
Birth of a Profession

THE INDEPENDENT ADVISER PROFESSION—OR “investment counseling,” as it was originally called—owes its existence to a convergence of events and influences in the first quarter of the twentieth century. It was shaped by a few tireless, visionary individuals who saw beyond traditional investment services to a new model that valued the client relationship more than the financial product. And it was tested and strengthened by a series of investigations and reforms that grew out of President Franklin D. Roosevelt’s New Deal.

Some background is useful here. In the early years of the twentieth century, corporate America was barely emerging from the era of the robber barons—bankers and industrialists whose great achievements were often matched by equally great abuses of power. As late as the 1920s, investing in most American companies was viewed as a highly risky activity. Pioneering investment adviser Theodore T. Scudder wrote that “prior to 1900 corporate morals were so low that common stocks of practically all publicly held companies could be considered nothing more than outright speculations.”¹

Investment bankers, insurance companies, and professional trustees dominated the investment profession; none allowed individual investors much control over their investments other than to

say yes or no to a recommendation. The firms that offered investment advice were the same firms that sold investment products.

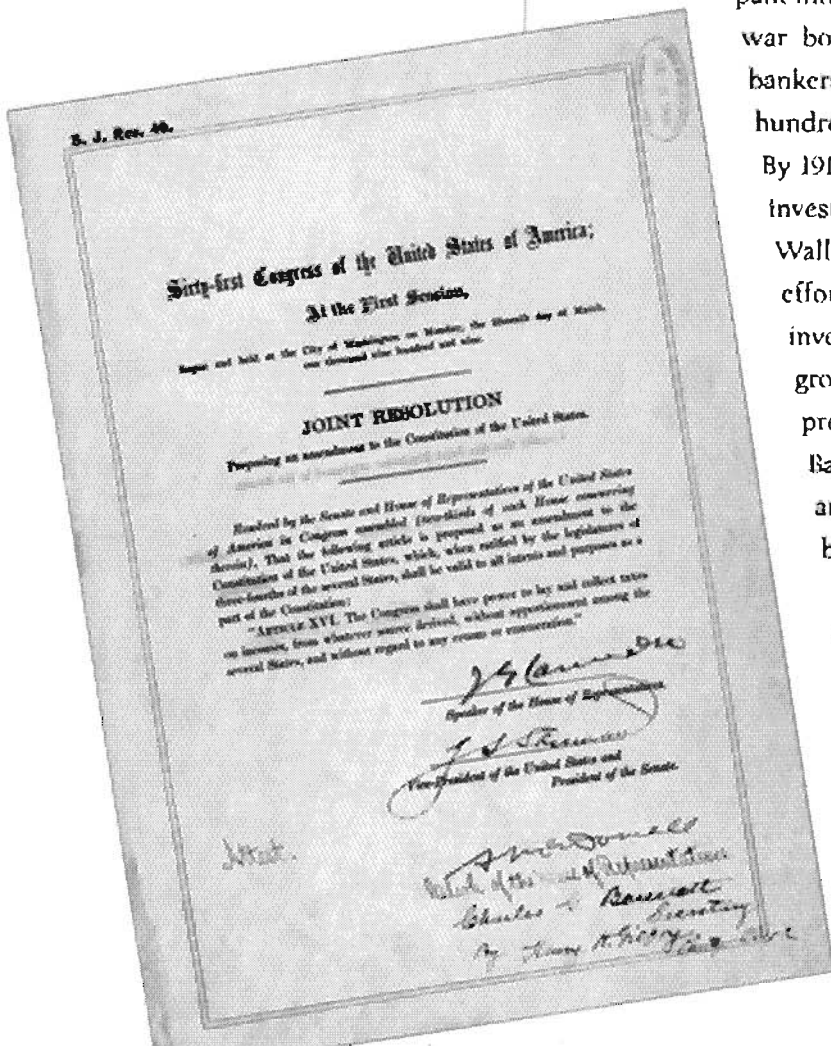
In 1912, Arsène Pujo, a Democratic congressman from Louisiana, received authorization to form a House committee to investigate the “money trust”—a group of financial leaders who were abusing the public trust to consolidate their control over many industries. The committee’s findings lent support to a number of reforms, including the Sixteenth Amendment to the Constitution, which authorized a national income tax and was ratified in 1913; the Federal Reserve Act, also in 1913; and the Clayton Antitrust Act in 1914. The Imposition of the federal income tax in particular stimulated interest in investment counsel.

The 16th Amendment established Congress’s right to impose a Federal income tax.

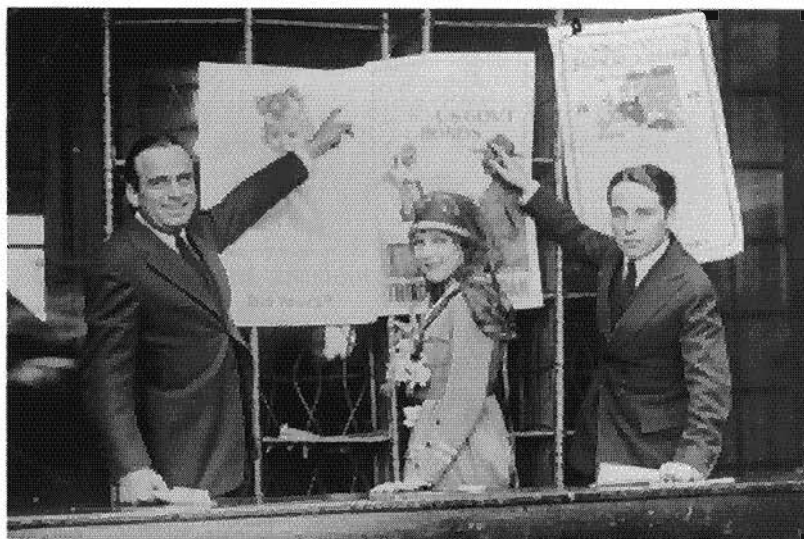
In 1913, due to generous exemptions and deductions, less than 1 percent of the population paid income taxes

Then came World War I and a second major influence on investment patterns: the issuance of huge numbers of bonds to finance the war effort. The liberty loans, as they were known, were the largest bond issues of their time; by 1919 more than \$21 billion in bonds were sold, in denominations of \$100 each. Ordinary Americans who had never been “speculators” responded to the U.S. Treasury’s exhortations to buy them—some out of patriotism and others because the bond issues were a tax-exempt hedge against the rampant inflation of the war years. In 1917, when the first war bonds were issued, Wall Street investment bankers had estimated that no more than three hundred fifty thousand people would buy them. By 1919 more than eleven million Americans had invested in liberty loans. “Inadvertently,” writes Wall Street historian Charles R. Geisst, “the war effort had given the vast majority of small investors a taste for securities that would only grow stronger in the 1920s.”² Charles Mitchell, president and chairman of the National City Bank (later Citicorp) referred to “a large, new army of investors . . . who may in the future be developed into savers and bond buyers.”³

A brief, severe recession followed the 1919 Armistice. But by 1922 the United States had made a striking recovery. The country



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experienced a surge in business activity that raised living standards, generated entrepreneurial wealth, and opened the door to a deluge of securities issuance on Wall Street. Between 1919 and 1929, the annual rate of corporate securities issuance nearly quadrupled. The flood of securities coming to market in those boom years overwhelmed amateur investors. They needed expert help to identify investments with good prospects amid the mass of new issues. As one investment adviser later described the situation, “The average private security buyer, whether he was retired or in active business, or even if he were to some extent connected to finance, had not the time or the money to cover the entire investment field and choose from the securities that were soundest and best suited to his particular objective. And in most cases he did not have the experience.”⁴ Moreover, the boom was playing out against a backdrop of economic uneasiness. The Federal Reserve was relatively new, and price stability was not yet on the horizon. Between 1913 and 1920, inflation had eroded fully half the dollar’s value. Caution, even fear, was the watchword of many investors in the 1920s. Preserving capital and its purchasing power was a major objective.

It was in this environment that a small number of independent advisers—then self-styled as “counselors”—got their start. In general, their clients weren’t speculators trying to cash in on a stock tip overheard at a speakeasy. Instead, they tended to be business

THEODORE SCUDDER, FOUNDER. SCUDDER, STEVENS & CLARK



As a young bond salesman in Boston, Theodore Townsend Scudder longed to expand his horizons. Born in 1889, Scudder had graduated from Harvard and gone to work as an office boy at an investment banking firm, then quit because he wasn't being trained for advancement. He returned to the firm in 1912 to take a sales position, at which he excelled. Yet he still wasn't satisfied. "It did not take me more than three months," he later wrote, "to come to the conclusion that although

I was selling securities in exactly the same way as other salesmen, I was not doing a good business."

What was missing? A clue came during a conversation Scudder had with Frederic H. Curtiss, chairman of the Federal Reserve Bank of Boston, during a sales call. "Have you looked all over these bonds, and do you think they are perfectly good?" Curtiss later recounted. Yes, he had, Scudder replied. "And then I said, 'Well, how do you know that is what I need?' ... Well, [Scudder] hesitated and said of course he didn't. ... Then

[Scudder] said, 'What is needed here is a separate agency that will give advice and that would have no interest in the things they have to sell.'"

As a result of insights like this one, Scudder left the investment banking firm in 1914 and went into business in Boston under the wing of a local brokerage house. In 1919, he established his own firm, Scudder, Stevens & Clark, with two fellow Harvard alumni, Sidney Stevens and F. Haven Clark.

At first, the three men remained in investment banking, offering investment counsel without charge. But it soon became clear that their advice was at least as valuable as their banking services. So Scudder approached about twenty clients and offered them counsel "on an impartial and increasingly expert basis. We agreed that they would tell us their complete portfolio and other pertinent facts, such as how much life insurance they carried, how much real estate mortgages they owned, what they needed per annum to live on, etc. We would

then diagnose their situation and suggest to them what we believed to be a sound investment

program to follow." In return, clients would pay the firm a fee of 1 percent of the value of any securities bought or sold on the firm's advice.

It was a "whole new revolutionary concept where instead of selling products, you're selling advice," observes David G. Tittsworth, executive director of the Investment Adviser Association (IAA) in Washington, D.C. "To me, that's the beginning of the investment adviser business."

Stevens found the concept too radical. After just one year, he retired from an active role in the firm. A few months later, Scudder and Clark wrote a five-page business prospectus in which they established the profession's first principles: offer "unbiased expert advice," create a diversified portfolio, and provide constant supervision of the account.

Scudder died in 1953, before the true flowering of the independent investment adviser profession. But his vision continues to guide every practitioner.

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owners, corporate executives, and members of the professions—knowledgeable individuals of means looking for ongoing advice in a challenging investment environment. Rising prosperity had given them the assets to meet the minimum account size required by independent advisers, typically \$1 million or more in today's dollars. And waves of innovation, which had brought forth the radio, the refrigerator, and air mail, among other novelties, increased their tolerance for new ideas and made them willing—even eager—to take a chance on independent financial advisory firms. The two new breeds—the independent adviser and the affluent client willing to delegate investment management to a trusted professional—emerged together. Both prospered as a burgeoning economy and a bull market created unprecedented new wealth. Though small in overall numbers—the SEC in 1942 reported just 753 registered advisers⁵—independent advisers represented a significant change in the status quo and an influence much greater than their size would suggest.

the pioneers

Who were the early investment advisers? What inspired them to pioneer a new profession?

Arthur M. Clifford was motivated by chance and imagination. He had opened his brokerage firm in Los Angeles in 1911, when that city's population numbered less than four hundred thousand. In 1915, one of his wealthy clients asked him to review her \$30 million in assets, and from then on Clifford called himself an "investment counselor and financial analyst." By 1921, Clifford was focusing exclusively on investment counsel and charging fixed fees for his services. His firm, Clifford Associates, is still active in Pasadena, California.⁶

Across the country in Boston, frustration and restlessness spurred Theodore T. Scudder to invent his own brand of investment counsel. In 1919, the young bond salesman had founded an investment bank with two partners, Sidney Stevens and F. Haven Clark, but he became dissatisfied with the conflicts of interest he faced serving customers of securities firms. Those firms held stocks and bonds from corporate underwritings or their trading inventories and—not coincidentally—often recommended those very securities to their retail customers. The savvier customers protested. Scudder

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later told the story about one hard-nosed customer to whom he'd tried to sell some bonds. "How do you know I should buy this bond?" the man shot back. "Perhaps I already own too many bonds. Perhaps I should buy more. How can a doctor or lawyer advise you what to do if they don't know all about you?" Finally, before shooing Scudder out of his office, the man declared, "I'd be willing to pay for unbiased advice if I could find it." He became Scudder, Stevens & Clark's first client when the firm left the investment banking business in 1921 to focus solely on investment advice.⁷

Slowly but persistently, other firms followed the lead of the pioneers on both coasts. By 1929 there were as many as seventy "investment counsel" firms throughout the country,⁸ including Laurence Booth & Company in Los Angeles; Farwell & Company (later Sheridan, Farwell and Morrison) in Chicago; Cambridge Associates and Eaton & Howard in Boston; Haydock, Cressler & Lamson in Cincinnati; and Investors Economic Services in Milwaukee. In addition to supervising wealthy clients' personal funds, the firms managed their clients' trusts, endowments, and charitable funds. Thus they were not only the country's first independent financial advisers but also the first independent money managers.

The new independent financial advisers differed in striking ways from their predecessors and competitors. First, they focused on their clients' unique needs rather than on selling a particular product. Second, they styled themselves as professional practitioners, emulating lawyers and accountants in the way they dealt with clients. To reduce conflicts of interest, many offered no services other than investment advice. Typically, they helped clients identify investment goals, set priorities, and prepare a formal investment plan. Investments were continuously monitored and supervised. Their fees, usually based on assets under management, were fully disclosed and paid directly by the clients. This method of charging fees required advisers to value client portfolios regularly and helped direct the attention of investment professionals to the performance of the client's total holdings. The experience of Scudder, Stevens & Clark illustrates the evolution of fee arrangements. When it entered the business, the firm charged 1 percent of all transaction amounts, either sales or purchases, with brokerage charges coming

out of Scudder's fee. Not only did that approach generate inadequate revenue, it also—contrary to the firm's philosophy—encouraged transactions. Scudder replaced that structure with a one-half percent fee on assets, with the brokerage fee being paid by the clients, and soon imposed a 1 percent fee on assets with breakpoints for larger account balances.⁹

A third innovation was financial planning. As a discipline and a profession, financial planning would not be recognized until the early 1970s (the College for Financial Planning, founded in Denver in 1972, was the nation's first financial planning educational institution). But these early independent advisers pioneered some of the essential tools of the financial planning process. In his 1940 testimony to the Senate Banking Committee, Charles M. O'Hearn of Clarke, Sinsabaugh & Co. in New York described his firm's approach in a way most modern financial planners would recognize and endorse:

Our first task is to prepare and maintain for each client a broad plan for his general financial objectives and for the methods appropriate to their accomplishment. . . . In making the plan, we must determine the soundness of the relation of his income to his standard of living. We must also consider his capacity to assume financial risks, his probable future expenses for educating his family, the number of his dependents, and so forth. We must establish with each client a relationship of trust and confidence designed to last over a long period of time because economic forces work themselves out slowly. Business and investment cycles last for years and our investment plans have to be similarly long-range. . . . It is not our objective to make money for him in a series of spectacular moves.¹⁰

Above all, independent advisers believed that ethical standards, professional objectivity, and trust were the keys to their success. When the Investment Counsel Association of America (predecessor to the Investment Adviser Association), the industry's first trade group, adopted its code of professional practice in 1937, an important provision was that "neither the firm nor any partner, executive or employee thereof should directly or indirectly engage in any activity which may jeopardize the firm's ability to render unbiased investment advice."¹¹

"ADVISER" OR "COUNSELOR"

In the early part of the last century, when the first independent advisers—Theodore T. Scudder, Arthur M. Clifford, and their contemporaries—were setting up shop, no term existed to describe their profession. They settled on *investment counsel*, which comprised education and "unbiased expert advice." *Counselor* remained the preferred term for several decades. The Investment Counsel Association of America, the first nonprofit organization to represent the new profession, was founded in 1937 in response to the Securities and Exchange Commission's moves to investigate investment trusts; the ICAA later played a role in the creation of the Investment Advisers Act of 1940.

The act further defined *counselor* and restricted its use:

The Investment Counsel Association of America, formed in 1937, became the Investment Adviser Association in 2005

only advisers who rendered "investment supervisory service" and gave "continuous advice as to the investment of funds on the basis of the individual needs of each client" could call themselves "investment counselors." The definition intentionally excluded others who were required to register under the 1940 act, such as newsletter publishers who dispensed advice but didn't manage money.

Gradually, however, practitioners began using *adviser* instead of *counselor* as an umbrella term, with *counselor* as a subset. In 1975, the ICAA established the Chartered Investment

Counselor program "to recognize the special qualifications of persons employed by member firms whose primary duties are consistent with section 208(c) of the Investment Advisers Act of 1940 (pertaining to the use of the term 'investment counsel')." The ICAA changed its name in 2005 to The Investment Adviser Association. Most states require licensing for investment adviser representatives through an exam called the Series 65. In addition, to use certain industry trade group marks such as "Certified Financial Planner," "Certified Financial Consultants," "Certified Financial Analysts," and "Certified Investment

Counselors," such industry groups require practitioners to pass specific certification exams.

Group Formed by Investment Counsel Here

Rose to Head Organization; Officers, Directors and Code of Ethics Approved

Investment Counsel Association of America was formally organized yesterday, and officers, directors and a code of professional ethics approved at a meeting of the Bankers Club. Dwight Rose, of Brundage, Story & Rose, was elected president, to serve until the first annual meeting, to be held in May, 1938.

The rapid growth of the investment counsel profession since the formation of the first firm in 1919 has shown clearly the need of a professional organization to promote the interests of its practitioners, the organizers maintain. Investment counseling is the largest field directly associated with the securities business that is not now under state or Federal regulation, but it is well known that members of the Securities and Exchange Commission have interested themselves in prospective regulation, particularly Commissioner William O. Douglas and Dr. Paul Goussich, director of the research division.

The code of professional ethics adopted yesterday attempts to set up in a broad manner the objectives of the association, and at the same time to, create standards which, the