The Raj Insider Dealing Sideshow

 Reuters

By James Saft
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If you as an investor think that insider dealers like Raj Rajaratnam are a top concern then I have a bridge, or perhaps an intricate highly-structured investment vehicle, to sell you.

Rajaratnam, the erstwhile billionaire and founder of hedge fund Galleon Group, was found guilty of 14 counts of securities fraud and conspiracy charges on Wednesday in a case that unveiled multiple instances of Rajaratnam obtaining and acting on inside information.

This has prompted all sorts of silliness to be asserted to the effect that the conviction will either restore investors’ faith in U.S. financial markets or stand as a testament to why investors don’t believe they will get a fair shake.

To be sure, much of the trial was genuinely shocking, not least allegations that Rajat Gupta, one-time global head of consultants McKinsey, and then a serving board member at Goldman Sachs, had called Rajaratnam within minutes of leaving board meetings. One call, which Rajaratnam was alleged to have acted on, took place 23 seconds after the meeting was gavelled. This is the Wall St. equivalent of finding out that the Pope leads black masses or seeing the Dalai Lama ringside at a dog fight.

Gupta, who denies wrongdoing, faces civil insider trading charges from the Securities and Exchange Commission.

While the prosecution is right and proper, and I look forward to many more similar trials, insider dealing is well down the list of forces that separate the average saver from what should be the fruit of his investments.

It is not the obvious problems, the things that are already crimes, that are the big issues, it is the outrages that are so normal we have all grown used to them, like executive compensation.

The average CEO makes 185 times the average worker in the U.S., having risen from just 35 times more in the late 1970s.

To make an understatement, shareholders have not shared fairly in the gains in innovation and efficiency they have bankrolled.

And in fact the times of worst excess in compensation are exactly the same times when shares are rising to unsustainable peaks, as in 2000 and 2007, as boards and executives play a cozy game of writing and cashing in share options. Now theoretically shareholders can oust boards and thereby impose pay discipline on executives, but the reality is that there are massive impediments to them doing so. Lucian A. Bebchuk, a Harvard Law School professor, went so far as to describe the idea of the power of the shareholder franchise as a “myth,” though given the way investors are treated like children perhaps the better term would be fable.
Can it be a coincidence that the periods of fastest growth in executive pay coincide so neatly with periods when it would have been foolish to buy shares?

**DEATH BY 2 AND 20**

Or take fees paid for investment management, that eternal example of the triumph of hope over experience. There is no solid evidence that money management is a skill that can be sustained over time, much less that you or the person you will pay to pick a manager can identify who will turn out to be a winner.

John Bogle, the founder of index fund giant Vanguard Group, and one of the great proponents of the philosophy of buying, holding and keeping the fees you pay low, points out that in the 40 years ending in 2008 $10,000 put into an S&P index tracker would have yielded more than $346,000. Actively managed domestic equity funds returned just over $200,000 in the same period. That’s a lot of fees, a lot of trading, a lot of lunches and client seminars.

The amazing thing about investment is that, as in fashion, it is usually the rich who get played for the worst fools. The aging fashionista spending tens of thousands for a haute couture outfit and the well-heeled investor listening uncomprehendingly over a nice lunch to a pitch for a hedge fund-of-funds, which piles fee totteringly upon fee, are siblings beneath the skin.

There is, again, no good evidence that hedge funds, or for that matter private equity vehicles, pay off in aggregate. There are plenty of people out there who would have made you rich, but perhaps more who would have left you poorer than if you had simply bought passive funds and sat on your hands.

The money lost in wasted fees must surely dwarf the money lost to crooked trading in scale, and the remedy is so cheap and so readily available.

So by all means, let’s go after Rajaratnam and his ilk; they’ve always been with us and always need controlling. Let’s not, however, confuse a capital market that is acting in accordance with the law with one that is functioning properly.