Trust Issues: When Financial "Experts" Have Other Plans

Professor Raghavendra Rau

03 February 2025

Introduction

My name is Raghavendra Rau and I'm a professor at the University of Cambridge. This is the fourth in a series of lectures on the human side of finance.

Let's start by considering what finance is fundamentally about. At its core, finance revolves around promises. These are promises to provide a certain amount of money in the future in exchange for money today. This forms the basis of most financial instruments and transactions. The key question we face in finance is: What are these promises worth today? Examples of these promises include:

- Stocks: A company promises a share of future profits in exchange for investment capital today.
- Bonds: An entity promises to repay a loan with interest over time.
- Insurance: A company promises to pay for potential future losses in exchange for premiums now.

So how do we value these promises? There are two approaches:

1. Rational classical finance: This approach assumes markets are efficient and participants are rational. It focuses on quantitative models and objective data. For example, what is called a Discounted Cash Flow (DCF) Model (usually the favourite approach for MBAs) is based on the time value of money. Here future cash flows are projected and then discounted back to present value. Similarly, another approach called comparative valuation (multiples) values assets based on how similar assets are priced in the market. It is a common approach in stock valuation using metrics like Price-to-Earnings (P/E) ratio.
2. The human side of finance: This approach recognizes that markets are influenced by human behavior and psychology. It introduces questions of trust and information asymmetry. Is the person making the promise being truthful? It introduces the possibility of fraud - deliberate lying - or incomplete contracts, where loopholes allow one party to take advantage of another.

In the first lecture in this series, I covered conflicts of interest between banks and investors. In the second lecture, I examined conflicts between managers and investors. In the third lecture, I focused on selection markets such as insurance markets. In this lecture, I focus on capital markets.

Capital markets and money doctors

Let's talk about why people need help with investing. Capital markets are complicated, and most investors don't have the time or knowledge to make investment decisions on their own. You have to deal with stocks, bonds, ETFs, options, futures, and dozens of other financial products. Each one comes with its own risks and rules. That's why people turn to professionals we call "money doctors" (a term coined by Gennaioli, Shleifer, and Vishny in a paper in 2015) - these are the mutual fund managers, investment advisors, financial planners, wealth managers, and brokers who help people invest their money.

When we look at what these money doctors actually do, we can break it down into three main approaches. The first is what they're supposed to do: help clients make smart investment choices. Good money doctors take time to understand what their clients need and guide them toward sensible investments. Say you're a young professional starting to save for retirement - a good advisor will help you build a balanced portfolio of stocks and bonds and steer you away from risky fads like crypto speculation. They'll explain why you might want 70% in stocks when you're young but less as you get older. They'll talk about diversification - not putting all your eggs in one basket - and help you understand why that matters.

These good advisors also do something really important: they stop you from making emotional decisions. When markets crash, many people panic and want to sell everything. A good money doctor will remind you about your long-term plan and help you stay the course. During the COVID crash in March 2020, the advisors who convinced their clients to stick with their investments ended up doing them a huge favor - the market recovered and reached new highs within months.

But there's a second approach that's less helpful: some money doctors just tell clients what they want to hear. In this lecture, I will talk about meme stocks such as Gamestop and AMC. Some advisors went along with their clients' demands to buy these "meme stocks," even though they knew the companies weren't worth nearly what people were paying. They put making their clients happy ahead of giving good advice. We saw the same thing during the dot-com bubble in the late 1990s, when advisors helped clients load up on tech stocks that had no earnings. And again during the 2021 crypto boom, when some advisors helped clients put money into tokens and coins they barely understood.

The third approach is the most troubling: some money doctors focus on making money for themselves instead of their clients. They might push expensive investment products that pay them high commissions but don't do much for their clients. A common example is when brokers get clients to buy their firm's own mutual funds, even though there are better, cheaper options available elsewhere. Sometimes they'll recommend complicated products like variable annuities or structured notes - investments that are so complex even many professionals don't fully understand them. These products often come with fees hidden in long documents that nobody reads.

There was an article recently where an advisor convinced a retiree to put their entire life savings into a variable annuity that charged 3.5% in annual fees. The same investment strategy could have been achieved with low-cost index funds charging less than 0.1%. Over 20 years, that difference in fees would eat up nearly half of the client's retirement savings!

Some advisors also play games with their clients' accounts to make themselves look better. They might do something called "window dressing" - buying stocks that have done well recently just before they report to clients, so it looks like they owned these winners all along. Others might engage in "cherry-picking," where they make trades and then decide later which client accounts get the profitable ones.

Why does all this matter? Because picking the right money doctor can make a huge difference to your savings over time. Let me show you the math: if you invest $10,000 a year for 30 years and earn 8% annually with a good, low-cost advisor, you'll end up with about $1.2 million. But if your money doctor steers you into expensive products that cut your return to 6% after fees, you'll only have about $838,000. That's a difference of over $360,000 - enough to fund several years of retirement!

The hard part is figuring out which money doctors are actually working in your interest and which ones might be taking advantage of your trust. This brings us to an important question: how can we tell if money doctors are actually earning their keep?

How do money doctors help their clients?

Let's get to the heart of what money doctors are supposed to do: deliver good investment performance. That means they should help you make more money than you would by simply putting your savings in a basic index fund. In the industry, we call this generating "alpha" - basically, doing better than what you'd expect given the risks you're taking. But how do we know if they're actually doing a good job?

There are two main ways we measure if fund managers are earning their fees. The first is something called Jensen's Alpha, developed back in 1969. Don't let the name scare you - it's actually a pretty straightforward idea. Let's say you invest in a fund that makes 15% in a year. Sounds good, right? But what if the fund manager took huge risks to get that 15%? Jensen's Alpha helps us figure out if that return was actually impressive or just the bare minimum, we should expect given how much risk the

manager took.

Here's a real-world example: imagine two mutual funds both returned 12% last year. The first fund invested in stable, blue-chip companies like Johnson & Johnson and Procter & Gamble. The second fund bet heavily on volatile cryptocurrency stocks. Even though they had the same return, the first fund manager did a better job because they got good results without taking crazy risks.

The second way we measure performance is called Tracking Error. This tells us how much a fund bounces around compared to its benchmark (like the S&P 500). Think of it like measuring how well a driver stays in their lane. Some deviation is fine - after all, if you want to pass other cars, you need to change lanes sometimes. But if a driver is swerving all over the road, that's a problem. Similarly, if a fund that's supposed to roughly follow the S&P 500 is swinging wildly up and down compared to the index, that's a red flag.

But here's where it gets tricky: we can only judge performance against some kind of benchmark. The two most popular ways to do this are the Capital Asset Pricing Model (CAPM) and something called the Fama-French Factors. CAPM is like a basic fitness test - it just looks at how well you do compared to the overall market. Fama-French is more like a complete physical - it looks at multiple factors, including how well small companies do compared to big ones, and how value stocks perform versus growth stocks.

The problem is that these benchmarks aren't perfect. They get updated over time, which can make past performance look different in hindsight. It's like changing the rules of a race after it's been run. Recent research by Akey, Robertson, and Simutin (2024) shows that when the Fama-French factors get updated, it can completely change how we view a fund's past performance. A fund that looked like a star performer under the old calculations might look just average under the new ones.

There are other challenges too. Market conditions change - a fund manager who looks brilliant during an economic boom might struggle during a recession. Short-term performance can be misleading - just because someone had a great year doesn't mean they can keep it up. And don't forget about fees - even if a manager is skilled, high fees can eat up all the extra returns they generate.

Even if you have the right benchmark however, mutual funds might try to game their performance in other ways. For example, mutual fund performance is often reported over standardized intervals, such as 1, 3, 5, or 10 years. While these intervals provide a convenient way to evaluate investment results, a paper I wrote (with Blake Phillips and Kuntara Pukthuanthong) showed significant issues with this method of reporting. One major problem we identified is that poorly performing funds often close or merge with others, which leads to their negative returns being excluded from performance samples. This phenomenon, known as survivorship bias, results in average returns being inflated, as only the better-performing funds remain in the dataset. For example, during the aftermath of the 2002 bear market, many funds that suffered substantial losses were liquidated. By the time five-year performance figures were recalculated, only the funds that had survived the downturn were included, creating an illusion of overall improved performance.

Another issue that we focused on in the paper arises from the impact of stale returns on reported averages. Stale returns refer to older performance data that continue to influence holding period returns (HPRs), even though they may no longer be relevant to current conditions. Changes in HPRs occur when new returns are added to the calculation while older, often poor, returns drop off. These shifts are frequently misinterpreted by investors as evidence of managerial skill. In one case, a fund's five-year HPR more than doubled simply because an earlier quarter of poor performance was removed from the calculation. This apparent improvement was mechanical, not reflective of any meaningful change in the fund's current or future prospects.

So while money doctors can definitely help their clients, measuring their true contribution is harder than it might seem. You need to look beyond simple return numbers and consider risk, consistency, fees, and whether the performance numbers you're seeing tell the whole story.

How do money doctors pander to their clients?

Let's talk about what happens when money doctors tell clients what they want to hear instead of what they need to hear. The GameStop story from 2021 gives us a perfect example of this behavior, and it shows how social media has changed investing in ways nobody expected.

Here's what happened: GameStop was a struggling video game retailer that most professional investors thought was headed the way of Blockbuster. A firm called Citron Research publicly announced they were betting against the stock, saying it was worth about $20. This made a lot of people on social media angry - especially on a Reddit forum called WallStreetBets. They saw this as Wall Street trying to kill a company they liked, and they decided to fight back.

What followed was unlike anything we'd seen before. Millions of small investors started buying GameStop shares, driving the price up from around $20 to nearly $500 in just a few weeks. This created what we call a "short squeeze" - those betting against the stock had to buy shares to cover their positions, pushing the price even higher. It was like a snowball rolling downhill, getting bigger and bigger.

Now, here's where the money doctors come in. Many financial advisors knew this was unsustainable. They knew GameStop's business fundamentals hadn't changed - it was still a struggling retailer in a world moving to digital games. But instead of warning their clients away from this speculation, many advisors went along with it. Some even encouraged clients to buy in, not wanting to be the party pooper when everyone else seemed to be making money.

GameStop's management team was clever about this situation. They took advantage of the high stock price to sell new shares, raising over $4 billion in cash. Think about that - they raised more money than the company had made in its entire history just by selling new stock during this frenzy. Some people joked that GameStop could make more money by repeatedly selling shares high and buying them back low than they could by selling video games!

The same thing happened with AMC, the movie theater chain. AMC was in real trouble during COVID - nobody was going to movies, and they were running out of cash. But when their stock became a "meme stock" like GameStop, their CEO Adam Aron did something clever. Instead of fighting the trend, he embraced it. He started tweeting regularly and engaging with small investors. The company even offered special perks to shareholders, like free popcorn and exclusive movie screenings.

AMC used their suddenly high stock price to raise enough money to avoid bankruptcy. They paid off debt and even started looking at buying other companies. It was a remarkable turnaround, but not because their business had improved - it was because they played into the social media hype and their advisors helped spread the excitement.

Here's the problem with this kind of pandering: it usually ends badly for most investors. While early buyers of GameStop and AMC made fortunes, many people who bought in late lost a lot of money when the prices eventually crashed. Good financial advisors should have been warning their clients about these risks. Instead, many just went along with the crowd, afraid of losing clients who might go to another advisor willing to tell them what they wanted to hear.

We're seeing this pattern repeat with different investment fads. During the crypto boom, some advisors helped clients put money into cryptocurrencies they barely understood. During the AI stock boom of 2023, advisors helped clients pile into any company that mentioned artificial intelligence, regardless of whether they had real AI capabilities. It's like the dot-com bubble all over again, when advisors helped clients buy tech stocks just because they had ".com" in their name.

This kind of pandering is particularly dangerous because it gives clients a false sense of security. When a professional advisor agrees with your investment ideas, you naturally feel more confident about them. But sometimes what clients need is someone to say "no" - to be the voice of reason when excitement overtakes good judgment. Unfortunately, saying no to clients who are watching their friends make quick profits is a good way to lose those clients to another advisor who will say yes.

The real damage often shows up later when the music stops and prices crash. That's when clients realize they would have been better served by an advisor who told them hard truths instead of comfortable lies.

How do money doctors rip off their clients?

Now we need to talk about something unpleasant but important: the ways some money doctors deliberately take advantage of their clients. This isn't about making honest mistakes or giving in to client demands - it's about financial professionals purposely putting their own interests ahead of their clients'. Let me show you how this happens in the real world.

One common form of exploitation is called "cherry-picking." In 2023, regulators charged Ken Leech, who was the co-chief investment officer at Western Asset Management, with this exact practice. Here's what he did: Leech managed several portfolios, including a strategy called Macro Opps that paid higher fees (0.6% or more) and some Core portfolios that paid lower fees (usually 0.3% or less). Instead of saying upfront which portfolio would get which trades, he would place trades early in the morning and wait until late in the day to decide which portfolio would get them. By then, he could see which trades had made money and which had lost money. The SEC found he allocated over $600 million in profitable first-day trades to his favored Macro Opps portfolios, and a similar amount of losing trades to the other portfolios. The chance this happened by random luck? Less than one in a trillion.

Another major problem involves the misuse of complex financial products. The SEC has brought numerous cases involving structured products that were misrepresented to clients. In 2019, UBS was fined $25 million for misleading clients about their "yield enhancement strategy" (YES) involving structured products. While UBS marketed it as a way to enhance portfolio yields with limited risk, they didn't properly explain that clients could - and did - lose significant amounts of money in market downturns. Many clients lost up to 20% of their investment. Similarly, Lehman Brothers' collapse in September 2008 left investors holding more than $18.6 billion in structured products that became essentially worthless. The products were marketed as "100 percent principal protected" notes and appeared to be safe, conservative investments. They were promoted as "100 percent principal protected" with "guaranteed" returns. The marketing materials emphasized safety and security and the products were specifically targeted at conservative and risk-averse investors. (Note that UK retail investors ultimately recovered between 76.53% and 97.48% of their investment, though this took eleven years.) The complexity of these products often masks their true risks and costs - and the substantial commissions that advisors earn for selling them.

Sometimes the exploitation happens on an even bigger scale. Look at what happened at Wells Fargo between 2002 and 2016. Bank employees, under intense pressure to meet sales targets, opened millions of accounts that customers never asked for. Approximately 1.5 million unauthorized deposit accounts were opened and about 565,000 unauthorized credit card accounts were created. Bank employees created false records and forged customer signatures, generated unauthorized PINs for debit cards without consent, altered customer contact information to prevent discovery, and moved money between these fake accounts. Some customers only found out what happened when their credit scores dropped because of unpaid fees on accounts they didn't even know existed. The bank ended up paying $3 billion in criminal penalties and civil settlements.

The exploitation of retirement investors through inappropriate investment products is particularly troubling. In 2019, the SEC charged Commonwealth Financial Network for failing to disclose conflicts of interest related to revenue sharing from its sales of mutual fund share classes. The firm was steering clients into more expensive share classes that generated higher commissions, without disclosing that identical, lower-cost options were available. They had to pay $93 million to settle the case.

In 2018, we saw another major case when the SEC fined Merrill Lynch $42 million for "masking" trades from 2008-2013. The firm was routing customer orders to other firms that would charge higher fees but give kickbacks to Merrill Lynch. The firm told clients it was executing orders internally when orders were actually being routed to other broker-dealers and modified its systems to give false statements about trading venues. This was not the first time Merrill was charged. In June 2016, Merrill Lynch faced one of its largest regulatory penalties when the SEC imposed a $425 million fine for multiple serious violations. The core offense involved misusing customer funds between 2009 and 2012, when the firm engaged in complex options trades lacking economic substance to artificially reduce required customer cash reserves, freeing up billions for its own trading activities. Additionally, from 2009 to 2015, Merrill Lynch improperly held up to $58 billion per day of customer securities in accounts subject to bank liens, putting clients at significant risk of losing their securities if the firm collapsed.

What makes these schemes especially troubling is how hard they can be for regular investors to spot. If someone steals your wallet, you know immediately. But financial exploitation often happens slowly, hidden behind complex jargon and thick documents. By the time investors realize what's happened,

their losses can be substantial and sometimes irreversible.

The safest approach is to verify everything independently. In February 2021, the SEC charged GPB Capital with orchestrating a massive Ponzi-like scheme that defrauded 17,000 retail investors of $1.7 billion. While the firm did own legitimate automotive dealerships and waste management businesses, its executives systematically deceived investors about the source of their monthly 8% distributions. Instead of paying investors from business profits as claimed, they used new investor money to pay earlier investors while creating false backdated documents to conceal the fraud. The criminal case concluded in August 2024 when a federal jury in Brooklyn found GPB's founder and CEO David Gentile and Ascendant Capital's head Jeffry Schneider guilty of fraud and conspiracy charges. Both men face up to 20 years in prison, with sentencing scheduled for October 2024. The firm is now under receivership, with Joseph Gardemal appointed in December 2023 to manage remaining assets and develop a distribution plan for affected investors. The case shows why you should never just take an advisor's word about where your money is going.

What can we conclude?

Let's pull together what we've learned about money doctors and what it tells us about modern finance. Remember how we started this lecture - talking about how finance is fundamentally about promises. Well, we've seen exactly how those promises can be kept, bent, or broken.

The GameStop saga showed us how some advisors will bend their principles to keep clients happy, even when they know better. The Western Asset Management case revealed how even a major firm's top investment officer might game the system through cherry-picking trades. And the Wells Fargo scandal demonstrated how an entire organization can break its promises to customers on a massive scale.

But these cases teach us something deeper about finance. When Ken Leech at Western Asset waited until the end of each day to allocate trades, he was breaking a basic promise about treating all clients fairly. When UBS sold complex structured products without properly explaining the risks, they were breaking a promise about honest communication. And when Wells Fargo opened millions of fake accounts, they were breaking the most fundamental promise of all - to protect their customers' money.

What's particularly interesting is how the nature of these broken promises has evolved. In the old days, financial fraud might involve someone simply running off with your money. Today, it's often buried in complexity. Look at how Commonwealth Financial Network steered clients into expensive variable annuities when cheaper options were available - the money wasn't stolen, it was slowly drained away through higher fees. Or consider how Merrill Lynch's order routing scheme took tiny amounts from each trade, adding up to millions in hidden costs.

The good news is that regulators are getting better at spotting these schemes. The SEC's ability to analyze trading patterns helped them catch Western Asset's cherry-picking - they could prove the odds of those trade allocations happening by chance were less than one in a trillion. Technology is making it harder to hide unfair practices.

But here's the challenge we still face: Finance is getting more complex, not less. When Lehman Brothers collapsed in 2008, many investors learned the hard way that their "principal-protected" notes weren't actually protected at all. The promise of safety was an illusion that vanished precisely when they needed it most.

So, what does this mean for regular investors? First, it means you need to be skeptical of anything that seems too good to be true. When GPB Capital promised steady returns from car dealerships, investors who did their homework might have spotted the red flags of a Ponzi scheme. Second, it means you should be especially wary of complexity. If your advisor can't explain an investment in simple terms, that's often a warning sign. The most egregious cases of financial exploitation we've seen - from structured products to variable annuities - almost always involve products that are needlessly complex.

This might all sound pretty discouraging, but it shouldn't be. Understanding how these problems work is the first step to protecting yourself from them. And remember - there are plenty of financial professionals who do keep their promises. The key is knowing how to tell the difference, asking the right questions, and remembering that in finance, like everywhere else, trust must be earned rather

than assumed.

The fundamental lesson here isn't that finance is broken - it's that finance is human. And just like in any human system, some people will try to take advantage of others. Our job, whether we're investors, regulators, or teachers, is to make that harder to do while making it easier for honest financial professionals to keep their promises. Because at its best, finance really does help people achieve their goals. The challenge is making sure it lives up to that promise.

References and Further Reading

Akey, Pat, Adriana Z. Robertson, and Mikhail Simutin, 2024, Noisy Factors? The Retroactive Impact of Methodological Changes on the Fama-French Factors, working paper, University of Chicago.

Phillips, Blake, Kantura Pukthuanthong, and P. Raghavendra Rau, 2016, Past performance may be an illusion: Performance, flows, and fees in mutual funds, *Critical Finance Review* 5, 351-398.

Gennaioli, Nicola, Andrei Shleifer, and Robert Vishny, 2015, Money doctors, *Journal of Finance* 70, 91-114.