



To: *Financial Analysts Journal*

From: Bruce I. Jacobs, Ph.D.  
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In re: Letter to the Editor

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**Investment Advisory Disclosure Standards and *Financial Analysts Journal*  
Conflict-of-Interest Policies**

In his "Postscript: Reviewer's Response" (*Financial Analysts Journal*, May/June 2001), Book Review Editor Martin Fridson states that disclosure by an investment advisor is adequate as long as "sophisticated investors who know the right questions to ask" would not be misled. This view flies in the face of U.S. regulatory standards (in particular Section 206 of the Investment Advisers Act of 1940), which hold that *caveat emptor* is NOT an adequate standard for the securities industry. The U.S. Supreme Court decision in SEC v. Capital Gains Research Bureau, Inc. (1963) gives cogent reasons for the strict disclosure requirements imposed on the securities industry:

The Investment Advisers Act of 1940 was the last in a series designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. . . . A fundamental purpose . . . was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry. . . . As we recently

said in a related context, "It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standard prevail" . . . in every facet of the securities industry. . . .

Rather than the full disclosure called for by over 60 years of well developed federal securities law, Fridson appears to embrace a *caveat emptor* standard for the securities industry.

Fridson uses this *caveat emptor* standard to come to the belated defense of Leland O'Brien Rubinstein Associates (LOR), the prime purveyor of portfolio insurance in the 1980s. LOR's strategies and marketing efforts are dissected in my book, *Capital Ideas and Market Realities (CIMR)*. Fridson had reviewed the book favorably in a previous issue of *FAJ*, praising it as "a meticulously documented book [that] presents compelling evidence . . . that portfolio insurance failed to deliver on its lofty promises" (*FAJ*, July/August 2000). In the January/February 2001 issue of *FAJ*, however, he published a "Postscript," which charges that I "marshaled selected quotations" to make my case and states that LOR was "candid in describing the likely impact of greater-than-expected volatility" on portfolio insurance strategies.

Under Fridson's standard of *caveat emptor*, LOR's disclosure was adequate. However, *caveat emptor* is not the legal standard. Section 206 of the Investment Advisers Act sets forth disclosure standards for advertisements for registered advisers. Each advertisement must meet these standards; disclosures in other venues, such as journal articles, cannot "make good" for a lack of required disclosure in the advertisement.

Section 206 prohibits advertising that is false or misleading (even if deception is unintended). I believe that the characterization of portfolio insurance as a "guaranteed equity investment" (in the LOR advertisement reproduced on page 37 of *CIMR*) would be construed as misleading and deceptive. Certainly, it is hardly candid about the strategy's susceptibility to excess volatility. (To learn more about the various claims made in LOR's advertisements, see the complete text of my response to Fridson's "Postscript," which is entitled "The Marketing of Portfolio Insurance and the Magnification of Market Risk: The Whole Story" and posted at my book's website, <http://www.cimrbook.com/cimr/ethicalissues.html>).

Furthermore, AIMR's own Standard of Professional Conduct IV(B.6) stipulates: "Members shall not make or imply, orally or in writing, any assurances or guarantees regarding any investment except to communicate accurate information regarding the terms of the investment instrument and the issuer's obligations under the instrument." To quote directly from the standard: "Standard IV(B.6) prohibits statements or implications that an investment is 'guaranteed' or that superior returns can be expected in the future based on the member repeating past successes."

Under Section 206, advisers are also prohibited from using model results in advertisements unless disclosures are made regarding the possibility of losses, the limitations inherent in model results, and any material effects of market or economic conditions on the results portrayed (for example, see Clover Capital Management, Inc., SEC No Action Letter, October 28, 1986). LOR used model results in its advertisements

(see page 37 of *CIMR*) to assert that: "Hypothetically, over the 10 years ending 1981, one dollar invested in the S&P 500 would have returned \$1.89 (6.5% per annum); one dollar invested in T-bills would have returned \$2.18 (8.1% per annum); one dollar invested in the S&P 500 and in T-bills in accordance with the principles of Dynamic Asset Allocation would have returned \$2.61 (10.0% per annum)."

This ad would appear to violate Section 206 in that it fails to disclose the possibility of losses and the limitations inherent in model results. The ad also fails to point out a very material market condition affecting the results shown--namely, the fact that during the simulation period, stocks rose less than T-bills. As I point out in *CIMR*, it pays to be insured (less than fully invested) in such markets, because holding cash is more profitable than owning stock. However, over the long run, equities have outperformed cash. My own simulations over the longer, 1928-82 period show that the decision to "purchase" portfolio insurance would have resulted in an enormous wealth sacrifice compared with a full investment in stocks (see page 49 of *CIMR*).

I believe that LOR's overreaching marketing did rely on a *caveat emptor* standard of disclosure to promote the idea that its product could provide above-market returns at negligible risk. This kind of marketing helped to fuel a faddish demand for portfolio insurance, which in turn led to a build-up of \$100 billion in "insured" assets by the fall of 1987. The abrupt sale of equity and equity futures required by portfolio insurance programs on October 19, 1987 converted what would have been a market correction into a crash larger than the Great Crash of 1929. This was exactly what the disclosure standards under Section 206 were designed to protect against. (Even LOR's principals Leland and Rubinstein admit that portfolio insurance contributed to the crash; for more details, see "The Marketing of Portfolio Insurance . . ." at the book's website.)

*CIMR* relies on compelling evidence of LOR's questionable tactics, evidence drawn from LOR's own advertisements and many other named sources, in analyzing this matter. Fridson's "Postscript" relies on a single reference to a Mark Rubinstein article (see my comments on this article in my complete response, "The Marketing of Portfolio Insurance . . .," at the book's website) and on several unnamed sources. Rather than taking the opportunity to identify these sources in his "Reviewer's Response," Fridson merely asserts that they are "neither purveyors of portfolio insurance nor investors who ultimately decided to buy the product. Accordingly, these 'anonymous critics' had no obvious reason either to attack Jacobs or defend Leland O'Brien Rubinstein Associates." In fact, however, *Pensions & Investments* (June 15, 2001; September 3, 2001) later uncovered the fact that the impetus behind Fridson's "Postscript" was Rubinstein himself, the leading purveyor of portfolio insurance as principal of LOR (which managed \$54 billion in the strategy) and also a member of the *FAJ* Editorial Board, who "suggested Mr. Fridson consider writing a 'correction' to his original review."

Not only did Rubinstein exert pressure on the *FAJ*'s Book Review Editor to reverse a previous favorable book review, but back in the 1980s, he was allowed to review and reject article submissions of mine that were also critical of portfolio insurance. In *Pensions & Investments* (June 15, 2001), Rubinstein accuses and excuses himself: "I did have a conflict of interest. The question is, did it affect my judgment?"

He says not, but how are we to judge? Best practice, in the case of an actual conflict, or even the appearance of a conflict, would have required his recusal.

These issues are hardly a mere matter of "he said/she said," as Fridson suggests in his "Reviewer's Response." Are we to endorse Fridson's standard of disclosure, which appears to be diametrically opposed to federal securities law? Are we to endorse LOR's *caveat emptor* mode of marketing, which appears to violate both securities law and AIMR standards? Are we to condone conflicts of interest that influence what gets published in AIMR's own journal? Or are we to abide by federal securities law, which mandates full disclosure in order to protect investors from the pernicious consequences of abuses in the securities industry? Are we also to abide by AIMR's Code of Ethics and Standards of Professional Conduct, which are designed to foster ethical behavior and avoid conflicts-of-interest? I would have thought the answer was obvious.

#### REFERENCES

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