

Ethics in Financial Management

Tobias J. Moskowitz

Fama Family Professor of Finance

University of Chicago, Booth School

Research Associate, NBER

Premise

- We typically start with the premise that as portfolio managers we should maximize expected risk-adjusted return
 - But, is this the only good objective?
 - And, even with this objective is it always obvious what “**the right thing**” is to do?
 - When do we run into ethical issues? And, how do we deal with these to make a sound decision?
- As with everything, there are **tradeoffs**

Financial Managers

- Here, I refer to financial managers as those managing private pools of capital
 - Hedge funds
 - Private equity
 - Real estate trusts and funds
 - Open and closed-end mutual funds
- Characteristics:
 - Performance fee
 - Fiduciary responsibility
 - Limited redemption rights

Example #1

- Hedge fund is down and will take years to reach its “high water mark”, meaning you won’t get paid a performance fee

Do you . . .

1. Stay with the fund until investors recoup their losses?
2. Close down the fund and start a new one, eliminating high water mark?

Example #1

1. Seems the most ethical, right?

- Keep commitment to your investors
 - Suffer along with your investors
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- But, what if can't climb out because
 - Talent leaves
 - Strategy no longer works
 - And, therefore investors are actually better off if you close the fund

Example #2

- A client wants to pull his money out

Do you . . .

1. Allow him to knowing it could hurt other investors by forcing you to sell and pushing the price down further?
2. Or do you tell your investors they can't take their money out for some time?

Example #2

- Clients can negotiate redemption provisions
 - “Side pockets”: place illiquid assets which investors can’t redeem until they can be fairly valued
 - “Gating mechanisms”: only a certain amount of money can be redeemed
 - “Suspension of redemption”: no one is allowed to redeem
- Abused by some funds during the credit crisis last year

Financial Managers Deal with

- Valuation*
- Trading activity*
- Risk management*
- Disclosure
- Compliance and conflict of interest
 - Not just legal and regulatory compliance
 - Fiduciary responsibility = act in clients' best financial interest

*Liquidity an issue

Example #3: Valuation

- Conflict of interest---valuation has direct effect on **compensation** of manager
 - Real problem for illiquid assets where no real prices exist or timing can be manipulated
- Segregate valuation from port. management?
- Conflict of interest---valuation also has direct effect on counterparty risk
 - For some illiquid assets **only** the broker-dealer or **counterparty** will have pricing information!

Example #4: Trading Activity

- Trades are often aggregated for efficiency
- Supposed to “fairly” allocate aggregated trades among funds
- Best execution should be provided “fairly” to all clients
- Even investment opportunities are to be “fairly” allocated across funds
 - What is meant by “fair”?
 - Tradeoffs have to be made across clients, how best to determine these?

Example #5: Disclosure

- Investors need information to determine how to invest, monitor, and redeem funds
- Conflict between revealing proprietary trades and providing investors with information
 - Reduces efficacy (“**alpha**”) of trading strategies
 - Exposes fund to “**predatory trading**”
 - Clients “talk” to other managers/competitors
- Conflict arises when dealing with **clients, financiers, and counterparties**

Example #6: Clients

- Do you take just **anybody's** money?
 - Money laundering concerns
 - Investor sophistication concerns
 - Liquidity of investor
- Client type affects disclosure, redemption rules, risk management, etc.
- On the other hand, why turn away good money?

Conclusion

- Ethical issues arise even when the objective is clear
- Financial managers face tradeoffs fraught with ethical issues
- Thinking through the tradeoffs and **all** the costs and benefits is important