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SPECIAL REPORT

The Search for Safety in Investing

by R. G. "Kelly" Caldwell, Jr.

"Are my assets safe?" In the light of recent failures and bailouts of several respected financial institutions, investors are asking this question more than ever. Safety is *the* paramount concern. But as we talk with average investors, we find many unaware that they face two kinds of risk: investment risk and a category we call institutional risk. You must manage both risks effectively in order to safeguard your assets.

Investment risk is the level of risk you assume when deciding to invest your assets. You can adjust this level by choosing CDs, bonds or stocks, for example. The return on your investments will reflect both the level of risk and the market conditions affecting your particular choice.

Institutional risk is perhaps the most important right now, and the only control you have over it is in your choice of financial provider. A level of risk is built into the business models of certain financial institutions—banks, brokerage houses and insurance companies—but absent *by legal mandate* from trust companies and the trust departments of banks.

We have seen numerous failures in the first three categories, each with a significant impact on some investors. If your bank fails, you may not have ready access to your money. If your brokerage house becomes bankrupt, you may not be able to access your brokerage account readily. If your insurance company collapses, you cannot be sure it will be able to pay your heirs the proceeds of your life insurance policy. Even money markets have been threatened of late, with the danger that you may not get back 100 cents for every dollar invested.

Why have so many institutions failed recently? And where has the money gone? Have you ever wondered why brokerage houses will hold your stocks and bonds for free? The answer in most cases is leverage. The business model of banks, brokerage houses and insurance companies is based on making money from the funds invested with them—including your money. If their business decisions fail, your financial security is at risk.

The amount of leverage is the degree to which an institution uses borrowed money (some of it yours) to fund its operations. Some institutions commingle your funds with theirs to make loans, with the intention of making a profit. Typically, a well-capitalized bank retains about ten times leverage, meaning they lend about ten times their capital. Lehman Brothers, one of the oldest investment banking and brokerage firms, had recently been operating with 30 times leverage before it declared bankruptcy.

Many investors find reassurance in the presence of FDIC and SIPC, government-backed insurance programs that provide a minimal level of insurance for bank and brokerage accounts. Be aware, however, that their limits of protection may not cover your assets completely. What if your accounts exceed FDIC and SIPC limits? How can you protect your assets if something goes wrong with your chosen institution?

Before choosing an institution for your funds, you need to understand its business model. To what extent does it use leverage? Since this leverage is accomplished by using investor assets,

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you want to be sure that a failure in its practices will not adversely affect your savings and investments. Should management make a judgment error in its business practices, your money is at risk as well as theirs.

Federal and state laws have removed institutional risk with independent trust companies and the trust departments of banks by forbidding them to employ leverage. In fact, these laws mandate that all client assets held by a trust department or trust company *must* be kept separate and can never be commingled with corporate funds. Your money is always held exclusively in your name. Further, trust departments and trust companies are not permitted to engage in financial services such as lending, mortgages and credit card operations. Even if a particular trust department should ever fail, your assets would never be in jeopardy as they could be with some types of non-trust institutions.

You do not want to entrust your life savings to an institution that can put them in jeopardy. When evaluating a financial institution, analyze your potential exposure to the two major elements of risk. Carefully evaluate the kind of investment help the institution can provide you and your family. More important, learn what institutional risks are inherent in its business model.

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