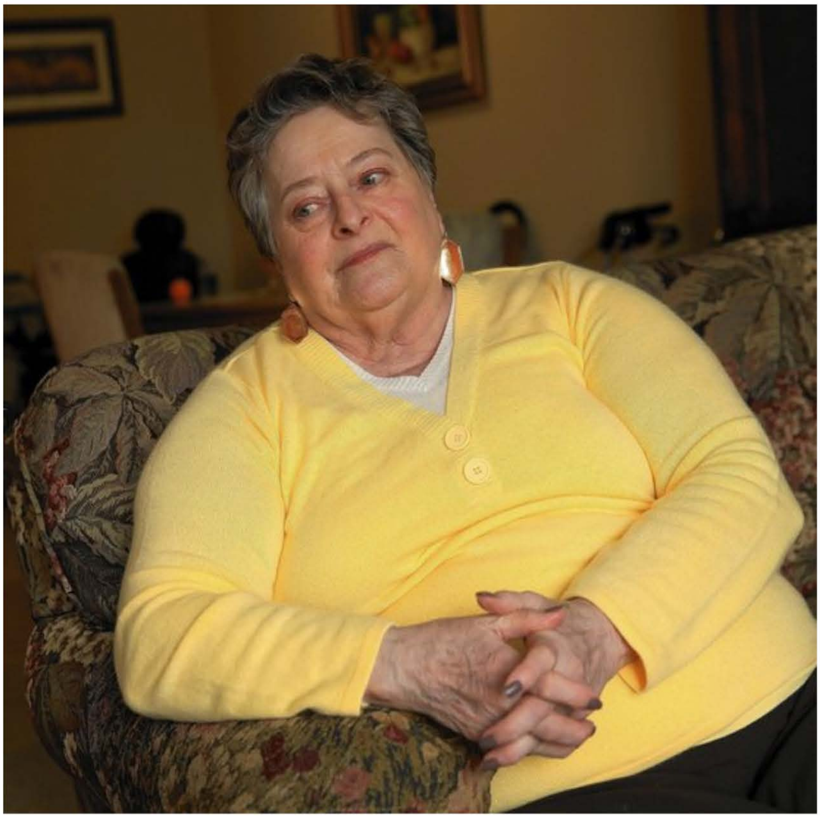
Investor's loss in mutual fund isn't uncommon

Schaumburg resident's experience in alternative fund is painful to accept, spurs complaint with agency that has issued a warning about such investments



In 2012, Cecilia Kruczek, of Schaumburg, learned that a brokerage employee had lost $100,000 of her money in a leveraged, actively traded fund just when she needed the cash. Recently, the Financial Industry Regulatory Authority issued an investor alert about alternative or "alt" mutual funds, which use strategies that differ from the industry's more typical buy-and-hold practice. (Terrence Antonio James, Chicago Tribune / February 23, 2014)

By Becky Yerak, Tribune reporter

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Cecilia Kruczek, a retiree living in Schaumburg, thought she could relax after she rolled over the individual retirement accounts held by her late husband.

The nest egg had been held in bank certificates of deposit, but Kruczek's sister and niece recommended that she get professional financial advice from a brokerage. Her main goal was to safeguard her principal, but she said the brokerage, in 2010, began putting most of the money, $223,000, into a leveraged, actively traded fund that invested in precious metals.

In 2012, Kruczek learned that a brokerage employee had lost $100,000 of her money just when she needed the cash to buy into an assisted living facility after a lengthy hospital stay.

"I was hysterical when I realized what was going on," said Kruczek, 73.

Last year, she filed a complaint with the securities firm watchdog Financial Industry Regulatory Authority; the case is ongoing.

FINRA recently issued an investor alert about alternative or "alt" mutual funds, which use strategies that differ from the industry's more typical buy-and-hold practice.

An alternative fund often holds more nontraditional investments and employs more complex and aggressive trading strategies, including the use of leverage and the purchase of swap agreements and other derivatives, to boost performance on a daily basis.

Last month, two St. Louis brokerages owned by Stifel Financial Corp. were ordered to pay more than $1 million in restitution and fines for selling leveraged exchange-traded funds to 65 consumers who suffered losses. FINRA said some brokerage representatives didn't even understand what they were selling.

Stifel neither admitted nor denied the charges, but it consented to the entry of the findings, FINRA said.

As of the end of 2013, more than $3.3 billion was invested in U.S. leveraged mutual funds like the one that Kruczek invested in, up from about $2.1 billion in each of the previous two years and at a six-year high, according to funds tracker Morningstar Inc.

Kruczek's fund had a goal of achieving 1.5 times the performance of the Dow Jones Precious Metals Index on a daily basis — meaning that its performance over a longer time period can differ significantly. For periods longer than one day, the fund itself acknowledges in its prospectus, it will lose money when the underlying index is flat, and "it's possible that the fund will lose money over time even if the level of the index rises." (See box for a hypothetical example.)

"Leveraged funds are funds on steroids," says Chicago securities lawyer Andrew Stoltmann, who is representing Kruczek. "Using these investments is like throwing rocket fuel on a fire, because they can implode extraordinarily quickly and are truly only suitable for the most sophisticated investors."

When the market is volatile, investors who own these securities "have a real chance of losing significant sums of money quickly," Stoltmann said.

Kruczek's claim is against LPL Financial, H. Beck Inc. and her broker. Her broker briefly worked for LPL before joining H. Beck.

LPL declined to comment, saying the case was pending. H. Beck also declined to comment. The broker has been in the industry since 1987 and has three other complaints on his record, mostly related to not disclosing risks or misrepresenting them.

Among other things, Kruczek's claim alleges, the broker failed to adequately disclose the risks of the leveraged precious metals fund.

"This is a little old lady who couldn't afford to take the risks associated with the products," Stoltmann said.

Kruczek was born in Chicago, graduated from Good Counsel High School and didn't go to college.

In January 2010, she began to invest her husband's retirement money, which was most of her investable assets, with the broker. It totaled $222,600. She said that he assured her that she had nothing to worry about.

"I had other things to worry about, like getting my life back together without my husband," she said. "I was signing papers left and right."

He told Kruczek that precious metals were the only way to make a return. The fund's prospectus said it's riskier than a fund that doesn't use leverage.

Some of the money was put into a variable annuity that also invested in the precious metals fund. Variable annuities are frequently criticized for their high costs and commissions.

Although her account was marked "growth," given her age — she was 69 at the time — and status — widowed and retired, with little prospects for returning to work — principal conservation should have been a priority, her claim says.

In August 2011, she fell and had to have emergency back surgery. She remained in a hospital until almost Thanksgiving because of infections. She was transferred elsewhere for rehabilitation and assisted living until March 2012.

She didn't become aware of the activity in her account until July 2012, when she wanted to use her money to purchase a unit in an assisted living facility.

Other allegations in her complaint include breach of fiduciary duty, negligence and failure of supervision.

She is seeking compensatory damages of $226,000, representing the difference between her account's performance and a well-managed account

Had the broker invested the money in a fund merely tracking the Standard & Poor's 500 index, she would have seen growth.

By November 2012, Kruczek had had enough, fired the broker and pulled her money out of the precious metals fund.

In retrospect, Kruczek said she wishes that she had asked others besides her sister and niece for recommendations.

"I felt that my family members know him, so I could trust him," she said.

She said she has two friends who are millionaires and who have brokers at another firm.

"They must have set rules" about investing older people's money, Kruczek said.

She said the experience caused a rift between her and her sister but that she is ready to patch things up.

"Life is too short to be angry," she said.

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How leveraged funds work

How can returns between leveraged funds and the indexes they track diverge so much?

Here's how the math works, according to a hypothetical example from the Securities and Exchange Commission and the Financial Industry Regulatory Authority:

Let's say that on day one, an index starts with a value of 100 and a leveraged fund that seeks to double the return of the index starts at $100. If the index drops by 10 points on day one, it has a 10 percent loss and a resulting value of 90. Assuming that the leveraged fund achieved its stated goal of doubling the return of the index, it would therefore drop 20 percent on that day and have an ending value of $80.

On day two, if the index rises 10 percent, the index value increases to 99. For the leveraged fund, its value for day two would rise by 20 percent, which means it would have a value of $96.

On both days, the leveraged fund did exactly what it was supposed to do — it produced daily returns that were two times the returns of the benchmark it tracked.

But look at the results over the two-day period: the index lost 1 percent, falling to 99 from 100, while the 2x leveraged fund lost 4 percent, falling to $96 from $100.

That means that over the two-day period, the leveraged fund's negative return was four times as much as the two-day return of the index, instead of two times the return.

The hypothetical was for a leveraged exchange-traded fund, but FINRA said some mutual funds are also designed with leverage and therefore raise many of the same concerns.

Chicago securities lawyer Andrew Stoltmann said he believes that most typical buy-and-hold investors should avoid leveraged funds, but, if they want to diversify their portfolio, they should limit their exposure to less than 5 percent of their holdings.

Investors should also read the prospectus.

"The parade of horribles of what could happen are listed," Stoltmann said.

Also, people who are rolling over individual retirement accounts should be careful, he said. Last month, FINRA issued an alert urging investors to be careful of how they move their IRA funds.

"Few things light up a financial adviser's eyes like an IRA rollover, because of the massive fees and commissions that can be earned," Stoltmann said.

Investors can get information about brokers at **finra.org/brokercheck** or by calling 800-289-9999.