Does Wall Street Rip Off Your Clients?

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by Michael Edesess

Wall Street traders are a nasty lot, out to beat you at a zero-sum game. Seth Klarman, founder and president of the Baupost Group, who should know, has said, "I know Wall Street will always try to rip our eyeballs out." Now, a new book confirms that view from close quarters. How, then, do investors avoid being these traders' victims?

The remarkable Mr. Polk

Reading Sam Polk's new book, *For the Love of Money*, leaves you thinking that the author is a remarkable person – and that his whole family is remarkable too.[1] Not because he is remarkable in the ordinary sense, that is, distinguished or even necessarily highly praiseworthy, but because his life navigated such tumultuous twists and turns, and somehow ended up right, or so it seems. How did he do this, and why did this happen to him? Part of the credit appears to be due to an unusual therapist, who lacked a conventional certification but gave very good advice.

Polk burst on the scene with a *New York Times* op-ed piece two and half years ago that highlighted the idea that the love of money is like any other addiction, one that afflicts most of the people on Wall Street. As he cured himself of other addictions with the therapist's help, Polk finally wound up freeing himself of the Wall Street money addiction.

His recently published book focuses less than the earlier article did on the idea that Wall Street employees are suffering from an addiction; perhaps the connection is clear from the context. Most of the book is a tell-all autobiography, chronicling Polk's many stupid mistakes and failures before he was even 25 years old. They are the failings of an addictive personality, beginning with a bout of bulimia. He also suffered alcohol and drug addiction, as well as an inability to control his tendency to react too aggressively when he felt slighted or insulted by another person – resulting in losing at least one good job.

Nevertheless, by dint of covering up his past failures and persistence – and having attended Columbia University – he managed to get a job on Wall Street and then a series of exponentially increasingly well-compensated Wall Street positions over the next five years. During that time he went from his first bonus of $40,000, which made him blissful because he could at last stop living hand-to-mouth, to one almost a hundred times as large, which caused him to protest angrily that it should be at least twice as big (with, it would appear from his account, some justice, given the gains he had made for the hedge fund firm where he worked).

Is this background typical of a Wall Street employee?

While reading this, I wondered if this was an unusual history for someone who wound up working on Wall Street – serendipitously, but also through aggressive perseverance and a very strong desire – or if it wasn't unusual at all. Polk notes that he was told, as a 22-year-old intern at CSFB, that whether or not you were hired full-time after an internship was not based on how smart you were. It was a question of whether the traders liked you.

The whole Wall Street setup Polk describes smacks of the worst kind of frat-boy culture (it is almost all boys), competing to be as crude as possible. If that's what it is and not about being smart, why is Wall Street so successful at making money? Perhaps the admissions ticket, typically an Ivy League education, assures that you're smart enough. After that, it's just a matter of how well you can take advantage of other people and how well accepted you are by your fellows.

In short, he paints an unsavory picture. We knew this, but Polk provides an up-close view. Given all this, why was he the one who wanted to break free and finally managed to, while so many others are content with their pushing-people-around role?

It turns out, they aren't.

Polk says that after he quit his last job as a highly paid trader for a multi-billion dollar hedge fund, he got calls from dozens of traders and all of them said, “I want to leave, but I can’t. I really want to be doing something better with my life.”

Why can’t they leave? They got stuck in the rut of the expensive task of keeping up with the Joneses of their tax bracket (oh, yes, that tax bracket; in the case of hedge fund managers, it’s still a low one because of the favorable treatment of “carried interest”). Or they just can’t shake the money addiction, as the alcoholic can’t shake the bottle or the gambler the table in the casino.

The sad case of Rajat Gupta

An extreme case was that of Rajat Gupta, who by all accounts was a brilliant former CEO of the consulting giant McKinsey. In 2012, Gupta was convicted of securities fraud for passing insider information he learned at Goldman Sachs board meetings to Raj Rajaratnam, the founder of the hedge fund Galleon Group.

Why would Gupta do that when he was held in highest regard and was worth at least $100 million? The answer, a *New York Times* article speculates, is that his stature and wealth brought him into the company of the most elite and wealthiest echelon of society – the .001% – people like multi-billionaire Steve Schwarzman, who was easily able to donate $100 million, Gupta’s whole fortune, to fund a library (and who was protective enough of his wealth to compare proposals to increase taxes on private equity firms to Hitler’s invasion of Poland).

Gupta felt he desperately needed to become a billionaire in order to fit in with the society in which he had found himself, or he would suffer the hell of humiliation and lack of self-worth. Such are the trials and tribulations of a sufferer from money addiction.

Where does all that money come from?

Many of the accounts in Polk’s book are of episodes in which dollars are being thrown around by the thousands and tens of thousands, as in scenes from the most debauched bacchanal. But Polk reached his limits, imposed partly because as a recovering alcoholic he did not drink when the others did. His moment of conversion, or one of the moments, came when he realized the wretched and senseless excess of the whole thing:

> What passes for conversation is a series of insults [of which he provides examples of profanity that can’t be repeated here].
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> …It wasn’t just the conversation. It was the whole shallow career. I’d been mulling over a famous Bloomberg message that had been sent out by a Goldman trader to the entire market. The subject line read, ‘Size Does Matter’; the message said that he’d buy or sell $5 billion worth of an index of derivatives in a single phone call. It was the largest index market in history.
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> Taking a situation to its extreme can illuminate an otherwise obscured absurdity. *Why would anyone need to trade $5 billion in derivatives at a single moment?*
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> Emblematic of the excess are the outlandish bonuses that Wall Street employees receive, especially traders for hedge funds and the proprietary trading desks of banks.

What is the source of all this money they receive? Who is on the other side of the trade? Is it a drain specifically on other investors, and do those investors and their advisors need to be aware of this drain in order to avoid falling victim to it?

There are several possible sources, and the question – which is not easy to answer – is how much does each one contribute to the enrichment of the .01% and .001% of finance. One is that the money comes from fees and rake-offs they receive in a zero-sum game with the other players. This seems to be the case with hedge fund billionaires, who over the past dozen years or so have not enriched their investors any more than they would have been enriched by investing in Treasury bills, but have taken billions of dollars in fees nonetheless. The takeaway from this is clearly not to invest in hedge funds, or in any event not to invest more than 3% of one’s portfolio in a very small number of them that have been thoroughly vetted, as Simon Lack, author of *The Hedge Fund Mirage,* recommends – and then, of course, only if one’s portfolio is large enough to invest so small a percentage in hedge funds.

Hedge funds and high-frequency traders also make money by nicking nickels and dimes off of the trades of other funds like mutual funds and managed pension funds – though apparently not enough for investors in them to overcome the deadweight of the hedge funds’ fees. They do this by taking advantage of the sluggishness of these “whales” – their name for the mutual funds and pension funds whose lumbering size prevents them from profitably making the huge trades that they must make. They do this by detecting when a whale is beginning to execute a large trade, and then front-running the bulk of it. When a $50 billion mutual fund's analyst recommends increasing the commitment to a security by half a percent, that means the fund has to buy $250 million of it. A hedge fund or high frequency trader or its bot can detect such a large trade in time to profit significantly at the expense of the mutual fund.

But what about the proprietary traders at banks? They're not making money from fees. Where are they getting it from? Perhaps they are so well placed in the stream of information -- especially if they are at companies like Goldman Sachs, where the flow of employees between the company and government is so fluid -- that however thick the Chinese wall at their company may be, they still have enough inside information and insight to benefit greatly. This is not likely, I would speculate, to negatively impact the small investor's portfolio to a very great extent because the sum total of bank proprietary trading is much less than the trading at hedge funds and mutual funds. Many of the trades may benefit at the expense of institutions like other banks and hedge funds – not, directly at least, individual or even institutional investors.

Another possibility is that these proprietary trading desks don't really make money on average over the long term, but the banks' managers don't know that. They do sometimes make large amounts of money over the short term, and that's what they notice. When they lose money, it's viewed as an aberration. Someone gets fired, and the proprietary trading desk gets bailed out by covering it with profits (coming from fees!) elsewhere in the company, or by the sale of the company, or – in the extreme case that occurs periodically – by a government bailout.

The implication for an investor is that if you don't want to just give your money away to the .01%, don't invest in hedge funds and don't invest in large mutual funds that have high turnover; and if you are a participant in a large pension fund, lobby your administrator not to invest in hedge funds or to hire managers whose turnover is high. A similar degree of wariness should be applied to private equity and venture capital funds, whose fees are as high as those of hedge funds.

In other words, avoid riding hyperactive whales.

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[1] I say his whole family because his identical twin brother Ben was in the lowest depths of alcoholism until the two of them agreed to a pact to give up drink. A few years later, we learn in passing, Ben had just graduated from Harvard's Kennedy School of Government, where he had been elected student body president, and was about to start Harvard Law School.

