

Asset Safety in an Unsafe Investment World

By Steve Taddie

When investment markets make a hasty retreat, you find out a whole lot of things you wish you had known before. Examples can be found in the various hedge fund blowups and Ponzi schemes that have graced the headlines since the 2008 meltdown. When the value of many investments dropped, the combination of shrinking new client assets, tight credit conditions, and withdrawals of existing client assets caused many cracks in the foundation to come to the surface. Some were the natural result of highly leveraged investment programs in a bad market and others the unnatural result of criminal actions.

An old sports adage that a good defense is the best offense also applies to protecting client assets. Many individuals start building their defense by contracting with an attorney to protect their business and personal assets. Businesses hire controllers, CFO's, and accounting firms to audit the work of otherwise trusted employees. Not a bad way to start, but for many, that's also where it ends.

In the 1930's, when Willie "Slick" Sutton was asked why he robbed banks, he replied, "Because that's where the money is." His response, whether legend or fact, is the basis for the "Willie Sutton rule," that is used in "activity-based costing" in management accounting, which focuses effort on where the most money is spent in the organization. Crooks are attracted to the investment markets because they follow the same activity based model...follow the money! So, how can an investor defend against criminal actions?

One easy to implement solution is using an independent, third-party custodian. Traditionally, the custodian's role is to hold client assets entrusted to them, facilitate transactions and cash flow activity, and report the investment inventory directly to the client. Since this is where the money is, the traditional deep pockets many attorneys desire can be found in the likes of Charles Schwab, Fidelity, TD Ameritrade, and many progressive banks that are willing to accept the sole role of custodian. An independent custodian has no other role, but a custodian serving in additional capacities, such performing brokerage transactions and/or providing investment management has other competitive interests. Many of the crooks created vertically integrated operations that controlled the custody, transactions, and investment management. As in the classic case of the fox guarding the chicken coop, if something was criminally wrong in the process, who was going to catch it, and who was going to report it? Maybe one of Bernie Madoff's clients has the answer...

In situations where a corporate trustee is required or desired, many independent custodians can also offer

trustee services. A more defensive route would be to use a combination of an independent custodian with an independent directed trustee. An independent directed trustee operates like any other corporate trustee, but is removed from the actual custody, management, and transactions. Their sole role is to provide trustee services to the client. The inclusion of a directed trustee improves the client's defense by adding another check and balance to the program. There is a growing list of quality firms willing to serve as directed trustee for both personal trusts and ERISA type accounts.

Another easy to implement solution is using an independent Registered Investment Adviser (RIA) that takes fiduciary responsibility and acknowledges that responsibility in writing. An independent RIA does not provide custody, does not broker transactions, and has a regulatory obligation to act in the sole interest of the client. Unless the investment manager accepts fiduciary responsibility, by definition, they are not required to act in the best interest of the client. I think ERISA addressed this situation a few decades ago with the "sole benefit" clause in the language of ERISA law...should a client's individual assets have any less protection? This does not mean stock brokers and insurance agents are bad people. I know many upstanding individuals in those fields; it's just that they just are not held to a fiduciary standard. Fiduciary requirements are causing quite a stir in the investment community as regulators would like to impose fiduciary standards on all industry participants, while those who currently operate as non-fiduciaries would like to keep it that way and avoid the additional responsibilities.

When addressing financial issues, a client's non-financial advisors typically focus on the things that are easy to measure such as name recognition, size of organization, investment performance, experience, and cost, missing some structural improvements that can add a tremendous amount of value. Not that those things aren't important, but some of the best laid legal plans have been compromised by faulty structures concerning custody, investments, and transactions.

An investment team comprised of an independent custodian and an independent investment adviser offers an investor a very defensible investment structure. The custodian is contracted and responsible to the client for the safety of the assets. They monitor inventory, valuation, transactions impacting the portfolio, and are responsible

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his practice growth would generate – buying a place in Park City, sending his son to Stanford, making a big contribution to the church’s building fund, and so on.

David told me that, more often than not, before he ran out of impressive things he was going to do with the money, his clients would interrupt him to ask, “How are you going to do that?” David’s response: “I’m going to target prospects that have these characteristics.”

He would then start describing his ideal client – by age, industry, income level, ambition, character, personality, shoe size – until his client would again interrupt him, this time to say, “Well, you should talk to . . .”, and then he would give David a name or two. (What made it easy for the client to think of someone was that David’s description of his ideal prospect sounded an awful lot like that lunch guest – similar age, income level, ambition, character, personality – and his lunch guest’s best friends.) To which David would reply, “Great, I’d love to meet him. You set up the lunch, and I’ll buy.”

Now, this scenario required some (but not much) practice and orchestration on David’s part, but it was well worth the effort, as this “cloning” of his best clients actually caused his practice to grow by more than 25% that year and again the following year. The keys to making it work:

a compelling vision for the future,



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for all the cash flows in and out of the portfolio. The investment adviser is contracted and responsible to the client for implementing an investment strategy that is appropriate, given the client’s investment objectives, and ensuring that transactions are made for the sole benefit of the client in a cost effective manner. When transactions are completed by the custodian or through another transaction agent to secure best execution, a report of that transaction is sent directly from the custodian to the client. On a periodic basis, an inventory valuation and a summary of all transactions are sent directly to the client by the custodian and the investment adviser. The belt and suspenders approach of adding a directed trustee to handle cash flows and adherence to legal documents, adds yet another set of eyes, and improves the overall defensive structure of the client’s accounts.

Bifurcating custody and investment management functions should not cost any more than bundled approaches. It puts the client in better control of his or her assets and creates a more defensive structure. Trifurcating custody, investment management, and trustee services is cost competitive with

a plan to turn the vision into reality, a standard for attracting referrals only from his most valued clients, and the tendency for people, when given a list of personal qualities, to automatically search their mental database for acquaintances who have those qualities and then to blurt out their names.

Scenario Three: The Will to Ask for Help

In his excellent book, *Winning With People*, John Maxwell writes about the powerful properties of telling people that you need them. That didn’t expressly come up in either Scenario One or Two, but it easily could have, with equally satisfying results.

If Tony hadn’t recommended that I call his attorney friend, I could have told Tony that I wanted to keep my growth curve alive, that doing so would probably require more than my meager abilities would produce, and that I needed his help in achieving my goals. Being the kind of person Tony is, he would have agreed to help.

If David’s client hadn’t asked, “How are you going to do that?”, David could easily have said, “I’ve never achieved that kind of growth before, and I can’t do it on my own. I need your help. The people I want to attract to my practice” – begin the recitation of that client’s personal qualities – “are ambitious, own growing companies, are in their thirties and forties, live at Troon, drive cars that cost more than most people’s houses” and so on. Names are soon to follow.

Conclusion - In another of his books, *The 17 Indisputable Laws of Teamwork*, Maxwell asserts that “One is too small a number to achieve greatness.” That law applies to building your practice. You can try to go it alone, looking to your own efforts to achieve 100% of your practice growth. Or you can share, with the best people you know, your current success and your vision for future achievement.

Unlike hanging wallpaper, involving others in your marketing efforts works better every time.



bundled approaches, and depending on the situation it may end up being cheaper if non-traditional assets are involved. Thinking through the investment process, you need to know what the risks are and where the risk is the greatest. Under what we’ll call the “Slick Willie” rule, “activity-based crooks” focus on where the money is. A defense built around an independent third-party custodian and an independent Registered Investment Adviser can shine light on the cracks in the system where these cockroaches show up.



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