



MONEY DUE REWARDS:



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The Ratings Game

In the television advertising industry, the ratings season is the period during which the various viewer surveys are run, and these are watched with great interest by advertising agencies and television stations alike. The reason for this interest is quite simple. If your TV station obtains high viewer ratings, its airtime will be in more demand from advertisers, and you can therefore charge them higher prices.

In the financial services industry, a similar system applies. There are a handful of “ratings agencies” or “research houses” whose business is to produce research reports on all kinds of investments for use by financial advisors, fund managers and others. The reports typically describe in some depth the aims, features, and performance of the investment product, and conclude with some kind of rating, such as “recommended” or “investment grade” as a guide to potential investors or advisors.

The role of these research organisations has been under some scrutiny of late, as a result of the recent crisis in the US sub-prime mortgage market. The collapse of this market in the last few months has led in turn to the collapse of a number of hedge funds which had held substantial exposures to certain sub-prime assets.

These issues have arisen not because the funds in question hadn't been professionally researched. In fact, many were not only covered by the major ratings agencies, but had been given glowing reports, with ratings such as “recommended”, “highly recommended” and “buy”. Some had even received industry awards.

Yet these funds have now gone broke, leaving investors with some worthless pieces of paper to show for their hard earned cash. As you can imagine, this created some anger among out-of-pocket investors, and in the US there have been lawsuits issued against the research houses involved.

So how could this happen? How could an investment which the experts regarded so highly turn out to be a dud?

The answer lies in the nature of the research houses' business. These organisations are paid to produce research, for which they are paid fees. In the good times, such as we have seen recently, there is a demand for all sorts of products – including some which are based on very complex new financial strategies. In response to this demand, the researchers are only too happy to produce the desired reports – but there is a catch.

The catch is that these research reports are only relative. In other words, if a fund is “highly recommended”, it simply means that in the researchers' view, the manager is executing the fund's stated strategy better than most others who are doing the same thing. What it doesn't necessarily mean, is that the fund is a good investment, nor that it is appropriate for any particular investor.

This is because the research houses don't see such issues as being their responsibility at all, but rather as the job of the investment advisor.

If this turns out to be the case, it is now quite clear that giving each investor “a bit of everything” is not going to be good enough. A good advisor will be choosy, and will try to steer clients completely away from some investment types, and guide them into others. Please don't assume, then, that just because you may have some investment research available to you, that you somehow don't need an advisor – because the research reports themselves only cover a few of the many factors which need to be considered.

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