

## The Case

This case was developed by the MIT Sloan School of Management. It is part of their “*Learning Edge*,” a free learning resource. This case was prepared by John Minahan and Cate Reavis. This case is based on actual events. Actual names are changed; some of the narrative is fictional.

In early 2012, as he prepared to enter a meeting with the board of trustees of a state pension fund, Harry Markham, CFA, couldn't help but feel professionally conflicted.

Since earning his Master of Finance in 2004 at one of the top business schools in the United States, Markham had worked for Investment Consulting Associates (ICA), a firm that gave investment advice to pension funds.

Since joining the firm, Markham had grown increasingly concerned over how public sector pension fund liabilities were being valued. If he valued the liabilities using the valuation and financial analysis principles he learned in his Master of Finance and CFA programs, he would get numbers almost twice as high as those reported by the funds.

This would not be such a problem if he were allowed to make adjustments to the official numbers, but neither his clients nor his firm was interested in questioning them. The board did not want to hear that the fund's liabilities were much larger than the number being captured by the Government Accounting Standards Board (GASB) rules and his firm wanted to keep the board of trustees happy.

How, Markham wondered, was he supposed to give sound investment advice to state treasurers and boards of trustees working from financials that he knew were grossly misleading?

Markham's dilemma came down to conflicting loyalties: loyalty to his firm, loyalty to the boards of trustees and others who made investment decisions for public pensions and who, in turn, hired his firm to provide investment expertise, and loyalty to the pensioners themselves, as Markham believed was called for by the CFA Code of Ethics and Standards of Professional Conduct.

In his role as investment advisor, the differing views on how to value pension liabilities challenged Markham on both a practical and an ethical level. "My role is not to decide the value of liabilities," he explained.

That is the actuary's job. My role is to give investment advice. However, as an investment advisor, the first thing you want to understand is the client's circumstances. That is a basic ethical precept. The CFA professional standards say you should never give advice without knowing what your client's circumstances are. And so what happens is that we have these funds that are grossly short of money, but the accounting does not show them as being grossly short of money. I make the case within my firm that we need to know where we

are starting before we give advice. And perhaps our advice would be different if the client knew they were starting from a multi-billion-dollar hole that they're seemingly not aware of.

In addition to the fact that Markham was constrained by not having what he believed were accurate accounting figures to work with, he was also well aware that his clients did not like bad news. He feared that if he was to raise the liability issue, he and his firm could very well be fired:

Most plan sponsors want to minimize near-term contributions to their pension fund, and this makes them predisposed to points of view that justify higher discount rates. Furthermore, investment committees and staffs consider their mandate to be to earn, at least, the discount rate assumed by actuaries. The social pressure to embrace overly optimistic return expectations can be enormous. As one plan sponsor told me, 'It would not be in plan members' interest to lower the discount rate because the increase in liabilities would so shock the taxpayers and the state legislature that it would undermine political support for the plan.' Given this context, plan sponsors do not want to hear the news that they are less well funded than the numbers show and may blame the messenger. Moreover, if it is an elected official you are dealing with; they do not want a crisis on their watch.

Nevertheless, an investment advisor has a professional responsibility to help plan sponsors make sound investment decisions, and understanding one's financial condition is a necessary precursor to making sound investment decisions. This may require telling plan sponsors things they do not want to hear. If investment advisors do not do this, they become enablers of their clients' denial and of the poor decisions that result from that denial.

As a CFA charterholder, Markham annually attested to his compliance with the Code of Ethics and Standards of Professional Conduct. Specifically, CFAs must not knowingly make any misrepresentations in investment analysis recommendations. "So if you have an investment recommendation that is based on bad numbers," Markham began, "numbers that are legal and comply with the rules, but you know they are bad, are you violating this ethical rule?"

As Markham was summoned into the conference room to begin his presentation to the board of the state pension fund, he was wrestling with whether or not to raise the liability issue. He knew there were risks either way. There was the risk that his client would choose to take their business elsewhere if he told them what he believed to be the fund's financial reality. Furthermore, such a move would not only result in lost business but would likely be interpreted as disloyalty towards his firm.

Then he thought about what did not happen during the 2008 financial crisis, and this reality gnawed at him:

When the subprime crisis played out, everybody was asking why, even though all these people had a role in making it happen, no one spoke up? Therefore, does somebody who is playing a bit part in creating a reprise of the last crisis have a responsibility to speak up on behalf of the pensioners

themselves even though this is contrary to the wishes of their employer and the board of trustees who has hired their employer to provide investment advice?