

BET THE RANCH

JANUARY 2005

“Don’t worry, Mr. & Mrs. Jones. Take out a home equity loan. Borrow the money to buy our latest IPO. You will make a fortune!”

The National Association of Securities Dealers is now investigating one of the more disgusting examples of brokerage house malfeasance that I have ever seen (And I have seen a lot). What I first thought were some isolated cases that I have helped several investors work their way out of seems to have spawned to epidemic proportions. Brokerage firms have been actively pushing individuals to borrow large sums of money on their homes to invest in the stock market. More often than not ***“betting the ranch”*** has turned out disastrous for the client.

This past month the NASD warned brokerage firms that they must utilize extra caution when recommending that investors take money out of a home to speculate on stocks. Really? Gee, thanks a bunch NASD! You should receive the master of the obvious award for January 2005. The NASD also stated that firms should disclose more fully both the risks and potential conflicts of interest.

“Investors may fail to recognize potential conflicts of interest, such as a broker’s interest in generating commissions or fees on investments from the cash proceeds of a refinancing or home equity line of credit.”

When reading this I was reminded of the old Jon Lovitz, Saturday Night Live character, the pathological liar. ***“Yeah, yeah, that’s the ticket...disclose conflicts of interest.”*** Investors need to understand that when these *“warnings”* come down from the NASD they are treated by the major brokerage firms with about as much respect as toilet paper. Think about it, ***“What are you going to do, fine me or suspend me for five days?”*** Randy Moss of the Vikings showed greater respect for his *“mooning”* fine than these guys do.

The NASD does not regulate mortgages so they are a bit handcuffed by this latest trend and the attorneys at the investment houses know this. It looks like we could have a jurisdictional nightmare where the losers will once again be the investors. We have received dozens of calls over the past few months from investors inquiring about why their broker is pushing them into 100% mortgages, interest-only mortgages, and the usual second mortgages. Say bye-bye home equity!

Ann Davis of the Wall Street Journal reported that in recent years giants such as Merrill Lynch, Citigroup/Smith Barney, and others have been encouraging brokers to go beyond stocks and bonds and look for other ways to maximize fee income from a diverse array of products, including mortgages, bank accounts and credit cards. Let me get this straight, these firms have been completely inept at managing individuals investment accounts now they want to advise them on debt? ***“Yeah, yeah, that’s the ticket.”***

Merrill Lynch states that they take great care to train brokers not to recommend inappropriate mortgage strategies. Smith Barney brokers hawk a wide variety of mortgages as well. They state that it shares the concerns of the NASD. ***Yeah, yeah, that’s the ticket.”***

Ann Davis this past month reported some recent examples of the great concern that brokerage firms have shown regarding the use of mortgages.

When upstate New York residents James and Sandra Dygert needed to put two teenage children through college a few years ago, their broker convinced them to turn their only significant asset, their home, into a vehicle for quick stock-market gains.

The Dygerts had a mortgage of about \$53,000 on a home valued at \$110,000. They contend that their Merrill broker recommended generating \$60,000 of instant cash by taking out a mortgage through the firm that would more than double the amount of the loan. They placed the \$60,000 in stocks in a Merrill brokerage account in late 1999. "The idea that was presented to us was essentially, *'Why go to the banks to borrow money for school? Why don't you let your home be your bank?'*" Mr. Dygert recalls.

Merrill, who hasn't been sanctioned for any abuses in this area, (YET) says the Dygerts got their loan by promising that they weren't actually going to use the money to invest in securities. Merrill says the Dygerts then deposited money from a personal check with their broker. The firm denies the Dygerts did this because of the brokers' advice, saying, "These clients misrepresented their intention." ***"Yeah, yeah, that's the ticket."***

Soon, according to the Dygerts, their college fund had mostly vanished, as technology stocks took a bath in the busted boom. (Why was a college fund invested heavily in tech stocks?)

Merrill's sales literature doesn't recommend that people pull money out of their home for stock trades. However, it does highlight the variety of roles that the firm seeks to fulfill in clients' financial lives. In a brochure distributed at Merrill's annual meeting this year, it states: *"You may think of your mortgage as a way to buy a house. At Merrill Lynch, we see it as a way to build your wealth."* ***"Yeah, yeah that's the ticket."***

Earlier this year, the NASD brought enforcement actions against former brokers at three separate firms -- WMA Securities Inc., Washington Square Securities and First Union Securities -- for making allegedly unsuitable mortgage recommendations to customers. In the case against First Union, now part of **Wachovia** Corp., a couple in Vail, Colo., in 2000 used \$400,000 of equity from their home to buy an annuity that generated the firm a commission of \$19,950, of which the broker kept \$7,980. Their net worth, excluding their \$800,000 residence, was \$110,000, according to the NASD complaint.

The annuity, essentially a tax-advantaged mutual fund with an insurance component, was valued at only \$184,187 by June 30, 2002. After the couple complained, Wachovia issued them a check for \$260,707, the NASD said. The broker has settled the case without admitting or denying wrongdoing and was fined \$26,280 and suspended for 30 days from the securities industry. First Union declined to comment.

Charles W. Austin Jr., an attorney for individual investors in Richmond, Va., says even wealthy investors don't always understand how such strategies might backfire. In another Merrill case, Joel Rhine, an attorney for Wilmington, N.C., widow Maureen Roberts, said she told her broker in 2000 she planned to buy a home in the mid-\$400,000 range by plowing proceeds from the sale of her existing smaller home. According to her pending arbitration claim against Merrill and the broker, she was persuaded to take out a mortgage for the full purchase price of the home, depositing her sale proceeds into Merrill investment accounts. Ms. Roberts says her investments were too heavily concentrated in technology stocks that subsequently plummeted. Merrill says it was her decision.

In a statement, Merrill said, "The Roberts case is not about investing mortgage proceeds, it's about a sophisticated investor with 15 years experience who made bad investment decisions and now seeks to shift the blame to Merrill Lynch." ***"Yeah, yeah that's the ticket."***

The Dr. Frankenstein's of Wall Street have created another monster capable of separating individuals and their money. Use extreme caution when approached with one of these mortgage deals. If you were sold one of these vehicles or have any questions please do not hesitate to contact us at (800) 447-0579.