Selecting the Financial Advisor and Investment Approach that is Right for You

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Selecting the Financial Advisor that is Right for You

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Deciding What Financial Advisor You Should Work With

The Right Financial Advisor is Key to Planning Success: Consider Cost

Deciding What Financial Advisor You Should Work With

- Consumers need to mange their savings to achieve financial security and retirement goals.
- This requires making a decision as to what type of investment or financial advisor to use.
- Cost is often a major consideration so we'll review that next.
- Just remember cost is only one part of the equation.

Costs of Investment Management and Planning

The Right Financial Advisor is Key to Planning Success: Consider Cost

It Should Not Only be About the "Cost"

- Selecting the right financial Advisor and relationships is not only about the advertised or stated cost.
- It's not so simple and lower cost is not always best. But let's look at cost first.
- There are three levels of costs in the advisory and investment business:
  - Investment cost.
  - Administrative cost.
  - Advisory cost.

Investment Cost: Active vs. Passive

- Investment cost is what you pay for the actual investments themselves, such as a mutual fund, exchange-traded fund ("ETF"), or stock. Note the difference between *active management* and *passive management*.
- In *active management*, you pay a portfolio manager to select the underlying holdings, stocks or bonds, in the portfolio they are managing. Mutual fund managers are often "restricted" to a certain style box, such as large-cap growth or mid-cap value, and cannot deviate from their investment mandate.
- In *passive management*, you buy the actual index, such as the S&P500, via an ETF, often at a much lower cost than what active managers charge. In addition to their low cost, the intrigue behind ETF investing is that, over longer periods of time such as a decade or more, index ETFs have often historically outperformed active managers.

Investment Cost: Active vs. Passive

- Investment cost can vary and will be understandably higher in special situations. Consider emerging and frontier markets. It may be worth paying the additional cost for an active manager who is familiar with the geopolitical environment, local currencies, industrial landscape, etc.
- Investors should also be aware of the terms “beta” and “alpha.”
  - Beta is the return of a market index, such as the S&P500.
  - Alpha is simply the additional return that an active manager seeks to provide over the index.
  - If an actively managed mutual fund that costs more than an ETF is outperforming the index, this manager is said to have provided alpha, and this may be worth the additional cost.
- Active managers may provide value in strategies that seek to anticipate market downturns, thereby minimizing extreme volatility in a portfolio. You’ll notice that in bull markets, such as the past 10 years, investors tend to rush into passive index funds because of low cost and performance. When markets turn down, historically investors seek active managers who can customize portfolios and strategies that may perform better than index funds.

Administrative Costs

- There are various administrative fees: annual custodial fees and trading costs, that can diminish portfolio returns.
- ***Administrative costs in a self-directed account*****:** if you're a do-it-yourselfer, you may be using a platform that has competitive trading fees. If you have significant assets with an institution, you may be able to get the trading fees waved or get a certain number of free trades per year. For most there's a cost per trade.
- ***Administrative costs in an advisory account*****:** in this type of account, you've hired someone to manage your portfolio. It may be a person, such as an advisor, or it may be an institution, such as Fidelity, Vanguard, or Schwab that allocates your portfolio to their model. Sometimes you can speak to an employee regarding your account.
- Some institutions advertise portfolio management for a lower cost than hiring an advisor. Be careful. You may not get the additional services and strategies that might benefit you. But paying won't necessarily assure you the services either.

Advisory Cost

- This is the compensation you pay an advisor or firm to advise on products and services, which may include investment management, financial planning, estate planning, and risk management, such as long-term care, disability, life insurance, etc.
- There are four cost models for financial advisors:
  - Commission.
  - Percentage of assets under management (“AUM”).
  - Flat fee per year or project.
  - By the hour.
- The model you choose should depend on your planning needs and investment objectives, and ultimately be in your best interest.

Advisory Costs: Commissions

- Example: A-share mutual funds, where the advisor earns an up-front commission, often starting at 5.75%, and a trail commission of 0.25% that starts in year two. This is common for so-called brokers.
- ***Pro***: if you have a long-term investment horizon, a decade or more, and don't need much planning, hiring an advisor on a commission basis may cost you less over the long run.
- ***Con***: advisors who charge commissions may be incentivized to "make the sale," but may not provide the additional advice and planning strategies you need. Commission-based advisors are compensated with a lower "trail commission" that may not be enough of a financial incentive to tweak your portfolio as economic conditions and your investment objectives change. If a mutual fund you own underperforms and the advisor wants to invest in a mutual fund offered by a different fund family, you'll have to pay another upfront commission.

Advisory Costs: Percentage of Assets under Management ("AUM")

- Example: 1% of your account balance over the year, billed at 0.25% per quarter. This cost usually drops on a graded scale the higher your investable assets are: for example, someone with $1M may pay 1% for fully comprehensive financial planning services while someone with $20M may pay 0.50%, or one-half of one percent.
- ***Pro***: this model removes the potential conflicts of interest when commissions are involved. Additionally, the advisor's compensation is tied to your account value; so, in theory, the advisor is motivated to provide you with sound portfolio management *and* the planning strategies that are unique to your profile.
- ***Con***: advisors who charge a percentage of your assets under management may arguably be charging you too much if what they are ultimately providing you is portfolio management and not implementing the planning strategies for which you are eligible.

Advisory Cost: Flat Fee

- Example: like an attorney's retainer, which is common for fee-only financial planners and/or advisors who offer project work like estate planning, tax planning, and advanced strategies for business owners, such as cash balance plans.
- ***Pro***: assuming the advisor is providing you with the full range of financial planning services, you remove the potential to pay more to the advisor as your account value grows over time. For some, there is also the preference to compensate an advisor on an annual or per project basis independently of the size of their investable assets.
- ***Con***: advisors who are compensated by a flat fee may not be incentivized to work for as many hours as they usually would because they have already been paid. Also, if your account value goes down during a recession, from withdrawals, or both, the advisor is technically being compensated at a higher rate because the planning cost remained the same as your account went down in value.

Advisory Cost: Hourly

- By the hour – This could be $75 to $500+ per hour depending on the advisor’s expertise, and the complexity of your needs.
- ***Pro***: if you’re a do-it-yourself investor who has the time and aptitude to manage your portfolio effectively, perhaps you want to spend some time with a qualified advisor to have a second look and evaluate if there are planning strategies that you may not be aware of. The peace of mind may be worth the cost.
- ***Con***: advisors who charge by the hour may be incentivized to have more billable hours so pick an honest, transparent fiduciary, and ask that they document their time.

Costs: Robo Advisors

- Robo advisors are computer-based platforms that provide automated, algorithmic investing and financial planning services. The intrigue of robo advisors is their low cost.
- The one thing that robos don't provide is a human connection.
- A robo advisor cannot understand the intricacies of your family, your core values, your desire to circumvent heirs fighting over your assets, your tax returns, and work alongside your CPA and estate planning attorney. But some combine robo investing with financial planners.
- Consider, however, that the true cost of not hiring a qualified advisor could potentially be more expensive than hiring one. Your financial picture is more than just the investment decisions.

Costs: Conclusions

The Lowest Cost Alone is Unlikely to Make Your Decision

Costs: Conclusions

- The question to ask is not "what are your fees" – this is like walking into the grocery store and asking the same question to the store manager. The questions to ask are, "Based on your review of my full picture, what are my true planning needs, how can you add value, and what will it cost?"
- Remember to ask the advisor to delineate fees in writing and, if you've narrowed it down to two or three advisors who are charging the same, consider hiring the one that offers the most strategies with the goal of bringing the greatest value. If one advisor charges a bit more but is the most qualified from a strategy standpoint it may very well be worth the additional cost.

Selecting a Financial Advisor

Selecting a Financial Advisor: Generally

- Financial advisors are not all the same. And cost is not the only factor to consider.
- Experience and expertise can make a big difference and should be a focus of your decision making.
- Experience and expertise are different. Many financial advisors have decades of experience doing the same things, but don't necessarily have a broad range of expertise. Conversely, a financial advisor may have the expertise by way of credentials but not much experience in practice. Knowing the difference is important.

Selecting a Financial Advisor: Accountability

- The decision affects your money and your financial future.
- It is OK to hold your advisor to a high standard – or, find a new advisor who can serve you better.
- Do you need a full range of financial planning strategies and services? Which services might you need? Which do you need to receive from your financial advisor? Are there other Advisors, e.g. your CPA and attorney who can supplement the services you need?
- You have to ask questions and make inquires. Managing more doesn't necessarily mean being more qualified. Are awards the Advisor has received recognition for sales, or recognition for expertise or for bringing value to their clients?

Selecting a Financial Advisor: Accountability

- What are your needs and how do they mesh with the advisors skills? If you are or will deal with issues of aging or health, what expertise does the Advisor have with those issues? If you are a newlywed with a young family, how many clients like that does the Advisor serve?
- Do you need tax planning help or is your CPA able to assist with those matters?
- Does your Advisor review your tax return to identify financial planning, tax, and other considerations for you?

Understand Who is Selecting Your Investments

This is a Critical Component of Selecting the Right Advisor for You

Who Selects Your Actual Investments?

- Does your advisor personally selects your investments?
- Inquire how your advisor may be selecting your investments. This might depend also on the compensation model.
- Some advisors outsource portfolio management to a third party, which may be at an additional cost to you. That is not necessarily good or bad but you should understand what the advisor is doing (and not) and what you are paying for all-in.
- Some advisors use model portfolios provided by their home office, which may be at an additional cost to you. Model portfolios are not necessarily bad, but is it right for you?
- It is extremely rare for an advisor to consistently outperform “the market” over long periods of time.

4 Types of Portfolio Management: Brokerage

- The brokerage model is where your advisor is paid a commission.
- This is the “classic” (some would say: “old school”) brokerage model where a broker sells you a commission-based mutual fund, stock, or bond.
- Under this model, your advisor is generally selecting the individual investments in your portfolio.
- Keep in mind many “brokers” also offer investment arrangements based on an asset under management fee as well.

4 Types of Portfolio Management: Managed Account

- The advisor-managed account in which your advisor manages your portfolio using portfolio models that the advisor creates using their own research and/or research provided by an independent third party or their home office.
- Some advisors will offer to pay your trading costs depending on their service model and the amount of money you have invested with the advisor.

4 Types of Portfolio Management: Home Office Model

- The “home office” model may go under different names because different firms have different names for them.
- In this type of account, your advisor places your money into a portfolio managed by the research team in their home office, usually at an additional cost.
- Some firms, for example, may charge 0.25% for this in addition to what your advisor is charging for his or her advisory services.

4 Types of Portfolio Management: Separately Managed Account

- With a separately managed account, or SMA, your advisor outsources the management of your portfolio to a third party. This often comes at an additional cost (perhaps 1%+).
- Trading fees are often covered by the SMA manager.
- If you use an SMA for your non-qualified dollars (e.g. non-IRA funds) understand the tax implications of this type of account. There are tax costs when you buy and sell in a non-qualified account, so you'll likely want an SMA that does some level of tax loss harvesting to offset these costs.
- Have your CPA review the tax efficiency of your non-retirement holdings.

Is your Advisor a Fiduciary?

Fiduciary or Not?

- Is your advisor acting as a fiduciary and therefore acting in your best interest?
- How do you know your advisor is only doing what is in your best interest? Look for potential conflicts of interest that your advisor may have. Some things to look for:
- Ask your financial advisor about relationships with product sponsors, also known as “wholesalers.” Wholesalers are hired by an asset management firm to get financial advisors in their territory to use their company’s products for their clients. Wholesalers are the investment industry’s equivalent of pharmaceutical sales reps.

Fiduciary or Not?

- Were you invited to a financial presentation and free steak dinner? Ask who paid for the dinner? Was the speaker a wholesaler for the financial firm whose product the advisor was suggesting to dinner attendees?
- Does that really sound like the independent advice you want?
- Some wholesalers can add tremendous value for advisors by way of education on products and economic and market insight.
- This situation isn’t necessarily bad if the investment product is in your best interests. But the lack of transparency of what is going on is itself suspect.

You Need Comprehensive Planning

Investment, Retirement, Insurance, Tax, Estate and all Planning Must be Addressed

What Does Your Advisor Offer? What Does Your Team Offer?

- Your “team” consists of all your advisors: financial advisor, accountant, insurance planner, and so forth. It does not matter which advisor gives you what advice so long as collectively you have comprehensive planning. If your financial advisor provides advice limited to certain areas you have to supplement.
- Some financial advisors may only offer insurance or investment products, not necessarily both, and some that offer both may not offer estate planning, tax, and other strategies. Understanding your true financial planning needs can help you select the right advisor team for your particular situation.

Questions To Ask Your Advisor

- Does your advisor work with your estate planning attorney to develop your overall planning strategy and help minimize the potential for your heirs to fight over your estate?
- Does your advisor ask for your tax returns and demonstrate how they drive the development of your overall financial plan?
- Does your financial advisor work with your CPA to implement possible tax alleviation strategies that could reduce your tax burden?
- Given current valuations of stocks, real estate, and bonds—has your financial advisor spoken with you about investment strategies that have historically helped reduce downside risk in periods like the Credit Crisis of ‘08 or the Tech Wreck of ‘00 – ’02?
- During your annual review, does your financial advisor have you complete an investment questionnaire to evaluate the extent to which your risk tolerance and investment objectives may have changed?
- How do you compensate your advisor for the products and services you’re getting?

Conclusion and Additional Information

Conclusion

- Hiring the right financial advisor for you is critical to your financial security.
- Ask questions.
- Understand compensation.
- Know your financial advisor's position (fiduciary standard or not).
- Understand who makes actual investment choices, how you will pay for that, and how it affects your planning.
- Be certain you have a comprehensive plan.

Additional information

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