Is My Money Safe?!

By Kimberly Sterling

There are many examples of financial scandals in the 21st Century, and sadly they continue. Bernie Madoff is at the top of the list. There have also been failures of financial services firms, investment banks and regular banks. In 2008 Lehman Brothers, Bear Stearns, Countrywide and Washington Mutual all failed. And locally, Old Southern Bank failed in 2010 and First Commercial Bank failed in 2011.

It is appropriate for investors to ask, "How am I protected? IS MY MONEY SAFE?!"

First, let's clarify that there are four categories of risk that investors face:

Investment or systematic risk is the risk that investments may fail to produce the return expected. The Tech Crash in 2000 and the Global Recession in 2008 are examples.

Diversification risk is the potential loss from having too much invested in a specific company, industry, geographic area, etc. The losses associated with Enron, WorldCom and Tyco are examples.

Custodial or systemic risk. What happens to your investments if your custodian (i.e., Schwab, TD Ameritrade, etc.) collapses?

Fraud, theft or errors can occur with any custodian or trusted advisor. Bernie Madoff is the best-known example of fraud and theft. All humans and organizations have the potential to make mistakes so it is important to know how you are protected if that happens.

This article isn't intended to be about **investment risk** or **diversification risk**. But let's briefly address them for clarity.

Investment risk

You've heard it before: risk and reward are related. Equities are risky. The trade-off is that they also have one of the strongest levels of reward for the risk you take. Finding the right balance of risk and reward in your portfolio will allow you to stick with a long-term investment plan and harvest the return that suits your comfort level and needs best.

Publicly held markets are safer than ever before in history. They are more transparent, highly monitored and better regulated. We also have greater academic knowledge about the best ways to harness the market through global allocation, low costs and utilization of multiple asset classes.

Diversification risk

Diversification protects you to some degree against Investment Risk. Here's an illustration to demonstrate that. Which portfolio do you think has greater risk?

$1 million dollars invested in Exxon? or

$1 million invested in the S&P 500?

If your answer is "*I need to know what the return will be before answering.*" then you are thinking more about the **return** than the **risk.**

If you answered Exxon, you are correct. Maybe it seems obvious? Yet, many investors still think that if they just find the right investment manager, he or she will be able to pick a few individual stocks that beat the market.

We now know that beating the market in this way is the result of either luck or taking more risk. One single stock is always going to have greater risk than a portfolio of 500 stocks. Likewise, a single asset class of stocks (such as the S&P 500) will have more risk than multiple global classes of stocks (like the portfolio model that RCG utilizes.)

Now let's address the two categories of risk that are the real subjects of this article and talk about how you are protected from custodial risk and the risk of fraud, theft and errors.

Who is Your primary custodian?

Investors rely on their custodian to ensure the safe-keeping of their money. Who is your custodian? It is **NOT** RCG - we do not have custody of your money.

For most of our clients, the primary custodian is Charles Schwab & Company. For others it is TDAmeritrade, Raymond James or Vanguard. The primary custodian holds the mutual funds, executes trades as instructed by RCG and provides monthly statements to the investor.

Did you know you have invisible custodians too?

There are "invisible" custodians behind the scenes. Dimensional Fund Advisors does not have custody. Their custodians are State Street and Citibank. Likewise, Vanguard doesn't have custody either. Dimensional and Vanguard are creating and managing mutual funds. They don't want the job of custodian.

To your benefit, each of these custodians (primary and invisible) adds a layer of protection. Each is monitoring investment shares and cash flow. If something goes wrong at one company, then things won't reconcile with the other.

What happens if your custodian goes bankrupt or out of business?

The first thing to know is that anyone who had their money custodied at Lehman Brothers or Bear Stearns didn't lose a dime. Custodial assets are not the legal property of the custodian and not subject to the claims of creditors. Those investment accounts are separated from the assets of the custodian and not at risk.

However, if an investor bought **shares of stock** in Lehman Brothers or Bear Stearns, their investment would have gone to nothing - or close to nothing. But if they **custodied** stocks, bonds and money with Lehman or Bear Stearns, their investment would have been transferred to another custodian with no impact on value whatsoever.

What safeguards are in place to prevent a custodian from committing fraud or theft?

It is extremely difficult for a custodial employee to steal client wealth for several reasons. Custodians have robust compliance and tracking systems. Each time an employee makes any change to an account, they must log in, and everything is tracked back to that individual employee. The custodian has an internal system to audit each account regularly. Furthermore, the SEC monitors all broker-dealer activity by requiring them to have external auditors come in annually to check all account activity. Finally, the fraud or theft would also likely be caught by other custodians or by RCG because information would not reconcile. RCG (and all custodians) reconcile daily and all differences must be accounted for.

Despite safeguards, how are you protected if there is a custodial business failure, theft or fraud?

We all know that theft and fraud still occur, even with all these safeguards in place. Several sources of restoration are available if it happens.

The SEC has stringent rules in place for all broker-dealers (Schwab, TDAmeritrade, etc.) to protect client's money. One important rule is the Net Capital Rule (15c3-1), which ensures that broker-dealers maintain sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.

In addition to the capital requirements above, the Securities Investor Protection Act of 1970 (SIPA) requires all broker-dealers to be part of the Securities Investor Protection Corporation (SIPC) www.sipc.org. Broker-dealers pay an assessment (a premium) based on the size of their business. SIPC insures each customer for up to $500,000 of which up to $250,000 may be in cash.

On top of the capital retention and mandatory insurance, Schwab has **additional** insurance through Lloyd's of London of up to $150 million per client loss, of which $1,150,000 may be in cash. All of the custodians we utilize have additional insurance as well.

Schwab also has insurance for errors and omissions, crime, and third-party cyber liability.

What about cash and money market funds?

Money market funds are treated like securities in a brokerage firm. So you have $500,000 of coverage from SIPC and $150 million from Lloyds of London as mentioned above.

Cash (also mentioned above) is covered by SIPC up to $250,000 and in addition up to $1,150,000 by Lloyds of London. You actually have much higher protection limits for cash and money market funds in your investment account than a bank since this is much higher than the FDIC limits.

How does RCG protect you from fraud, theft and errors?

How did Bernie Madoff manage to defraud clients for so many years? Because he had BOTH custody and investment discretion. No one was reconciling to his records. He also paid off his "small-time" CPA/Auditor to look the other way.

Here at RCG, you have multiple organizations that are monitoring all the other organizations in the process. Your primary custodian, your invisible custodian, the mutual fund companies, and RCG reconcile daily through independent systems.

Sometimes we hear clients talk about the risk of "having all your eggs in one basket". Bernie Madoff is a good example of that metaphor. Having all your money with RCG is the extreme opposite. In addition to the multiple organizations (baskets), your portfolio is spread out among close to 12,000 stocks (more baskets) and about 4,000 bonds, if you have fixed income.

Like the brokerage firms, RCG has systems and processes in place to hold employees accountable. Trading always involves two advisors with a certain level of experience. Trades and account values are reconciled daily. Our Compliance Department monitors the regulations and our systems for compliance. As you can imagine, compliance regulations have steadily increased in the 21st century.

RCG has several types of insurance in place to protect clients. One is errors and omissions insurance. Clients are covered for up to $2 million for one claim and RCG is covered up to $5 million in aggregate annually.

The other type of insurance we carry is for theft or fraud. Clients are covered up to $1 million for employee theft and funds transfer fraud. We also have an aggregate limit of $500,000 for cyber liability.

But wait, there's more!

There is one more custodian behind the scenes. The Depository Trust & Clearing Corporation (DTCC) provides clearing and settlement services to the financial markets. It provides a way for buyers and sellers of securities to make their exchanges in a safe and efficient way. It also provides central custody of securities.

DTCC was established in 1999 to combine The Depository Trust Company (DTC) and National Securities Clearing Corporation (NSCC). It automates, centralizes, standardizes, and streamlines processes in the capital markets for equities, corporate and municipal bonds, unit investment trusts, government and mortgage-backed securities, money market instruments, and over-the-counter derivatives. It also manages transactions between mutual funds and insurance carriers and their respective investors.

In 2011, DTCC settled the vast majority of securities transactions in the United States and close to $1.7 quadrillion in value worldwide, making it by far the highest financial value processor in the world.

In conclusion

Your money is safe at RCG. We hope this detailed information provides you with peace of mind. Let us know if you have any specific questions.