

INVESTORS CORNERED: “YOU DON’T FIND OUT WHO’S BEEN SWIMMING NAKED UNTIL THE TIDE GOES OUT”¹

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The next wave of FINRA arbitrations is finally approaching the shore. Years of historically low interest rates from 2009 through 2021³ (in some instances negative real interest rates⁴) saw the broader market indices increase *six-fold* over thirteen years. 2022 saw the first sustained pullback in a generation, with over \$30 trillion of stock and bond losses in a single year.⁵ After years of ‘yield hunting’⁶ and asset bubbles⁷ created by these low-interest rate market conditions, valuations across asset classes are reverting towards their means.⁸ Some “alternative” investments, such as cryptocurrencies, have

1. This famous comment was made by Warren Buffett at the Berkshire Hathaway 1994 Annual Meeting in the context of overspeculation in the reinsurance business.

2. Partner, Fishman Haygood LLP. I would like to thank my co-author, and to thank Jeffrey A. Koncius for his help revising this article.

3. Indeed, it is hard to overstate the historically anomalous market conditions of the past decade. Following the 2008 financial crash, the Federal Reserve’s headline Fed Funds rate remained essentially at zero for seven years, did not rise above 1% until June 2017, and did not exceed 2.5% until September 2022. Every single day of the 2010s, the Fed Funds rate was lower than any single day of the 1970s, 80s, or 90s.

4. Talmon Joseph Smith, *Inflation and Deficits Don’t Dim the Appeal of U.S. Bonds*, N.Y. TIMES (Jan. 30, 2022), <https://www.nytimes.com/2022/01/30/business/economy/inflation-bonds-treasury-yields.html>.

5. Tommy Stubbington, Adam Samson & Kate Deguid, *Stock and bond markets shed more than \$30tn in ‘brutal’ 2022*, FIN. TIMES (Dec. 30, 2022), <https://www.ft.com/content/87ed8ea6-4913-4452-9135-498040ad338f>.

6. E.g., Colby Smith, *Desperate hunt for yield forces investors to take ‘extreme risk’*, FIN. TIMES (July 26, 2020), <https://www.ft.com/content/b44281c0-2ddb-46ae-83e2-150461faed65>.

7. E.g., Amy Fontinelle, *What Causes Bubbles?*, INVESTOPEDIA (Updated July 19, 2022), <https://www.investopedia.com/financial-edge/0911/what-causes-bubbles.aspx>.

8. E.g., James Chen, *What Is Mean Reversion, and How Do Investors Use It?*, INVESTOPEDIA (Updated Aug. 18, 2021), <https://www.investopedia.com/terms/m/meanreversion.asp>.

collapsed or been exposed as outright frauds.⁹ The tide has gone out on excess liquidity in asset markets and plenty of people were skinny dipping. Given the financialization of the American economy,¹⁰ the process of unwinding bubbles and frauds is just beginning and will become more dramatic as higher interest rates slow the economy.

Brokers who were giving bad advice and selling inappropriate products—whether unsuitable, over-concentrated, fraudulent, or misaligned with the client’s objective or risk tolerances—will soon run out of excuses for why their predicted “imminent rebound stay the course” has not occurred. Soon their clients will seek legal advice and want to file FINRA cases.

This phenomenon is just part of the historic rhythms, the ebbs and flows of financial markets. The history of the stock market is one of bubbles that beget frauds that beget regulations and litigation that make markets more efficient and safer for investors.¹¹ Indeed, research shows that securities litigation increases market efficiency, the purpose of markets.¹² The securities market is in need of a deep cleanse, and claimants and their counsel are going to spend several years cleaning up the mess created by brokers who spent the past thirteen years engaged in irrational exuberance.

A ‘Rule of Thumb’ for Modern Portfolio Theory is to subtract the investor’s age from 100 to determine the amount to have in equities and the

9. David Gura, *FTX made a cryptocurrency that brought in millions. Then it brought down the company*, NAT’L PUB. RADIO (Nov. 15, 2022), <https://www.npr.org/2022/11/15/1136641651/ftx-bankruptcy-sam-bankman-fried-ft-crypto-cryptocurrency-binance>.

10. E.g., *Financialization*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/financialization.asp>.

11. For a historical review of prior bubbles, frauds and subsequent reforms in markets, See Michael S. Edmiston & Bradley Stark, *The Financial Services Industry’s Historic Pattern of Opposition to Reform: “Wolf” is the Only Cry*, 22 PIABA B.J. 165, 171-72 (2015).

12. Rafael La Porta et al., *What Works in Securities Laws?*, J. Fin. (Jan. 2006), <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2006.00828.x> (“We examine the effect of securities laws on stock market development in 49 countries. We find little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets.”).

remainder in bonds and cash.¹³ Given the almost non-existent yield in Treasuries and other highly rated bonds in this asset class over recent years, we expect to see over concentrations of high-yield junk bonds, stocks, and the many other risky asset classes that rose in valuation due to this vast increase in liquidity. In particular, one can anticipate that brokers sold to investors bonds of companies (or other alternative investments) that were very high risk, and that in more ‘normal’ times these companies would be unable to raise money by selling bonds at any yield.¹⁴

Historically low interest rates created bubbles in many asset classes. Real estate is one such asset class and thus REITS may be found to be over weighted or not of investment grade in many portfolios. Other defective products will emerge amongst the skinny dippers because, as one scholar observed, “(i)f the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension, with a double loss to society: talents are wasted in search for better duping opportunities and the mistrust towards the financial sector increases.”¹⁵

The stock market bubble created ‘Meme’ stocks that had no basis in the fundamentals of finance but rather were popular amongst day traders, some newly minted while stuck at home during the pandemic.¹⁶ Meme stocks were sometimes manipulated by retail day traders themselves and offered enticing returns due to their volatility. Meme stocks such as GameStop Corp. (GME), AMC Entertainment Holdings Inc. (AMC), Blackberry Limited (BB), Bed Bath & Beyond Inc. (BBBY), Koss Corp. (KOSS), Vinco Ventures (BBIG), Support.com, and even the meme stock enabler Robinhood Markets Inc.

13. Daniel Kurt, *Stock Allocation Rules*, INVESTOPEDIA (Updated July 11, 2022), <https://www.investopedia.com/articles/investing/062714/100-minus-your-age-outdated.asp>.

14. Sebastian Pellejero, *Falling ‘Real’ Yields Drive Investors to Junk Bonds*, WALL ST. J. (Updated Nov. 17, 2020), <https://www.wsj.com/articles/falling-real-yields-drive-investors-to-junk-bonds-11605643777>.

15. Luigi Zingales, Harvard University, NBER, and CEPR, *Does Finance Benefit Society?*, Am. Fin. Ass’n Presidential Address (Jan. 2015) at 16, 22, available at <http://faculty.chicagobooth.edu/luigi.zingales/papers/research/Finance.pdf>.

16. Adam Hayes, *What Are Meme Stocks, and Are They Real Investments*, INVESTOPEDIA (Updated Sept. 12, 2022), <https://www.investopedia.com/meme-stock-5206762>.

(HOOD) briefly rocketed upwards, and should be viewed suspiciously if they appear in any portfolio.¹⁷

Other alternative investments were likely unsuitable for any investor. No one should ever have received advice to invest in a cryptocurrency, ever. Besides the fraud sometimes discovered in cryptocurrencies like FTT with its parent issuer, the bankrupt and indicted FTX, the historical volatility of cryptocurrencies is excessive. In addition, there is no substance to cryptocurrencies. A currency issued by a government, no matter how rogue, small, corrupt or inflated, at least has some value because the government of the country accepts it as legal tender. Cryptocurrencies have underlying value, if at all, merely for their ‘greater fool’ pyramid valuation and as an aid to money laundering.

Another defective product that became popular during this period of ‘yield hunting’ was Variable Annuities, often sold in IRA or tax deferred accounts to Seniors. In this issue, Fred Rosenberg’s “Why Variable Annuities are Unsuitable for Seniors” explains why a Variable Annuity found in a retirement account should be carefully scrutinized.

The pandemic created unusual times for investment, but ‘once in a lifetime’ market conditions are not an excuse to suspend the fundamentals of Modern Portfolio Theory (MPT), which is premised on the fact that markets are by definition unpredictable and cannot be timed. This is the basis for diversification in Modern Portfolio Theory. The efficacy of MPT and passive investing is well summarized by Burton Malkiel in “The Random Walk Guide to Investing: Ten Rules for Financial Success”.¹⁸ Malkiel writes, “(i)t’s true that when you buy an index fund, you give up the chance to boast at the golf course that you picked the best performing stock or mutual fund. That’s why some critics claim that indexing relegates your results to mediocrity. In fact, you are virtually guaranteed to do better than average. It’s like going out on the golf course and shooting every round at par. How many golfers can do better than that? Index funds provide a simple low-cost solution to your investing problems.”¹⁹

But passive investment in index funds produces very few fees or commissions, and the financial services industry is not built on the sale of products that yield little return for brokers and advisors. We expect there are much more risky, and expensive, products in many investors’ accounts. Now

17. *Id.*

18. BURTON G. MALKIEL, *THE RANDOM WALK GUIDE TO INVESTING: TEN RULES FOR FINANCIAL SUCCESS* (2003).

19. *Id.* at 137.

that the tide is receding, those investors are only now beginning to discover they were unwittingly skinny-dipping. Having been left cold and exposed by their brokers, many of them will turn to securities arbitration attorneys to provide them a cover up and escort them back to shore.