listed outside of India. Basically, there are many Indian mutual funds available in the US and in London through global firms that are managing these funds for investors in those countries.

**How active is the private equity market?**

The private equity market with foreign funds is much more active than with Indian domestic funds. Most of the private equity in India is coming from foreign funds that have invested in India as part of their global funds.

If you look at the number of private equity firms investing in India, almost everybody is there: Blackstone, KKR, TPG Capital, Carlyle, all the big names. If you look at the number of domestic Indian firms that are in private equity funds, it’s at a much smaller scale.

**Where are the attractive sectors in India?**

The financial services sector has all the ingredients to do well in India, especially very favorable demographics: a large, young working population that will need financial products over the long term. Consumer debt levels in India are significantly lower than in other emerging economies. The housing finance market is picking up. The consumer finance market is expected to grow to $1.2 trillion by 2020. Historically, this sector has been growing at 18% CAGR (compound annual growth rate).

Penetration of financial services in India is still low compared with other economies. The government has launched _Jan Dhan Yojana_ —a financial inclusion program by which almost all households in India now have banking accounts available to them. Almost 150 million new bank accounts have been created in the last year, and India has reached 95% banking penetration. The government is going to deliver subsidies and welfare benefits directly into banking accounts. This is going to create—over the long term—a lot of business for the banking sector.
Infrastructure is another theme. India is really behind other countries in its infrastructure. Railways, roads, and power sectors are areas where we are going to see investments. I think infrastructure, over the long run, will be a good theme, but it tends to be more for investors who are direct investors rather than necessarily for stock market investors.

Another area poised to do well is the digital economy. The number of internet users in India has risen quite dramatically to more than 300 million users, which makes it the second-largest internet market (after China). India is developing a fast-growing e-commerce market. The Indian internet industry will see more innovation and activity from venture capital and private equity funds. Some estimate that the size of the internet industry could grow to $137 billion by 2020; therefore, the market capitalization of the Indian internet companies could rise significantly.

In pharmaceuticals and health care, again, we have attractive demographics—increasing health insurance penetration and potential for medical tourism. Estimates suggest that the hospital industry could grow at 11% CAGR to $82.5 billion by 2018. Indian pharmaceutical and health care has been a very good theme, and I think it will continue to be good.

Are the BRICs still relevant? And is India the best of them?
Yes, I think India is the best of the BRICs (Brazil, Russia, India, and China), from a long-term point of view. India has one of the best demographics. I think that really helps. I don't think “BRICs” is an investment concept so much—it's more of an economic concept.

From a stock market perspective, I don't think the BRICs are really an asset class. Emerging markets is an asset class. You can observe that through the number of assets and funds that are linked to the MSCI Emerging Markets Index. It's significantly larger than the amount of assets that are linked to any kind of MSCI BRIC Index.

The Reserve Bank of India is issuing gold-backed notes. How relevant is this?
I think that will really help. India is one of the biggest importers of gold. This should help reduce some reliance on imports. They’re trying to encourage people to buy gold bonds instead of just importing gold.

Indians love gold. For centuries, gold has been very important in India. Basically, gold is a big asset class in India. People allocate significant amounts of their net worth to gold. People keep gold in their homes or in safe deposit boxes. For most people, the access to gold has been through hard assets, not financial assets. India has about 20,000 tons of gold in private hands and 2,500 tons of gold in major temples. This “idle gold” can be monetized and help India's trade and current account.

How does India’s savings rate impact the investment environment?
Traditionally, Indians have saved quite a bit. I think the younger population is a little bit more consumer oriented. I wouldn’t be surprised if the saving rate declined as younger people consume more. I think financial assets are becoming more core to people's portfolios than used to be the case. For instance, in urban India, mutual funds and insurance products are readily accepted. In rural India, [such acceptance is] not so much the case. As I mentioned, most of rural India is putting their savings into hard assets, such as gold and land.

Still, the bulk of the population is not putting their money into equities or even fixed-income mutual funds. In fact, that is largely where rural India is—they’re not as educated on the merit of equities.

Is there potential for growth in equity investing?
Certainly. The volatility of equity markets still scares a lot of people. Basically, I think the Indian equity markets have to get more institutionalized for the rural retail investor to really start feeling comfortable with them as an asset class.

Why did you decide to host a TV show?
I was already on TV quite a bit during my time as the CIO of Blackstone Asia Advisors. I have always wanted to bring more financial literacy to the Indian market by doing a show that brought together global perspectives and policy implications for India. Basically, the goal was to raise the level of the discussion and bring that to audiences in India.

How does hosting a TV show compare with being an investment adviser?
It's funny—initially, when I started anchoring I thought, “This is much more difficult than being a guest.” When you ask questions to people, you feel like answering them yourself! Now I find it quite seamless. There is one similarity to being an investment manager: as an anchor and an investment manager, my job is to ask questions. As investors, we ask questions of the companies and management that we invest in—we are constantly grilling them. I just had to put on that same hat. Then the anchor role became a lot easier. I'm asking tough questions to my guests the same way I do in a conference room or in a one-on-one meeting. The only difference is that in a meeting you can be much more conversational. On screen you have to be much more concise.

I'm very hands-on. I call up the guests, read their research (if they’ve written something, I read the book or articles), and get involved in the editing. My understanding of the subject matter is better because I’ve been in the business. That’s the exact difference that I want to bring to the show—I’m a practitioner and hoping to raise the level of the discussion.

What’s the advantage of being from the markets you invest in?
When I started, there were not many Indians in the industry. Now there are many Indians in the investment industry. I would say that a large number of India funds are now being managed by people of Indian origin. I think that’s true for, say, China funds, that’s true for Japan funds, and we find that the people who have some affinity or association with a region are generally in the position of managing those funds.

Part of the reason, particularly in the emerging markets—and I can comment specifically on India—is that it’s a
very relationship-oriented economy. People care a lot about relationships. Therefore if you’re a person who understands that culture, you’re better able to build those relationships. These days in the US, companies don’t do so many one-on-one meetings anymore. But in Asia and in emerging markets they do.

If you have cultural affinity or you understand the culture of the people then you really can understand the drivers of the underlying growth.

Some examples of how this helps?
If you understand Indian consumers, you know what kinds of products they will be looking for. That would enable you to understand which companies might be better positioned.

In India, for example, there’s this concept of paisa vasool, which essentially means that Indian consumers are very cost conscious. They will not spend much. They would prefer to buy small sachets rather than big packets because people don’t like to waste. Companies that have mastered the art of marketing with paisa vasool are better positioned.

You were one of the first Indian investment managers in Boston in 1991. What was that experience like?
I think I probably was the first Indian—or at least one of the first—in the Boston investment management industry. I don’t even think there was another Indian man at that time in the Boston investment management industry. I’m sure there were some in New York but not in Boston.

When I went for meetings, I would definitely get noticed. It helped me create my own position. I got to know a lot of people and people got to know me at that time.

Were there also challenges in that position?
Yes, there were challenges as well. Boston was a somewhat parochial town at that time, and because there was not much ethnic diversity in the firms I initially worked at, people were very curious about me and asked me questions about India, including even asking me whether elephants were still on the streets! There was pressure to fit in. It was also hard to integrate socially, especially for out-of-office informal get-togethers. I even took some courses that could help my effectiveness in American culture.

Looking back 25 years, how much has changed?
The first few firms I worked in had pretty good gender diversity. They didn’t have a lot of ethnic diversity. Now the ethnic diversity piece has really changed. In almost every firm there are lots of Indians and lots of Asians. At the time, I started there were very few firms investing anywhere outside of the US. Even international equities were sort of a new asset class.

We were still trying to get people comfortable with putting 5% to 10% of their portfolios in international equity, let alone in emerging markets. Now those asset classes have really developed. As a result, you have many more people of different ethnic origins working on those teams. Gender diversity may also have improved, but I thought gender diversity even when I started was pretty good.

Do you have advice for women entering the investment profession?
I think it’s probably a lot easier now. A lot more women are coming out of business schools, and many [firms] are hiring women as a result. There’s a much bigger pool of women to hire from. Also, many more women are choosing to enter the investment management business.

I’d say the investment management business has gained in recognition, scale, and size significantly in the last 25 years. I think it’s a great industry for women to work in because it does provide a fairly good work–life balance compared with some other industries. And because results can be easily measured, one’s performance can be judged very objectively.

What’s challenging about being a woman in the investment industry?
One of the challenges I found was on the marketing side. To be able to market well, you have to be able to build relationships with people. It becomes a little bit harder as a woman to build those relationships with your investors.

I’ll tell you why it’s hard. People generally give money to people they trust. Trust doesn’t build in one meeting or two meetings. Trust is built over a long period of time. A lot of that trust comes from people you meet socially, outside of work. For instance, people are buddies on the golf course or play some sport together or studied together or lived in the same dorm. Those kinds of relationships are quite important when you’re marketing. These types of networks are not so easy for women to develop—particularly if you have grown up in another country or another culture. This makes it harder to be an effective fund-raiser. That’s where I think women find it challenging.

What was your access point? How would you meet people socially?
I didn’t, or not much at least. That’s why I said that my male counterparts (most of my male counterparts who had grown up in the US) obviously had better access and more extensive networks and probably did a lot better than me in terms of marketing.

Nathan Jaye, CFA, is a speaker on intelligence and member of CFA Society San Francisco.
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Do Asset Managers Pose a Systemic Risk?

By Kurt N. Schacht, JD, CFA

Remember the great financial crisis, when financial institutions were on the brink of implosion and governments were scrambling together emergency support measures to prevent a global collapse? It seems like a distant memory—unless you are a regulator charged with preventing another episode. We have seen multiple new rules to rein in financial leverage and excess at banks and other institutions.

Next on the radar is the investment management industry. The question of whether asset managers pose a systemic risk to the financial system is a controversial one. In the United States, ever since the Office of Financial Research (OFR) released a report in 2013 hinting that asset managers were next in line for designation as “significantly important financial institutions” (or SIFIs), vocal critics—mainly the largest asset managers—have argued forcefully that the asset management industry is different and does not pose a risk to financial stability. Similar debates are occurring in European markets as well. Meanwhile, some industry observers, including even some smaller asset managers, have expressed concern that a run on the world’s largest players would have much broader (and more dangerous) implications for systemic risk.

WHERE DOES CFA INSTITUTE STAND ON THE ISSUE?

CFA Institute noted its support for further review of the issues back in 2013—that is, for having the OFR objectively conduct research on issues related to financial stability. In the end, that research lacked readily available data to support OFR determinations about asset managers’ activities and whether they posed significant systemic risk. Moreover, the report gave little weight to the fact that existing federal regulations under which many asset managers fall already restrict a number of activities that the report suggests would amplify risk. Thus, we urged additional research and analysis before reaching conclusions about whether stricter and more onerous banking and Federal Reserve regulation is needed for this industry.

Regulators ultimately put off asset manager SIFI designations and instead solicited public comment on the potential risks to US financial stability from asset management products and activities (specifically, liquidity and redemptions, leverage, operational functions, and resolution in the asset management industry). As previously noted, it is not a US issue only—the Financial Stability Board and the International Organization of Securities Commissions have sought public comment on proposed methodologies for identifying globally active, systemically important investment funds.

CFA Institute supports the monitoring of asset management firms by existing regulators for their potential to create risks to the financial system because we recognize how the use of leverage, inability to delay redemptions, and significant asset concentrations could transmit problems throughout the financial system. Additionally, this existing oversight is coupled with regulations already covering asset managers, large and small, from amassing huge leverage and permitting the use of mechanisms, such as “gating,” to modulate redemptions. Even those that are permitted to use leverage—hedge funds and exchange-traded products—have built-in protections, including market-based pricing, that mitigate the potential for systemically transmitted failure.

In the final analysis, asset management is fundamentally different from bank and insurance institutions in that, beyond the mechanisms noted previously, asset managers typically don’t own the assets they manage, which usually consist of publicly traded, more marketable, and more liquid securities.

CFA Institute does support and encourage efforts for an ongoing assessment of potential systemic risk posed by the asset management industry. It supports stronger oversight and regulatory refinements in this regard by existing regulators. Accordingly, a decision to introduce and overlay the existing system with a further set of regulations and regulators less knowledgeable and experienced with the sector’s business models must be well founded. As it stands, such an action would be very costly, inefficient, and unsupported by the reviews conducted.

Kurt Schacht, JD, CFA, is managing director of Standards and Market Integrity at CFA Institute.

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Improving Compensation Disclosure

By Matt Orsagh, CFA, CIPM

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity …"

What do the opening lines of Charles Dickens’s A Tale of Two Cities have to do with the new and improved CFA Institute Compensation Discussion and Analysis Template? They’re a metaphor for what investors don’t want in a company’s Compensation Discussion and Analysis (CD&A)—long, meandering information that eventually gets to the crux of the matter, but it takes a while.

What do investors want in the CD&A section of the proxy statement? Think Hemingway—a clear, concise narrative of a company’s policies and decision making related to executive pay. And that’s what the newly released CFA Institute CD&A template provides. Since we first published our template in 2011, many best practices have emerged from leading companies for creating a CD&A that tells a story that investors can easily understand. To highlight these best practices and aid companies currently struggling with the CD&A process or with limited resources to clarify the elements of disclosure that are most useful to investors, CFA Institute has published a revised CD&A template.

Because the CD&A is a company’s primary engagement tool with investors, it must tell a company’s compensation story in a concise manner that investors will understand. The CD&A is also used to comply with US SEC requirements, but thinking of the CD&A first and foremost as a compliance document misses the opportunity to communicate more effectively with investors.

Perhaps most importantly, the CD&A is often the main document used to understand a company’s pay practices before investors decide how to cast their ballots on a company’s “say on pay” vote. It is therefore imperative that a company and its board’s compensation committee tell their executive pay story in a clear and succinct manner so investors can make informed decisions.

The aim of the CD&A template is to improve investor understanding of a company’s pay practices, serve as a global model for improved investor communications around compensation issues, and elevate compensation disclosure above an exercise in legal compliance.

The sections of the CD&A template are arranged in order of importance from an investor’s perspective, starting with an overview of the company’s corporate performance for the previous year and an explanation of the link between that performance and executive pay. The remaining sections delve into detail about compensation elements and decisions, compensation-setting processes and policies, and other areas of interest.

We have added a number of new features and new appendices to the template to provide better guidance for issuers in creating a more useful CD&A.

One of the main changes in the template is a graphic executive summary that attempts to present the main information investors are looking for in an easily scanned, one- or two-page format. In the years following the first edition of the CD&A template, many companies established a best practice of drafting an executive summary of compensation disclosures at the front of a CD&A to highlight a few issues of greatest concern to investors. The graphic executive summary aims to improve on this innovation by offering investors a more user-friendly executive summary format.

**THE CD&A SHOULD BE A PROPERLY CUSTOMIZED STORY AND SHOULD NOT DEVOLVE INTO "BOILERPLATE" LANGUAGE.**

We also highlight best practices in the creation and execution of the CD&A in the first of three new appendices to the template. This section summarizes the best guidance of the CD&A working group of issuers, investors, and other practitioners in the compensation field.

Another new appendix in the updated CD&A template highlights the best CD&A disclosure practices of more than 30 companies, both large and small, from a host of industries. This resource should give investors and issuers a better idea of what to look for in seeking out best-in-class disclosure.

Finally, with the aid of participants in our CD&A working group, we have created a CD&A timeline to guide issuers in planning and producing the CD&A section of the proxy statement, keeping in mind the unique timeline under which a company’s compensation committee operates.

Companies and compensation committees should view this CD&A template as a flexible one. The CD&A should be a properly customized story and should not devolve into “boilerplate” language. The goal is to use the template approach to include the basic elements of the compensation narrative in a manner that best tells a company’s compensation story.

Matt Orsagh, CFA, CIPM, is director of capital markets policy at CFA Institute.

**KEEP GOING**

View the Compensation Discussion and Analysis Template: cfa.is/1GvM7w6

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Pippa Malmgren

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High-Frequency Trading: Beyond the Hype

By Bob Dannhauser, CFA

Equity markets have fragmented in the past 10 years, consistent with policy initiatives designed to spur innovation and competition (e.g., Regulation NMS in the US, MiFID in the EU) and thereby to produce greater efficiencies for investors. These policies have been successful in achieving at least some of their market quality objectives: spreads have narrowed, intra-day volatility is relatively low, and (especially for retail investors) costs of transacting are sharply reduced. Institutional investors have also benefited from greater choice among execution venues and trading modalities to transact orders.

A combination of factors (proliferation of market venues, increasing complexity, continued refinement of technology) has enabled the rise of “high-frequency traders,” a term used rather imprecisely to refer to a broad group. Some of these traders depend on the fastest connections to market venues to take advantage of superior knowledge of changing prices (latency arbitrage), and others engage in passive market-making activities to capture the spread and produce profits with a high-volume of trading.

The latency arbitrage traders have aroused the ire of many observers. These traders anticipate incoming orders based on telltale trading activities and use their lightning fast connections to multiple venues to adjust their order prices in anticipation of incoming trades. Using price-prediction algorithms and order-anticipation strategies, they can move market prices up or down by a small fraction in advance of a investors’ orders hitting the market, thereby resulting in price “slippage,” which is a frequent complaint from the buy side. These HFT traders don’t have to be right all the time to turn a profit, and traders with slower connections are frustrated by “phantom liquidity” that disappears between the time an order on one venue is received and the milliseconds that elapse until a second order is received on another venue. If these latency arbitrage traders were trading against knowledge of their customers’ orders, they’d be guilty of front-running and certainly would be counter to the integrity of the markets. But they are proprietary traders risking their own capital with no client information to protect. Their methods blur the distinction between front-running and arbitrage.

Stock market microstructure remained an esoteric topic until the publication of the 2014 book Flash Boys by author Michael Lewis, who cited this kind of phantom liquidity as evidence of the market being rigged. The well-written story stirred up a lot of people, including policymakers and some CFA charterholders, who found the characterization of misdeeds very compelling.

At CFA Institute, we listened carefully to our members’ perspectives on these issues, spoke with practitioners and policymakers as part of our analysis of the issues, and have focused on the aspects of HFT that we find most troubling. We have concluded that more research is necessary for regulators and market participants to truly understand the implications of this complex web of venues and trading interactions, where a fraction of a second can make all the difference in the profits associated with a trade. We’re concerned about the multiple points of vulnerability that a decentralized equity market implies and have urged regulators to require that firms control algorithms’ access to market systems and frequently test system resiliency. We recognize the futility of preventing speedy connections through “co-location” of servers at exchanges (such bans would only move servers across the street to private facilities beyond the reach of regulators) and urge that such connections be made available on nonpreferential commercial terms to all who find such investment worthwhile. We think HFTs that engage in market-making activities shouldn’t have preferred access to order books unless they assume the same transparency and capital obligations of traditional market makers. And we think regulators should pursue enforcement of all incidences of market fraud or manipulation, including front-running of client orders or trading through resting limit orders without providing meaningful price improvement.

CFA Institute has already contributed to a better understanding of this new world of multiple lit and dark trading venues. Our 2012 report Dark Pools, Internalization, and Equity Market Quality applied empirical analysis to the question of whether market quality suffered as use of dark venues increased in the US and concluded that beyond a “tipping point” market quality could indeed suffer. Our 2009 paper Market Microstructure: The Impact of Fragmentation Under the Markets in Financial Instruments Directive found no detriment to the price-formation process from the decentralization of markets spurred by MiFID. Our staff is completing work on a new study (due in August 2015) that examines the effects of concentrating so much of total market liquidity with HFT participants. You can find all of these publications at cfainstitute.org, including our HFT policy brief that has links to our comments to regulators.

Not all HFT market participants are the villains suggested by media accounts, but the increased complexity of equity market microstructure poses challenges to investors’ confidence in markets. We’ll continue to focus on these issues to ensure that policymakers go beyond the hype and take reasoned approaches to reform that will put investors first.

Bob Dannhauser, CFA, is head of global capital markets policy at CFA Institute.
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Past participant

Information and registration:
Mélanie Ruiz: +33 493 187 819
EXECeducation@edhec-risk.com
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Language Lessons
HONE YOUR SKILLS; DON’T BE A GORMLESS TRIMMER OR LAZY PIRATE

By Ralph Wanger, CFA

Language is the key skill. Why? Because it is not what you know that matters, but how well you can convince other people that you know it. Value is directly related to marketing ability. If you can bring in business, you win. If you can convince a portfolio manager to buy your idea, you win. My son’s aphorism is “People who know how to make stuff work for people who know how to sell stuff.”

Language skills, flattery, looks, and personality can get you remarkably far. For instance, take the handsome, treacherous, slimy courtier Peter Baelish in the television series Game of Thrones. In contrast, the character Tyrion is a sarcastic, drunken dwarf who has enough intelligence to survive. So far, Baelish has skated into the fifth season of the show in comfort while Tyrion has been through a grim maze of prisons and mutilations. I hope Tyrion will win in the finale, but what a costly victory!

In a CFA charterholder’s working life of 40 years, you will meet thousands of people. Some will be gormless trimmers who fooled some people long enough to get rich and powerful, eventually becoming bulletproof. The C-suites of many investment companies (and the companies you follow as analysts) are quite likely to have a few of these Baelishes.

In other words, the rise of Baelish-like characters to positions of power is a harsh political reality of business life. Someone who has the ambition but not the talent to rise to the top needs an alternative strategy to get ahead. A cynical way is to find a person in the same organization a few years older who is a skilled politician and become that person’s henchman (or henchwoman— I have never met a henchwoman, but there may be some).

EVERY LITTLE BIT HELPS
Communication skills are sterile without something to communicate. If you actually know something like math, economics, or mechanical engineering, leverage that knowledge to gain an advantage.

Rather a while ago, I was privileged to make an analyst call on a small company in Michigan that made ball valves (handy in piping systems). I talked to the finance guy for a while, until he got bored and shunted me to the factory manager. The factory manager soon convinced me that his idea of a fun afternoon did not include me and that he had a lot of production that needed managing. Desperately trying to learn how to make ball valves, I asked if he had a critical manufacturing problem, and he disdainfully said, “Foundry.”

Now, I had been in a couple of foundries, and foundries are disagreeable places full of hot metal, dust, sand, and noise. But I remembered a word that might have had to do with casting metal. “Do you have rejects due to a porosity problem?” I bluffed. In one second, his attitude changed completely. I stopped being an ignorant suit from Chicago who was wasting his precious hour and became a valuable sand-pounding colleague who wanted to help him eliminate porosity in his ball valve castings. We were buddies, and he was now an eager font of information. (You don’t need to know what porosity is to make this technique work. A tiny bit of knowledge combined with persuasive language skills can work to your advantage.)

What we discussed was not “inside information” as defined today, but our talk was useful in evaluating management and the quality of the factory. Every little bit helps. My fund bought some stock and made a reasonable profit.

I do not recommend that you become a specialist in foundry companies, because there are hardly any around these days. But the principle is sound, and I have two related bits of advice.

First, read some technical journals in your area of interest. You might spot some changes going on before the Wall Street Journal runs a story. Make friends with the writers and editors of trade journals, for they have both expertise and contacts you can use and their job is dull enough that they will consider you a pleasant distraction.

Second, do your homework. You have certainly been on a conference call when, near the end of the hour, some empty barrel interrupts you and bleats out a question, the answer to which had been published in the quarterly report two weeks ago. The bleater is a lazy, arrogant pirate. (If you steal my time, you are a pirate.) Pirates get hunted down and hanged.

Read the material before the call starts. Cultivating this habit will do great things for your reputation with management and your fellow analysts.

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