Why Your Financial Adviser Should Be a Fiduciary

by Larry Stein

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Some AAII members may read the title of this article and wonder if it's relevant to their situation.
After all, most of you probably invest on your own. But think about your life during retirement and your interest may change. As we age, it's common for even do-it-yourself investors to seek the services of a financial adviser, especially in our later years. Given that you may eventually engage a financial adviser, here are some guidelines on how to select one.

It's a big decision. You've worked hard all your life to build your savings and you want a financial adviser who cares as much about your financial situation as you do.

But how do you know who to hire? You've heard of the big investment firms and you walk in one. You've seen their TV commercials and it seems like it might be a good fit. The firm's reputation is sterling and their experts are frequently interviewed on TV. You walk inside and meet a financial adviser. Nice guy, sharp suit, good handshake—firm and dry. His philosophy makes sense and his materials are professional. Yes, this is the adviser for you. Or is it?

You may not realize some things about your new adviser and his blue-chip firm. Your adviser may:

1. Not always place your interests ahead of his own,
2. Have conflicts that influence the advice he gives, and
3. Collect fees on investments he selects for you that are much greater than you might expect.

How can this be possible? How can an adviser not put your interests first?

The Fiduciary Versus the Suitability Standard

Many financial advisers are not fiduciaries; they are essentially brokers who are subject to a “suitability” standard. For suitability, the Securities and Exchange Commission (SEC) says the financial adviser “must have a reasonable basis for believing that the recommendation is suitable for you.” This is a lower standard than being a fiduciary, which demands that the adviser place the client’s interests ahead of his or her own. This may not seem like much of a difference, but it can be very significant.

Here’s a typical example: Suppose an adviser can either sell a high-commission product or recommend a no-commission fund, both of which are suitable for you. The fiduciary adviser will be required to recommend the no-commission fund, because he or she always must put your interests ahead of their own. But the non-fiduciary adviser could go either way because both products are suitable. Of course, you will probably be worse off if the adviser selects the high-commission product, since the added costs, often in the 3% to 6% range, tend to reduce the product’s total investment returns.

Think about it: You invest $1 million, your adviser makes $60,000 in an instant (based on a 6% commission), and you’re worse off. Yet his or her conduct is just fine under the suitability standard since the investment was suitable for you.

That’s why you should always invest your hard-earned money with an adviser who practices according to a fiduciary standard. Your interests should always come first.

Conflicts of Interest Cost Investors

This isn’t just my view. The problem has become so large and widespread that the U.S. government has stepped in to try and fix the situation. In February 2015, President Obama directed the U.S. Department of Labor (DOL) to propose rules that “require retirement advisers to abide by a ‘fiduciary’ standard—putting their clients’ interests before their own profits.” According to the DOL, “A White House Council of Economic Advisers analysis found that these conflicts of interest result in annual losses of about one percentage point for affected investors—or about $17 billion per year in total.”

The DOL proposal requires that “retirement advisers put the best interests of their clients above their own financial interests.” The proposal also seeks to protect investors from conflicts of interest, particularly “backdoor payments and hidden fees often buried in fine print.” Sounds like an ugly situation that needs fixing, right? Yet the government is facing heavy resistance from large investment firms who are against this proposal—they want to keep things just the way they are.

Watch Out for Dual Registrants

As with most things in the investment business, the term “fiduciary” can have shades of gray. A financial adviser may serve as a fiduciary for some transactions and “switch hats” to act as a broker on others (subject only to the suitability standard). Sounds crazy, but it’s actually very common.

According to a FINRA study cited by the SEC (www.sec.gov/news/studies/2011/913studyfinal.pdf), 88% of investment adviser representatives are also registered as brokers. These are called dual registrants. They can engage in “hat switching,” serving as a fiduciary on one transaction (typically a no-commission fund) and a broker on another (usually a commission product). As you can see, it can be difficult to tell which advisers always adhere to a fiduciary standard. Of course, simply because an adviser is dual-registered should not disqualify him or her from your search process, though it may raise questions in your mind as to whether the adviser will always act in your best interests.

The Client Should Come First

Regardless of what market the adviser serves—retirement plans or family portfolios—the client should always come first. So, do your homework.

- Ask your adviser: “Do you always act according to a fiduciary standard? Are you legally bound to act in my best interest?”
- Look at the adviser’s documents: Is the adviser’s adherence to a fiduciary standard clearly stated in writing?
- Look at your account statements: Make sure you are not invested in proprietary funds (created or sponsored by the adviser’s firm) or products that charge commissions when your objective could be just as effectively be met by non-commission funds.

How to Find a Fiduciary Adviser

Finding an adviser who operates as a fiduciary is not as easy as it sounds. As mentioned previously, a FINRA study revealed that 88% of investment adviser representatives are also registered as brokers.

Many of these dual-registered advisers are employed by broker-dealers, which include the big-name investment firms you see in print ads and TV commercials. While these large firms undoubtedly employ many high-quality advisers, they may also have advisers who are perhaps more focused on generating fees and commissions than they should be. Every adviser is different and it’s unrealistic to categorize. Nonetheless, you should be aware of the differences in various types of firms.

Registered Investment Advisor (RIA) firms are generally regulated by the Investment Advisers Act of 1940 (Advisers Act) and relevant state statutes, which stipulate that investment advisers must act in the best interests of their clients. The U.S. Supreme Court has interpreted the Advisers Act as binding investment advisers to a fiduciary duty

in SEC v. Capital Gains Research Bureau Inc. As such, they must clearly know their clients and provide complete disclosure regarding fees and conflicts of interest. Section 206 of the Advisers Act specifically prohibits an RIA firm from using deceptive or manipulative tactics and from conducting fraudulent business activities. Of course, there are some RIA firms that offer products with commissions or develop their own products that have built-in fees, so you need to be aware of those potential conflicts of interest.

Even the U.S. government has become concerned with the quality of financial advice, especially with numerous surveys suggesting that large numbers of U.S. consumers are not prepared for retirement. The Labor Department is leading the charge on this front and offers a fact sheet called "How to Tell Whether Your Adviser Is Working in Your Best Interest: A Fiduciary Guide for Individual Consumers"

(www.dol.gov/ebsa/newsroom/fsfiduciaryoutreachconsumers.html).

An easy way to find a fiduciary is to go to the Let's Make a Plan website (www.letsmakeaplan.org) and click on "Find a CFP Professional." All CFP professionals (certified financial planners) are required to adhere to a fiduciary duty when providing financial planning services. They are not allowed to engage in hat-switching either. To become a CFP professional, advisers must pass a rigorous test about various aspects of personal finance that is administered by the Certified Financial Planner Board of Standards. [Editor's note: The Financial Planning Association (www.plannersearch.org) and The National Association of Personal Financial Advisors (www.napfa.org) also have searchable databases for finding an adviser.]

The CFP Board, the Financial Planning Association and the National Association of Personal Financial Advisers are working closely to promote a fiduciary standard for financial advisers. These three organizations form the Financial Planning Coalition, which, among other things, supports the SEC in establishing a strong and uniform fiduciary standard of care for broker-dealers and investment advisers. This would be a major step in the right direction for the investment marketplace, assuring individual investors that their financial advisers place their clients' interests first. Unfortunately, some major investment firms have mounted strong opposition and the outcome of these proposals is uncertain.

Make an Informed and Prudent Choice

You've worked hard and long for your money. If and when you feel it's time to hire a financial adviser, make an informed and intelligent choice. Don't hand your future over to your relative or golfing buddy; your retirement savings are too important. Hire a financial adviser who places your interests ahead of their own.

Go in with your eyes wide open. Ask the right questions and probe deep. Be picky—there are plenty of quality professionals out there. Find an adviser who is both intelligent and experienced, and commits to a fiduciary responsibility to always place your interests first.

Four Additional Questions to Ask

Not all fiduciary advisers are Certified Financial Planners (CFPs). Many are registered investment advisers (RIAs) who call themselves wealth managers or financial planners. Regardless of their title, you need to make sure the financial adviser you are considering hiring is actually operating according to a fiduciary standard.

Here are four questions that may help get you to the heart of the matter. Get the real answers. Probe if you have to—you deserve straightforward responses. A fiduciary adviser will find these questions simple to answer. An adviser who is not a fiduciary may sweat bullets or offer answers that seem to skirt the issues. If the adviser doesn't welcome these questions and answer them with ease, move on—there are plenty of high-quality professionals who are fiduciaries.

1. How Does the Adviser Get Paid?

A financial professional can be paid in a variety of ways. The key thing is for them to disclose to you how they are paid. If they say they are "fee only," the only compensation your adviser should receive is your advisory fee, which should be clearly stated in your client agreement.

If the adviser gets paid by commissions, that must be disclosed. Seek to understand the commission schedule, as it may vary for each product they offer. Is the amount of commission you pay similar to the amount of advisory fees from a non-commission adviser? Look out for trade churning or high-commission products—neither should be tolerated. Your adviser should be compensated fairly and reflect the highest professional integrity and objectivity.

Higher fees do not indicate a higher level of expertise. Paying higher fees is not akin to buying a high-priced Porsche, which has better handling and acceleration than lower-priced cars. In the investing world, higher costs subtract from your returns.

Keep in mind that an adviser who gets paid for selling products could be swayed by high commissions, especially the fees offered by private placement products (such as some investment, real estate investment trust (REIT) and commodity funds), insurance products and other financial products.

Conflicts of interest abound in the investment business. Does your adviser have close relationships with product wholesalers? Some advisers who sell commissioned products may be wined and dined by wholesalers trying to win their business. It's perfectly legal for an adviser to enjoy lunch with a

product wholesaler. But it’s certainly not a good business practice if that discussion persuades the adviser to sell you a product that may not be in your best interests. In that case, you are not working with a fiduciary. An adviser who serves as a fiduciary will always put your best interests first.

2. How Does the Adviser Invest?

The way in which an adviser invests can tell a lot about their expertise and integrity. You want both. An adviser who invests in a lot of high-commission private placement funds may not have the highest integrity, while an adviser who simply selects funds rated as five stars by Morningstar may not have the greatest expertise. Advisers who invest in low-cost index funds tend to have high integrity since they don’t collect fees from those investment instruments. On the other hand, performance rules the day, and high integrity does not guarantee you will receive the returns you desire.

Unfortunately, there are very few genius investors, if any. Even the so-called genius investors have their dog days. That’s why so many funds close their doors—either they’ve lost their magic or the market dynamics no longer favor their strategy. According to the SPIVA U.S. Scorecard Year-End 2014 research report published by S&P Dow Jones Indices, roughly 24% of equity funds have been merged or liquidated over the past five years! Investing is a humbling task, and those who lack humility are eventually forced to accept it.

The reality is that it is highly unlikely that you or any adviser can choose managed mutual funds that will beat the S&P 500 index over the long term. Management costs are the main reason. Over the long haul, it becomes exceedingly difficult for managed funds to outperform their unmanaged benchmarks. The SPIVA 2014 statistics show that over the past 10 years, only 18% of large-cap equity funds and 12% of small-cap equity funds have beaten their respective benchmarks. That’s fewer than one in five.

If you think an adviser can pick those relatively few funds that beat the benchmarks, think again. An MSCI study, “Some Like It Hot,” from January 2011 showed that only 9.6% of large/mid-cap managers and 7.1% of small-cap managers achieved top-quartile performance in three successive three-year periods in the nine years ended March 31, 2010. Those figures are very close to the probabilities that would result from a random selection of managers. So, good luck with that!
Warren Buffett understands the realities of investing. In 2008, he bet $1 million that a hedge fund manager couldn’t beat the Vanguard S&P 500 index fund over a 10-year period. So far, he’s way ahead on the bet. In fact, in the 2013 Berkshire Hathaway annual report, Buffett revealed that he

instructed the trustee of his estate to allocate money bequest to his wife by putting “10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund” upon his passing. Apparently, Buffett appreciates the value of low-cost funds. No question: costs matter.

If your adviser invests in a lot of high-priced funds—whether they’re mutual funds, non-traded REITs or commodity funds, or insurance products—your interests are probably not being well-served. Chances are that adviser is earning fees and commissions that are well beyond a reasonable amount and putting his or her own interests ahead of yours. Those fees and commissions directly reduce your returns. Don’t stand for it; find an adviser who invests in low-cost funds.

Morningstar apparently agrees. Though famous for its star-rating system, the company performed research that demonstrates, “In every single time period and data point tested, low-cost funds beat high-cost funds.” In the study, “How Expense Ratios and Star Ratings Predict Success,” Morningstar concluded, “Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance.”

3. Does the Adviser Invest Along With You?

If you really want an adviser who is dedicated to your best interests, ask if they invest their own portfolio in much the same way as they invest yours. Their asset allocation may be different from your portfolio, but the securities they buy for you should be essentially the same as they buy for their own portfolio.

Moreover, they should trade their portfolio at the same time and at the same price as your portfolio, so you get the same deal as they do. They can do this by executing block trades, which should constitute the lion’s share of their trading.

If your adviser has you in high-commission products, ask if he or she has the same products in his or her own portfolio. Make sure it’s not just a token position. Your adviser’s percentage allocation of that high-commission product should be similar to your own. Put simply, your adviser should eat their own cooking.

4. Is Your Adviser Completely Independent?

Look at your statements. Do you see any proprietary funds? For example, if your adviser is employed by XYZ Company, did your adviser select any funds managed or owned by XYZ? Be aware that

some funds may have different names, but are still managed or owned by the adviser's firm. This is important to know, since your adviser should be choosing the very best funds for you based on an intelligent and completely objective decision process.

In large investment firms, right up to the biggest and most respected names, senior management may pressure its advisers to fill their clients' portfolios with in-house funds. Is that the way you want to invest your money? Those advisers certainly do not place their clients' best interests first. Don't be impressed by the firm's name or its TV commercials. Neither will make your portfolio perform better or improve the quality of your adviser's advice. Independence is 'mission critical'; you want an adviser who puts your interests first.

Larry Stein is the founder and CEO of Disciplined Investment Management. He is also an ambassador to the CFP Board and author of "Peace of Mind Investing" (Chicago House Publishing, 2012).