Jacobs Levy

EQUITY MANAGEMENT

June 20, 2001

H. Gifford Fong, Editor
Financial Analysts Journal
560 Ray C. Hunt Drive
Charlottesville, VA 22903

Dear Editor,

In his "Postscript: Reviewer's Response" to my "Postscript: Author's Comment" (*Financial Analysts Journal*, May/June 2001) letters, Martin Fridson expresses the view that disclosure by an investment advisor is adequate as long as "sophisticated investors who know the right questions to ask" would not be misled. His 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 endorse a *caveat emptor* standard for the securities industry.

Given *caveat emptor* as the standard of disclosure, it is perhaps not surprising that Fridson's "Postscript" (*FAJ*, January/February 2001) postscript to his original, favorable review of my book (*FAJ*, July/August 2000) review found that Leland O'Brien Rubinstein Associates (LOR) was "candid in describing the likely impact of greater-than-expected volatility." But what about the relevant legal standards? 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 the deception is unintentional). I believe that the characterization of portfolio insurance as a "guaranteed equity investment" (in the LOR advertisement reproduced on page 37 of my book, *Capital Ideas and Market Realities*) 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 posted at my book's website, www.cimrbook.com).

Under 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 advertisement fails to disclose the possibility of losses and the limitations inherent in model results; there is also no explicit discussion of 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).

CIMR relies on compelling evidence of LOR's questionable tactics, evidence drawn from LOR's own advertisements and many other named sources. Fridson's "Postscript" ignores the evidence and instead relies on a single reference to a Mark Rubinstein article (see my comments on this article in my complete response 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." But if these sources had not purchased portfolio insurance, how can they speak to the question Fridson posed at the outset of his "Postscript"--"the question of whether *users* of the product were, or should have been, surprised by portfolio insurance's performance on Meltdown Monday" (emphases added)? Had Fridson talked to actual users of the product, he would likely have reached the opposite conclusion.

CIMR did look at what happened to portfolio insurance in the aftermath of the crash of 1987, and found that the actions of those who *had* bought portfolio insurance strongly indicate that they were *very* surprised by its performance. The great majority of them canceled or failed to renew their portfolio insurance policies (Ring [1988]). More tellingly, the amount of insured assets managed by LOR fell from $54 billion in early 1987 to $8.4 billion in early 1988 to $154 million in early 1989 (according to LOR's ADV filings with the SEC). Would investors have withdrawn so completely from portfolio insurance, had they *not* been surprised by the performance of their "insurance"?

These issues are hardly a mere matter of "he said/she said," as Fridson suggests in his "Reviewer's Response." I believe that LOR's overreaching marketing and their failure to disclose potential problems with the strategy created a faddish demand for portfolio insurance, which led to a $100 billion market in "insured" assets by the fall of 1987. The enormous magnitude of required insurance selling on October 19, 1987 turned what might have been a modest correction into a crash even greater than the Great Crash of 1929. This was exactly what the disclosure standards under 206 were designed to protect against. (Even LOR principals Leland and Rubinstein now admit that portfolio insurance contributed to the crash; see my complete response, posted at the book's website, for more details.)

Are we to endorse Fridson's “sophisticated investors who know the right questions to ask” standard of disclosure? Are we to endorse LOR's *caveat emptor* mode of marketing, which Fridson defends? Should the onus of discovery be on the investor, or the burden of disclosure on the advisor? Are we to condone beguiling marketing campaigns that transgress the legal line, and lead to capital commitments so large that they can adversely affect not only their investors, but entire markets and even economies? Or are we to abide by federal securities laws, which mandate full disclosure and are designed to protect against the pernicious consequences of abuses in the securities industry? I would have thought the answer was obvious.

Sincerely,

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