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Making S.M.A.R.T. Financial Decisions

Financial Advisors

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My sister Patty once asked me if I thought she should hire a financial advisor. After talking with her for a few minutes, I recommended against it. Not much later, my friend Howie asked me the same question. I told Howie I thought he should hire a financial advisor. Why one recommendation for Patty and another for Howie? Patty's financial situation was simple. At the time, she was single and saving regularly. Her account was smaller than the usual minimum for the financial advisor she was considering, who would have charged her a fee of 1.5% of her assets every year. I asked Patty how she thought she would react if the market took a dive. She didn't think she would panic. We talked about asset allocation choices-- that is, how much she should put in domestic stocks, international stocks, and bonds. I recommended that she open an account at Vanguard and buy low cost index funds. Howie's situation was more complicated. He wanted to save for his kids' education. He had questions about tax strategies. He wasn't sure if he was saving enough to retire when he wanted to. And we both thought how we might benefit from someone to talk with if the markets were crashing.

I introduced Howie to Audrey Grubman, a financial advisor I know and trust who invests her clients' money in low fee funds. Many people benefit from financial planners or advisors, while others do pretty well on their own. Investment advisors help make asset allocation investment decisions. They may assist with tax and estate planning, even insurance decisions. They help you choose feasible retirement goals and strategies for achieving those goals. Good advisors are coaches. They may praise you when you save more, or even scold you when you don't. And almost certainly, they will help you stick to your investment strategy when markets get rocky. Good financial advice is valuable, but it can also come at too high of a price. Furthermore, people don't always understand how much they are paying for the financial advice. In this video, I'm going to talk about fiduciary responsibility, conflicts of interests, and how financial advisors are compensated. These topics are all interrelated.

An advisor who is a fiduciary has a legal obligation to put her clients' interests before her own. Conflicts of interest arise when an advisor faces a choice between taking actions or giving advice that's better for the client or better for the advisor. Compensation models determine how giving different advice might benefit an advisor. For example, some financial advisors are paid by commissions. Mutual fund companies sometimes pay advisors a commission when the advisor's client buys a fund or pay an ongoing annual commission as long as the advisor's client continues to own the fund. Some funds pay large commissions. Some pay small commissions. Some funds don't pay any commission whatsoever. Funds that pay higher commissions usually charge higher fees. And funds that charge higher fees underperform similar funds that charge low fees. So high commission funds are profitable for the advisor, but not for the client. And that creates a conflict of interest.

Financial advisors who don't accept commissions are called fee-only advisors. These advisors are paid only by the client, not by companies whose services they recommend. This greatly reduces conflicts of interest. Note, there's a difference between a fee-only and a fee-based advisor. Some fee-based advisors receive commissions from the companies whose products they sell, as well as fees from their clients. The most common compensation model for fee-only advisors is to charge clients a fee based on the value of the client's assets under management, or AUM. For example, if the advisor is helping you manage $500,000 in investments, the advisor might charge you 1.25% of that $500,000 each year. That's $6,250 a year. Fee-only advisors tend to recommend investing in low-fee funds, which is a good thing. However, fee-only advisors whose fees are based upon the value of their client's investment portfolios may lose income if they recommend that their clients purchase products, such as deferred income annuities, because this purchase reduces the investment portfolio legal size.

Deferred income annuities protect against outliving one's savings. So, a conflict of interest could arise for clients who need such protection. However, many fee-only advisors cater to wealthy clients who are not in danger of outliving their savings. Other fee-only compensation models for financial advisors are to charge an hourly rate for advice or to charge a flat fee for specific services, such as creating a financial plan. Paying advisors for the time they and their staff spend helping you makes a lot of sense. However, charging by the hour or by the service has not proven popular with clients. People balk at paying advisors $300, $400, or $500 an hour, yet many pay thousands of dollars a year to advisors who charge a percentage of assets under management. Why? One reason may be that hourly charges are likely to be paid by credit card or check, and thus more salient than a percentage directly deducted from a client's account. Another reason is that people don't like to look at their statements when the accounts are down. And when the accounts are up, the percentage fee doesn't feel that important. Finally, $500 seems like a big number, and 1% just seems small. But when it comes to investments, 1%, it's big. The 1% or even 1.25% paid to a financial advisor is guaranteed. You agreed to pay it. You will pay it. It's deducted from your portfolio. And it's usually based on the beginning of period portfolio values.

How high of a risk-free guaranteed return can you earn on your investments these days? One risk-free investment that you can buy is a federally-insured certificate of deposit. While rates may go up, the day I made this video, most banks were paying less than 1% a year on certificates of deposits. So when you agree to pay a financial advisor 1% of the value of your investments each year, you may be paying him or her more than the total return those investments could earn without taking risk. I think that most financial advice is more expensive than it should be. And I expect that prices will come down over time. But many people do benefit from advice. Whether the benefit exceeds the price for you depends on what services a financial advisor gives you and how much you need those services. Almost all financial advisors will make asset allocation and fund recommendations. But 1% of your assets every year is definitely too much to pay for asset allocation and fund recommendations alone. You'd be far better off using an age-based asset allocation rule of thumb and index funds or buying low-fee target date funds than paying an advisor 1% just to choose funds for you. So don't pay 1% for asset allocation and fund choice.

However, most financial advisors do more than asset allocation and fund choice. They create a financial plan for you with projections as to how much you need to save and when you'll be likely to retire. They help you invest and save tax efficiently. Some prepare your taxes for you. But the biggest potential benefit from having an advisor is that the advisors lower the chance of making serious financial mistakes. Good advisors won't let you, or at least will strongly advise you, not to put all your money into gold or sell all your equities because the market's down. They'll protect you from real estate and investment scams. And they'll help you make sensible decisions about things like downsizing your home for retirement. Whether you need these services depends upon your age, wealth, the complexity of your finances, and your ability to make some financial decisions on your own. The most important difference in financial advisors is whether or not they have a fiduciary responsibility to put your interests before their own. You want an advisor who is willing to commit in writing to being a fiduciary. In another video, I discuss questions you should ask your financial advisor or someone you're considering hiring as a financial advisor. Whether he or she is a fiduciary is at the top of that list.

Financial advisors tend to have letters after their names. These letters usually represent financial certifications. Some of these certifications require quite a bit of training, including passing classes and exams. Others don't. There are too many certifications for me to discuss here. I'm going to list a few of the better known ones. These certifications vary in their focus, but all of these require education and exams. Certified financial planner, or CFP-- as the name suggests, CFP training focuses on financial planning. Chartered financial analyst, or CFA-- the CFA exams are tough, with an emphasis on portfolio management and security analysis. Certified investment management analyst, or CIMA-- the CIMA certification focuses on investments. Certified public accountant, or CPA, and personal financial specialist, PFS-- CPAs are, of course, accountants. And the CPAs with the PFS certification have taken additional training in financial planning. If you are considering an advisor who has a certification other than one of these, search online to see what the qualifications, training, and exams are for that certification.

Finally, the Security Exchange Commission recommends before you hire someone to be your investment advisor, always ask for and read both parts of the advisors form, ADV. The form ADV reports information about advisor's business compensation model, past legal problems, and much more. At the end of the video, there's a link to the SEC's Investment Advisor Public Disclosure website. I also suggest reading the SEC's short publication, "Investment Advisors, What you Need to Know Before Choosing One." One final warning-- do not hire a financial advisor who claims that he can beat the market. He's lying. And you don't want to hire an advisor who lies. Maybe he did beat the market in the past. A lot of people have. Maybe he'll beat it in the future. People do get lucky. But he isn't going to beat it through skill. And he's going to add risk to your portfolio if he tries. Attempting to beat the market is not what financial advisors should be doing. If you decide to hire a financial advisor, shop carefully. Make sure the advisor commits to a fiduciary responsibility. Read his or her form, ADV, and ask questions.