CHAPTER 1

NON-TRADED REITs: A SECURITY THAT SHOULDN'T EXIST

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POOR ADVICE

"I'm afraid you've been poorly advised," I told the new client as she sat in my office. That was certainly an understatement—in fact, she'd been ripped off by the advisor at the brokerage firm that invested her money.

We had just finished reviewing the investments in her portfolio, which she had brought to me out of dissatisfaction with her existing advisor. It was a familiar discussion for me. I have worked in finance my entire life, mostly in New York, but early in my career I was in London. Since 2009 I've run my own investment business helping clients from individuals to institutions invest their money. The 23 years I spent at JPMorgan and the banks that preceded its many mergers was great preparation. During that time, I managed derivatives trading through enormous growth and at times high volatility; oversaw traders handling risks across multiple products and currencies; and more recently, led a business that helped new hedge funds get off the

ground. I had seen Wall Street and "The City" (London's financial district) from the inside. It had been a great career, but by 2009, I was ready for a new challenge. The daily commute was increasingly a mind-numbing grind, and big financial companies were likely to face ever-greater constraints on their activities. The politics of financial reform understandably reflected public abhorrence at the required level of support from the US government following the 2008 financial crisis.

I was and remain very proud of my career at JPMorgan. The company emerged from 2008 in better shape than any of its peers. While it's true that it has had to concede substantial settlements to regulators since then, it's impossible for any big company to be immune from poor decisions or bad behavior somewhere in its ranks. The culture and the people with whom I worked overwhelmingly reflected the best in terms of values and integrity.

So I'd left the huge company where I'd spent almost my entire adult life to run something far smaller but also completely devoid of bureaucracy. My firm would reflect the values of the best people I'd worked with over the years as it sought attractive long-term investments in a format that treated clients' money as if it was mine. Many firms, and many people, do the same thing. But as I've found out since 2009, they don't *all* do the right thing. There's plenty of room for improvement in the quality of financial advice that is given to investors.

We all have to trust professionals when we need help with something that is not what we do for a living, whether it's medical treatment, legal advice, or auto repair. We generally buy products and services with the knowledge of an amateur, and we are often vulnerable to an unscrupulous provider. We look for honesty; when we don't find it, sometimes we discover in time to protect ourselves and sometimes we don't.

The world of investment advice can be dauntingly confusing. Saving for retirement is increasingly the responsibility of the individual, as defined benefit pension plans are phased out in favor of defined contribution plans, 401(k)s, and IRAs. Unless you're a public-sector employee where pensions are still based on your salary just prior to retirement, the money you have when you stop working will largely

be the result of decisions you made (or failed to make) during your decades in the work force.

My client, whom we'll call Penelope (not her real name), sat across from me waiting for an explanation as to precisely what poor advice she had received. She was here with her husband, and we had met through a mutual friend. Like many investors, Penelope and her husband are smart people who have enjoyed professional success without having to understand the intricacies of investment products. Penelope is in the pharmaceutical industry (not uncommon in New Jersey) and her husband works for an information technology company.

Penelope had bought into a very common investment called a Real Estate Investment Trust (REIT). REITs typically own income-generating commercial property, including office buildings, warehouses, shopping centers, rental apartments, and so on. They can be a great way for individuals to own real estate managed by a professional company. Many REITs are publicly traded, allowing investors to sell their holding at the market price, and there are mutual funds and exchange traded funds (ETFs) that provide exposure to REITs. Used properly, they can be a legitimate component of an investor's portfolio providing income and some protection against inflation.

However, not all REITs are good, and a particular class of them called "non-traded REITs" is generally to be avoided. Penelope had unwittingly invested some of her savings in the wrong kind of REIT, one that provides substantial guaranteed fees to the broker selling it while often generating disappointing returns for the investor.

Public securities are registered with the SEC under the 1940 Investment Company Act. Registering a security requires the company to meet various tests for accounting standards, transparency, and so on. The advantage of registering is that the security can be sold to the general public. Unregistered securities have a far more restricted set of potential buyers. The investors have to be "sophisticated" (meaning wealthy, in this case), and the seller of such securities has to adopt a targeted marketing approach, going directly to people he thinks may be interested. You won't often see an unregistered security advertised, because the laws are designed to prevent that.

Hedge funds are another example of an unregistered security. Their sale is restricted to "sophisticated" investors deemed able to

carry out their own research. It's a sensible way to divide up the world of available investments. Retail investors are offered securities that are registered and usually those securities are publicly traded, enabling the investor to sell if they wish. Sophisticated investors including high-net-worth individuals and institutions don't need the same type of investor protection, which allows them to consider unregistered investments that have higher return potential and also higher risk.

Non-traded (also known as unlisted) registered REITs fall in between these two classes of investment. By being registered, they are available to be sold to the general public. Having gone to the effort of registering, it's a reasonable question to ask why they don't also seek a public listing. It would clearly seem to be in the interests of the investors to have the liquidity of a public market listing so that they can choose to sell in the future. In fact, non-traded REITs have highly limited liquidity and often none at all. They can only be sold back to the issuing REIT itself, and the REIT is under no obligation to make any offer to repurchase its shares. They are a hybrid security—no public market liquidity and yet available to be sold to the public.

Generally, companies that need to raise capital, whether equity or debt, desire liquid markets in which to issue their securities. Liquid markets are widely believed to reduce a company's cost of finance. This is because investors require an illiquidity premium, or higher return, if they have limited opportunities to sell. Private equity investors expect to earn a higher return than if they had invested their capital in public equity markets. Small-cap stocks similarly need to generate higher returns than large-cap stocks to compensate for their more limited liquidity.

Although monthly income is the main selling point, the illiquidity can mean that your holding period exceeds the lease term on the properties. For example, if the non-traded REIT in which you're invested has five-year leases on its properties but you hold the investment for ten years, you have much more at risk than just your exposure to the monthly income.

Bond issuers care a great deal about the liquidity in the bonds they issue, and the selection of bond underwriter is based in part on the firm's commitment and ability to subsequently act as market maker after the bonds are issued. The ability to sell bonds at a later date

induces buyers to accept a lower yield than they would otherwise, thereby reducing the bond issuer's interest cost.

To cite a third example, the justification for high-frequency traders (HFTs) with their lightning-fast algorithms in the equity markets is that their activities improve liquidity. Michael Lewis in *Flash Boys* provided a fascinating perspective on how HFT firms have been able to extract substantial profits from investors through using their speed to front run orders. I'm not going to examine HFT firms here, but suffice it to say that their existence reflects the overwhelming public interest in the most liquid capital markets possible.

WHY NOT GET A LISTING?

So now we return to non-traded REITs, and consider why a company that is qualified to seek a public listing because its securities are registered nonetheless chooses not to. Generally, you want to raise money at the cheapest possible cost, so why do these companies deliberately operate in a way that raises their cost of financing?

I think the answer is, they don't wish to attract any Wall Street research. Brokerage firms routinely publish research on stocks and bonds, and they look to get paid for their research through commissions. Good research gets investors to act on it, and the commissions generated by this activity are what pay for the analysts. Companies want positive research because it will push up their stock price, making the owners richer as well as making it easier to raise more money later on.

But suppose you run a company that is designed primarily to enrich the sponsors at the expense of the buyers? What if you know that drawing the interest of research analysts is likely to result in reports that are critical of fees charged to investors and the conflicts of interest in your business model? Then you would conclude that the higher cost of financing caused by the absence of a public listing is a reasonable price to pay for the higher fees you can charge away from the glare of investment research. Because if there's no public listing, there are no commissions to be earned from trading in the stock, and no commissions means there is little incentive to produce research coverage.

It is into this regulatory gap that the sponsors and underwriters of non-traded REITs have built their business. Illiquid securities are normally only sold to sophisticated investors, but since the securities are registered they can be sold to anybody. This means millions of unsophisticated investors can be induced to make investments that they'd be better off avoiding.

Inland American Real Estate Trust, Inc. (IAR) was the non-traded REIT that drew my attention to this sector. Penelope held an investment in the REIT that had been recommended by her broker at Ameriprise. Disclosure is a great defense. It turns out you can do some pretty egregious things to your clients if you tell them you'll do so in a document. IAR's prospectus discloses many of the unattractive features that characterize how they run their business. Because they are registered, their registration and many other documents are publicly available. They don't necessarily represent either the worst or the best of the sector, but they are one of the biggest non-traded REITs, so it's useful to examine their public filings.

For example, underwriting fees on the issuance consisted of a 7.5% "Selling Commission," a 2.5% "Marketing Commission" and a further 0.5% "Due Diligence Expense Allowance," adding up to a fairly stiff 10.5% of proceeds. But it didn't stop there. In some cleverly crafted prose, the document goes on to explain that "… our Business Manager has agreed to pay … expenses that exceed 15% of the gross offering proceeds." In other words, up to 15% of the investor's money could be taken in fees.

The registration statement is full of tricky English language such as this. The entire document is 132,192 words, approximately twice the length of this book. It's absurd to think that any investor who's not employed in the industry will read and digest such a thing. The 15% in fees were disclosed around 20% of the way through the document, so in a legal sense the client was informed, but not in a way that represents a partnership between the advisor and the individual.

There are other little gems, too. The company will invest in property that will then be managed by an affiliate. So in other words, the sponsors of IAR will make money from managing the assets owned by IAR as well as for running IAR itself. "Management Fee" occurs 45 times throughout the document, and includes fees on the gross

income (i.e., rent). There's also a 1% management fee on the assets. The investors do have to receive a 5% return first, but that return is "non-cumulative, non-compounded," which means that if they didn't earn the 5% return for investors in one year, they don't have to make it up the next year in order to earn their management fee. There are fees of 2.5% to the business manager if they buy a controlling interest in a real estate business. There's also a 15% incentive fee, basically a profit share, after investors have earned 10% (although it's not on the excess profit over 10%, but on the whole profit). The simple word *fee* occurs 528 times.

There are 40 matches for "conflict of interest," including most basically that the buildings owned by IAR will be managed by an affiliate of the sponsor with whom they do *not* have an arm's-length agreement. Said plainly, don't expect that the management of properties is done at a fair price, but be warned that it may be unfairly high.

Now, to be fair, whenever companies issue securities to the public they hire lawyers to construct documents whose purpose is to protect the company from the slightest possibility of being sued after the fact. Glance through the annual report (known as a 10K) of almost any company and you'll find a whole list of "risk factors" telling you why you might lose money on your investment. Even Warren Buffett's Berkshire Hathaway, as honest a company as you'll find, includes a list of risk factors in its 10K that seem fairly obvious, such as, "Deterioration of general economic conditions may significantly reduce our operating earnings and impair our ability to access capital markets at a reasonable cost." You'd think any investor would be aware of this, but it's in there anyway just so they can say they warned you.

IAR mentions "risk factors" 44 times. It warns the investor that it is operating a "blind pool," in that they don't yet know (at the time of the offering) what real estate assets they're going to buy. They go on to warn that there may be little or no liquidity for investors to sell (how true *that* turned out to be).

Another common problem with non-traded REITs is that the high dividends that attract investors may not be backed up by profits. Interest rates have been low now for years and are likely to remain historically low for a good while longer, as I wrote in my last book, *Bonds Are Not Forever: The Crisis Facing Fixed Income Investors*. Low rates

benefit people and governments who have borrowed too much, which applies widely in the United States as well as other countries. The low yields on bonds mean investors are starved of opportunities to earn a reliable, fair return with relatively low risk.

Non-traded REITs are sold because of their high dividend yields. However, there's no requirement that the dividends they pay are backed up by profits. They can simply be paid out of capital. This issue isn't limited to REITs, of course. Any company can pay out dividends in excess of its profits, at least for a while. Many companies follow a policy of paying stable dividends even while their profits fluctuate, recognizing the value investors place on such stability. As long as their profits are sufficient to pay dividends and reinvest back in their business for growth over the long term, paying dividends in excess of profits in the short run may not do any harm.

But non-traded REITs can pay a dividend that's higher than they can sustain even in the long run. It's like having a savings account that pays 2%, taking out 3% of it every year, and calling it a dividend. Part of the dividend is your own money coming back to you. Calling it a dividend misleads investors into thinking it's from money earned, which it's not. On top of that, non-traded REITs can often invest in properties that pay high rent but depreciate. An example might be a drug store such as Walgreen's, which could hold a ten-year lease on a property that has no obvious alternative tenants should Walgreen's decide not to renew the lease at its termination. It will pay above-market rent to compensate the building owner (i.e., the REIT) for the possibility that in ten years the building will have to be expensively reconfigured or even torn down in order to find a new tenant. As such, the building may well depreciate during the term of the lease, given the specialized nature of its construction. The depreciation often won't show up in the REIT's financials, leading to a delayed day of reckoning.

In fact, non-traded REITs are notorious for maintaining an unrealistically stable net asset value (NAV). They simply don't update the value of their holdings, and because their securities are not traded there's no way for investors to know if the value of their holding has fluctuated.

DISINGENUOUS ADVICE

Some advocates of the sector, with utterly no shame, argue that the absence of a public market is a good thing. Sameer Jain, chief economist and managing director of American Realty Capital and someone who really ought to know better, praises "illiquidity that favors the long-term investor" (Jain 2013) as a benefit. Sameer Jain surely must know that illiquidity *never* favors any investor, long term or otherwise. This is why illiquid investments always require an *illiquidity premium,* a higher return than their more liquid cousins, to appropriately reward investors for the greater risk they're taking. Inability to sell what you own is never a good thing. He adds that non-traded REITs are "not subject to public market volatility," as if that's a further benefit. That's like arguing that closing the stock market is good for investors so they can't see their investments fluctuate. Sameer Jain is a graduate of both Massachusetts Institute of Technology (MIT) *and* Harvard University, so I know he *must* be smarter than these statements make him sound. If you don't want to know what your portfolio's worth, don't look! In any case, as long as you haven't borrowed money to invest (rarely a smart move), fluctuating prices need not compel you to do anything you'd rather not do. Looking at an old valuation that's wrong and not updated should not provide comfort to anyone. It's head-in-the-sand, ostrich investing.

For example, in July, 2014 Strategic Realty Trust, another non-traded REIT, reduced the valuation of their REIT by 29% (InvestmentNews 2014), from $10 per share to $7.11. The previous $10 value had remained unchanged since it was launched in August 2009, at what should have been a great time to be investing in anything. It's doubtful any of the hapless investors in Strategic Realty would agree with Sameer Jain that five years of no reported changes in valuation had been helpful.

The reality is that the value of the underlying assets fluctuates depending on the economy, shifts in demand for real estate, location of properties, competition, successful retention of tenants and other reasons. Failing to change the NAV of the security in no way shields investors from their exposure to all these factors, it simply shields them

from the knowledge of how their investment's value may have shifted. Publicly traded REITs provide a market perspective on these factors every day through their fluctuating prices.

The true value of Strategic Realty Trust didn't suddenly fall by 29%; that move reflected the cumulative effect of not updating the value over the prior five years. This is why investors normally seek higher returns on illiquid investments, notwithstanding the sales pitch for NTRs.

The point of this is to show how much important information can be buried in the lengthy legal agreements that accompany almost any investment. The challenge for the investor is how to navigate this territory. Penelope's experience is emblematic of an all-too-common problem for individuals trying to invest their money. They often find themselves sitting down with someone who calls themselves a financial advisor, when really they're talking to a salesperson.

In fact, the illiquidity doesn't benefit the "long-term investor" as Sameer Jain misleadingly asserts, but the issuer. For it turns out that, if you want to sell your regrettable investment in a non-traded REIT, without a stock market listing the only realistic buyer is the NTR itself. Persuading investors that they should prefer illiquid securities, and then being positioned to be the only plausible buyer when a hapless investor wants out is the essence of the sales pitch described above.

Penelope made this investment on the recommendation of the person who covered her at Ameriprise, a large brokerage firm (known as a broker-dealer from a regulatory perspective). Ameriprise, like other large brokerage firms, calls the people who deal with clients financial advisors. It's true they provide financial advice to Penelope and millions of others, but it doesn't mean they have a legal obligation to put their clients' interests first. The US regulatory structure recognizes two types of firm facing investors—broker-dealers and investment advisory firms. The difference is a subtle one, especially because many big firms operate as both. Broker-dealers generally charge commissions on trades you do, or in the case of bonds charge a price mark-up if they're selling you a bond they already own. Investment advisors charge a fee for their advice. The crucial difference is the broker profits when you do a transaction. They earn a commission, or a mark-up (or sometimes both). This can present a conflict of interest, in that a

transaction may not be good for the client but is always good for the broker. Brokers are not required by law to put the clients' interests first, whereas investment advisors have a legal, fiduciary obligation to put their clients' interests ahead of their own.

One of the confusing things is that a broker can employ people it calls financial advisors, but they are not the same as investment advisors, a term that's legally defined to mean someone advising you as a fiduciary.

Who on earth wants to study the intricacies of US financial regulations? People just want access to honest advice. Calling someone a financial advisor places them in the same category as a doctor or lawyer, two professions that have a legal obligation to put the interests of their client (or patient) first. It's a bit like calling a car salesperson a transport advisor, or a real estate broker a housing advisor. Both will provide you advice, and the recipient of that advice will assess it with the knowledge that it's proffered by someone whose objectives are different than your own. There's nothing wrong with that as long as you know what type of relationship you're getting into.

I should at this point note that many financial advisors at brokerage firms are honest people truly putting the interests of their clients first. I have friends who do just that, and I'm not trying to criticize a whole industry. But they're not all good, and the bad ones create a problem for their clients as well as for the rest of us.

Some feel it would make a lot of sense for the people who work at brokerage firms and call themselves financial advisors to adopt a fiduciary standard, the same as investment advisors. (Yes, I know it's confusing. Financial advisors sound like investment advisors, but they're not.) If financial advisors had to meet a fiduciary standard it would make life far simpler for investors who choose not to become regulatory experts as they look for investment advice. But the brokerage industry recently lobbied successfully against such a move so it's unlikely to happen. I think that as long as a client understands their advisor's actual responsibilities they need not be a fiduciary.

Penelope misunderstood the type of relationship she had with her financial advisor at Ameriprise. Penelope thought she was dealing with someone who was required to consider her interests first and foremost (like a doctor or lawyer) whereas in fact she was dealing

with the equivalent of a realtor, someone who would get paid out of the transaction fees extracted from Penelope.

This is where Inland American Real Estate Trust came in. The 10.5% of fees (and potentially up to 15%) that was to come out of the client's money the moment it was invested would typically be shared substantially with Penelope's "advisor." So when Penelope was "advised" to make the investment, the advisor clearly had a conflict of interest. It's no different than a doctor prescribing medication to a patient and receiving a payment from the drug company that provided it.

WHOSE SIDE IS YOUR FINANCIAL ADVISOR ON?

Some people who call themselves financial advisors sit on your side of the table acting on your behalf. These are Registered Investment Advisors (RIAs). They act as your agent and they're legally obligated to put your interests before theirs. Other financial advisors sit across the table from you, and their interest in the client's well-being is similar to that of any other salesperson. They generally work for brokerage firms (as opposed to investment advisory firms). Yes, they want you to invest your money in something worthwhile, but they also earn a transaction-based fee so products with higher fees benefit this type of advisor and inaction rarely makes them any money.

Many if not most of the financial advisors who work for brokerage firms genuinely put the interests of their clients first. I have friends in the industry about whom I feel comfortable making this statement. And clients who invest through an RIA are charged an advisory fee as well as having to incur commissions on the investments they buy. This can make the use of a financial advisor who works for a brokerage firm appealing in that there are only commissions to be charged. However, I believe the potential for conflict of interest can represent a negative for the client. The protections for clients against being marketed a poor investment can be weak (which was why Penelope was persuaded to invest in the non-traded REIT). The brokerage industry successfully fought attempts to impose a fiduciary standard on their salespeople (who often refer to themselves as financial advisors) so

the client is basically reliant on the quality of the person with whom they're dealing.

My own business is a Registered Investment Advisor (RIA) and I am an Investment Advisor Representative (IAR). I'm pretty comfortable that although we charge a fee to manage money, the commissions charged on transactions by the brokerage firms through which we trade are low enough to not make much difference. If you trade online and infrequently, you minimize transactions cost, taxes, and the irrational impulse to try and profit from short-term market moves. The RIA has an obligation to put the client's long-term interests first. The financial advisor at a brokerage firm may put your interests first if he's so moved, but he may not be legally obliged to. As long as his recommendations are suitable and appropriately disclosed, then he's fine. He'll be paid based on his revenue production, and that production is often driven by transaction volume rather than the size of the accounts on which he's providing advice.

So let's return to Penelope and the non-traded REIT, Inland American Real Estate Trust, which she unfortunately owned. It had no public market valuation and therefore no way for Penelope to sell her holding. It had performed very poorly since being initially launched, and the fees charged were shockingly high. In fact, even more surprising than the level of fees was the fact that they weren't actually illegal. You would think being charged 15% of your investment would trigger some kind of securities violation, but it does not. I guess if it's there in the documentation you're expected to have read it.

Nonetheless, I suggested to Penelope that she go back to Ameriprise, who had sold her this investment, and ask them to buy it back from her at the original price. She clearly had not understood what she was getting into, and in my opinion it should never have been sold to her. At first, Penelope was unwilling to do this. She felt the advisor she'd been dealing with was a nice person (albeit evidently not that good at providing financial advice), so Penelope decided to move on and hope that somewhere down the road the REIT might buy back her shares.

A few months later, Massachusetts announced a settlement with the same firm on the same security. William C. Galvin is the Secretary

of the Commonwealth of Massachusetts. In this role, he often pursues financial firms for wrongdoing in his state. No doubt many of these firms think he's overly aggressive, but it seems to me he's protecting the citizens of the state he represents. In early 2013, Massachusetts announced a settlement with Ameriprise over the improper selling of Inland American securities, which included an $11 million fine. Although the security itself was clearly designed so as to generate healthy commissions to the brokers that sold it, Ameriprise was merely guilty of selling the REIT to investors who were deemed unsuitable in that they didn't meet the minimum income or wealth standards Ameriprise had set. In other words, some brokers at Ameriprise violated their own standards, a lesser sin than if those standards themselves had been too lax.

Nonetheless it illustrated the conflict of interest that can face financial advisors at a brokerage firm. They may want to sell a security to an investor because of the fees they'll generate, whereas if they were truly an investment advisor not paid on commissions and legally obliged to put the client first, they wouldn't be in that position.

When this news broke, I was able to persuade Penelope to submit an official letter of complaint to Ameriprise. The settlement in Massachusetts was due to a regulator who saw it as his mandate to aggressively protect the citizens of his state. The absence of a similar settlement in New Jersey didn't vindicate Ameriprise in that state; it could simply be that the New Jersey regulator hadn't pursued the company on the same issue.

Penelope hadn't understood the risks and costs of the investment when she'd made it, but it's pretty hard for an individual to achieve redress in such situations. The prospectus (all 132,192 words of it) had spelled out the risks and Penelope was assumed to have read it. Ameriprise declined to do anything. Soon after, a private equity fund offered to buy investors out at a 35% discount to the original offering price. Penelope reasonably enough decided to take the cash offered, and move on. Caveat emptor ("Buyer beware") ought to be on every non-traded REIT prospectus.

Penelope had been poorly served by the financial advisor assigned to her account. While Penelope had treated the relationship as one in which she was receiving advice tailored to her best interests, in reality

she was involved in a buyer/seller relationship with misaligned interests. Of course there's nothing necessarily wrong with buying something from a salesman. You just need to approach the relationship with the right perspective. Penelope treated the relationship with her financial advisor the same way she would with a doctor, assuming that the advice offered was devoid of any conflict of interest and was with her best interests first and foremost. Really, she was dealing with a used car salesman.

WHERE ARE THE REGULATORS?

At this stage, you might ask yourself, where are the regulators? If investors are being sold securities with ridiculously high fees and no liquidity, how come the government isn't doing something about it? There's certainly no shortage of laws and regulations that apply to finance. It is a highly regulated industry, and becoming more so every year. Fortunately, though, the Securities and Exchange Commission (SEC) is not responsible for offering a view on whether an investment is good or not. That's obviously as it should be. Reasonable people disagree all the time on the relative merits of one investment versus another. There's little benefit to the government having a view as well.

But the regulators can warn investors against certain types of investment. FINRA (the Financial Industry Regulatory Authority) has, to its credit, done this. Its website (FINRA 2012) offers warnings about the most adverse features of non-traded REITs, including the fees, lack of liquidity, and the fact that it operates as blind pools (you invest before any properties have been bought so you don't know what you'll own). The website notes that fees can be up to 15% of your invested capital (15% is the legal maximum—probably not coincidentally what Inland American set as its maximum).

FINRA's "Investor Alerts" section of its website includes warnings about several investments that should be approached with a high degree of skepticism, including certain types of annuity, structured notes, and some exchange-traded funds (ETFs). These and other pitfalls are all covered elsewhere in this book. I wasn't even aware of this website myself until I started looking for it—FINRA should find

ways to publicize its existence, but it's not the kind of topic that's going to get TV producers lining up to book you on their business show. Nonetheless, at least the regulators are trying to do *something* to warn investors.

If a security is on FINRA's "Investor Alert" page, why would any self-respecting firm even get involved? Shouldn't that be enough to persuade firms that truly put the client first to stay away from such a security? I think that's part of the problem. Too few retail investors are aware of the warnings and potential problems. The brokerage firms involved like the fees and hardly ever find themselves in conversations explaining why they're selling something that, in effect, carries a government warning. It's why finance earns itself a poor reputation. Anybody who's bought a non-traded REIT and after regretting it subsequently found FINRA's website has every reason to be outraged at being offered the security in the first place. There's not enough good judgment being exercised. Maybe there ought to be a requirement that if you're recommending a security that is the subject of one of FINRA's Investor Alert pages, you have to provide a copy of the alert to the clients before they make a decision. Non-traded REITS' warning should be prominent, like that on cigarettes. The warning is already out there, just not well publicized. Doesn't the regulator want the retail investors they're charged with protecting to be aware of the dangers the regulator has identified? Isn't FINRA doing more than just expressing a research view?

I've chatted to some in the industry who disagree with me on non-traded REITs. One in particular thought my criticisms were unjustified and based on a poor understanding of the merits of the product. His argument relied on the fact that he'd had some very positive experiences for his clients with non-traded REITs, in that they'd made money. In other words, he'd found some that worked, so as long as you invested through someone like him possessing the insight to tell the wheat from the chaff, you'd be in good shape.

It's a common argument, and a weak one. First of all, just because some people have made money doesn't mean that on average they will. You can make the same case for casinos or the lottery. There are always some winners, but most gamblers understand that the odds

are against them. These people gamble because the excitement of potentially winning overwhelms any understanding they may have of probability theory. Casino owners aren't poor, and publicly run lotteries augment tax revenues in many states. I avoid casinos and don't buy lottery tickets, but the people who do bet on lotteries save the rest of us from even higher taxes so they're performing a selfless public service.

Of course, using the fact of one good non-traded REIT as support for the overall investment sector isn't exactly careful research, any more than the bells ringing on a slot machine should persuade you to sit down with a bucket full of tokens. The correct question is, how have non-traded REITs done in aggregate? It turns out there's no reliable answer to this question. There's no non-traded REIT index. For the brokers who make fees selling them, such an index would probably hurt business. They certainly wouldn't want clients who knew enough to ask for the returns on such an index—the less sophisticated the better. And the existence of an index would also allow the performance on a specific non-traded REIT to be compared against its peers, revealing whether the profitable return was simply a result of a good market for similar securities rather than value-added security selection by the broker.

OVERALL RETURNS ARE POOR

There is a 2012 study (Reuters 2014) by Blue Vault Partners and the University of Texas that analyzed the start-to-finish returns on 17 non-traded REITs. They found that the internal rate of return (a type of investment return that reflects inflows and outflows on multiple dates) was just over 10%. That sounds good, except that over the same time, publicly traded REITs performed 1% or so better.

Another study carried out by Securities Litigation and Consulting Group (Wall Street Journal 2014), a research company based in Fairfax, Virginia, compared 27 non-traded REITs that had gone through a full cycle from raising capital to returning the proceeds to investors. Their study covered a period of more than 20 years, from June 1990

to October 2013. They found that after fees investors earned 5.2%, compared with the Vanguard REIT Index Fund (a mutual fund) of 11.9%. So in exchange for no liquidity, higher fees, and generally fewer safeguards, investors earned a lower return. Private equity investors expect returns above those available in the public equity market, as compensation for the additional risks involved. An additional return of 3% to 5% is not an uncommon requirement, meaning that if a chosen equity index such as the Russell 2000 returns 10% during the time period that the private equity investor held his investments, he would expect to have earned 13% to 15% or more. Otherwise, the choice of private equity was not worth the risk compared to its more liquid publicly traded equivalent.

There's a saying on Wall Street that certain investments are sold, not bought, in that they require a salesman to push them on a willing investor rather than the buyer actively seeking them out. This would certainly apply to non-traded REITS. Because the first question any investor, or for that matter well-intentioned advisor, should ask before considering non-traded REITs is how the sector is likely to perform going forward. Asset allocation, the choice of how much an investor should put in stocks, investment grade bonds, REITs, high-yield bonds, commodities, or any other asset class generally drives 80% to 90% of the investor's overall return. In other words, assuming you hold a reasonably diversified portfolio and don't bet heavily on just a few investments, if stocks are up 10% you should be up by a similar amount. Of course it's a generalization, but the point is that the biggest decision an investor makes is how much to allocate to an asset class.

So before even considering an individual non-traded REIT, you need to consider how the sector is likely to perform and how this compares with the other assets available to you. This is how institutional investors start their investment process. Given the limited amount of data available for non-traded REITs and the unsophisticated investor base, it's unlikely this basic question receives any attention. It also means that investors are unlikely to properly evaluate the performance of a non-traded REIT once they've bought it. Unless you're in finance for a living, comparing results with a benchmark won't come naturally.

THE IMPORTANCE OF BENCHMARKING

Non-benchmarked returns are great for the broker, though. You'd think that because numbers are the very essence of investing, they'd be used in discussing performance. It's really quite incredible how often results are presented without comparison to the alternative choice, or the relevant benchmark. A 5% return can only be evaluated if you can compare it with what else you could have done with your money. In the case of non-traded REITs, the upfront fees and ongoing expenses represent a substantial impediment to outperforming or even matching any relevant benchmark. That's why the results are not usually compared with anything. Brokers love nothing more than to use adjectives rather than numbers to characterize the results they've achieved for their clients. It's so much easier to tell a client they were "up 7%, which was good." However, if the investment has lost money, the advisor may well resort to a comparison with a benchmark, such as, "you were down 9% which wasn't bad considering equities were down 11%." It may or may not be a valid comparison. A balanced account with 50/50 stocks and bonds shouldn't be compared simply with equities.

Clients should always ask how a strategy will be evaluated. It's as simple as asking at the beginning of the relationship, "What should we both look at in order to correctly evaluate the performance of my account once you're managing it?" Ideally, it should be compared with a relevant benchmark. An equity strategy should be compared with the S&P 500 if the underlying stocks are large cap US equities. The Russell 2000 might be more appropriate if smaller stocks will predominate. A fixed-income strategy should be compared with a bond index, such as the Barclays Aggregate Index. It should be possible to agree on an index at the outset. If the advisor is any good, he shouldn't mind having his performance benchmarked. Many will try to argue that their strategy doesn't fit easily against a benchmark, or that a previously agreed benchmark is not relevant "for this type of market." As the client, your response should be simple. Tell the advisor that if we can't agree on how to evaluate you, we'll never know if you're doing a good job. And if we can't tell how you're doing, why are we bothering with you in the first place?

Obfuscation of performance is the mediocre financial advisor's friend. Non-traded REITs are the perfect product for a salesperson who doesn't want to be evaluated other than on the fees he generates. There's no accepted benchmark and hardly any investment research. These factors work against the interests of the client.

PUTS AND CALLS

Recently, I was asked by a new client to evaluate an IRA that was being managed by his former advisor. It included a selection of dividend-paying stocks combined with some options positions. Many people like what are called "covered call" strategies, in which they write call options on stocks they already own with a strike price above current market levels. It's often described as a way to generate additional income through earning option premium, and if the stock that's owned does get called away well, it'll be at a price at which you were in any case happy to sell.

There are a couple of problems with this. One is that if you own XYZ stock and you write a call option against it, you have created the exact same position as if you had simply sold a put option. It's called "put-call conversion." Like a mathematical equation, the profit/loss on your covered call trade can be shown to be identical to that of a simple, short put option with the same strike price and expiry as the call option. Although a covered call strategy doesn't sound that risky, many people would find shorting put options to be very risky. You've got all the downside associated with owning the stock, and have only limited upside. I've run interest rate options trading in the past, ranging from plain vanilla to complex and exotic options. Exploiting put–call conversions to manage risk was one of the basic elements in our toolkit, and this remains so for today's options traders.

I once met a hedge fund manager who claimed to run a covered call strategy. I asked him why he didn't just sell put options instead, since it required fewer trades to execute and so would be a cheaper way of achieving the same result. For a brief moment, his honesty exceeded his marketing skill as he admitted that no investor would

seriously consider investing in a hedge fund that simply shorted put options. Naturally, we didn't invest with this manager.

Covered call strategies are also very appealing for managers who would prefer that their results are not easily compared with a benchmark. Covered call strategies will generally underperform a rising market, as the winners get called away and cash has to be reinvested. They can outperform in a down market if the premium income offsets some of the losses on stocks that have fallen in price. But it's impossible for the typical investor to figure out if the returns were good or not. If stocks are +10% one year, is +6% good for the covered call strategy? Should it be +8%? There's no really good answer. Similarly on the downside, is losing 15% when stocks are down 20% good, or should you only be down 8%? Because it's not clear and therefore open to judgment, the broker managing the account can use terms like "good" or "acceptable under the circumstances" when reviewing performance with his client. Therefore, it's often very hard for the client to know if the return he earned was commensurate with the risk he took. It can be great for the broker, yet bad for the client. And the commissions can add up, too.

FINANCIAL ADVISORS NEED TO DO BETTER

While the financial services industry is full of good people, Penelope is representative of thousands of clients who have received less than a fair deal. Non-traded REITs are by no means the only investment designed with hefty fees. As I learned what she'd gone through, it deepened my conviction that, while the system isn't broken, it sure could use some improvement. Public opinion routinely reports an unfavorable view of Wall Street. The banking bailouts of 2008 contribute to this, although my personal reading of history is that while the government deserves a lot of blame for getting us into the crisis, they made the right decisions to get us out. Government subsidized mortgages were made available to people who weren't equipped for home ownership; regulatory oversight was too relaxed; there was too much leverage, most especially among the investment banks.

But having created the stage for the excesses that led to the financial crisis, I don't think there was any serious alternative to the series of bailouts that were undertaken.

As traumatic as that period of time was for so many, it doesn't fully explain current negative views more than six years on. One poll (Wall Street Journal 2014) noted that Congress was even more unpopular than Wall Street. Neither should feel good about the comparison.

Managing people's savings is a serious subject. Preserving the purchasing power of your retirement pool so it can provide you with what you need when you're no longer working is, for most people, up there alongside physical wellbeing in terms of importance. It ought to be that the professionals advising you on your financial health can be relied upon with the same confidence with which the medical profession is trusted to help you live gracefully to a ripe old age. Through my own business I see too many cases of misplaced trust by investors in individuals or firms that they believe will guide them to fairly priced, good investments whereas they wind up paying too much for something inferior. The individual investor mistakes a sales relationship for an advisory one. Financial salespeople often understand this subtle difference and present themselves as advisors while behaving like salespeople.

Penelope's experience got me thinking about the perception problem that finance has, and what causes it. As I talked to friends of mine in the industry the response was invariably the same. "Oh yes, I just picked up a new client who had been sold a lousy investment." It might be an annuity, a closed end fund IPO, or a municipal bond with too high a mark-up. But it was clear that others were seeing the same thing I was.

I had one client who showed me the asset allocation recommendation he'd received from a large, global bank. Typically, such an analysis will include forecast returns for each asset class. As I reviewed the presentation my friend had received, I noticed that the expected return on bonds was 6%, because that was what they had done in the past. Quite apart from the fact that every investment document you ever see is required by law to warn you, "Past performance in not indicative of future returns," interest rates are no longer 6%. What you earn on a bond is heavily impacted by the yield when you buy it. Given current

interest rates of 1% to 4% depending on maturity and credit risk, using a 6% return assumption was just stupid.

Another friend showed me a trust fund that her late father had created for her. The trust company holding the assets was responsible for selecting appropriate investments. They had a chunk in fixed income with a yield of 1.5%. The fees on the account were also 1.5% annually, and on top of that the account was taxable. So my friend was owning bonds, paying away fully 100% of the return to the trust company in fees, and on top of that had to pay tax to the federal government. So the trust company and Uncle Sam were making money out of this arrangement while my friend was losing money. Although there was nothing illegal in this set up, you'd think the trust company would feel some obligation to come up with a different arrangement (perhaps including lower fees) that could at least ensure that the trust for which they had responsibility wasn't being depleted to pay themselves and taxes. It just seems common sense.

It is with the belief that sunlight is the best disinfectant that my colleagues and I have written this book. We hope that by telling you what we avoid for ourselves and our clients, we'll help you, the investor, and perhaps in some modest way raise the standards of financial advice along the way. There is certainly room for improvement.