When You're Serious…

by Bradley R. Newman, CFP®

Let's Be Honest

As I read a recent investment industry trade publication I was shocked to note five discrete stories about investment firms, banks or brokerage firms that were either involved in new lawsuits, SEC fines, or arbitration settlements – what made it particularly shocking is that it was a weekly periodical; this was not a month's or a quarter's worth of bad news, just one week. For an industry that is based on trust, at least in theory, how could so much legal and regulatory action be resulting from ongoing dealings with the public at large? The easy answer, somebody had violated the public's trust – somebody wasn't being honest.

The Problem Is Simple

Although the details are often complex the simple problem that causes the legal or regulatory action is that an investor feels as if he/she has been taken advantage of by somebody. In most cases the root cause can be traced back to some level of opaqueness or confusion about either 1) compensation or 2) investment suitability. In either case, the investor did not receive what he/she anticipated or felt was reasonable.

Compensation

The issues that lead to regulatory fines or lawsuits are rarely about the absolute level of compensation paid to an advisor, but are usually based on a lack of full disclosure; i.e., the advisor is paid more than what the investor anticipated. The world of investment advisor compensation can get pretty murky between the overt compensation paid and the covert compensation paid.

The most straight forward compensation structures are the ones at either end of the spectrum; commission-only and fee-only. Each one is exactly what you would anticipate:

- A commission-only advisor is paid solely by commissions or sales charges; i.e., he/she earns nothing unless they sell you something.
- A fee-only advisor is paid solely by fees for service: i.e., he/she is paid directly by you, the investor, for services rendered.

The most confusing compensation structure, and where most of the problems arise, is the fee-based relationship. It is a hybrid of the other two structures. It often involves one type of fee being off-set by the other, which can be very confusing, or covert fees that are not fully disclosed.

The information that you need to determine how advisors are compensated is readily accessible. For example, the detail about compensation for Registered Investment Advisors is contained in the annual disclosure (Form ADV) that they are required to file with the SEC. These disclosures can be obtained from the U.S. SEC website (www.adviserinfo.sec.gov) for firms that manage in excess of 100 million dollars and from the PA SEC website (www.psc.state.pa.us) for firms that manage less than 100 million dollars.

Investment Suitability

Investment suitability touches every aspect of the investment management process, from the initial creation of an Investment Policy (what is the macro strategy being employed) all the way down to security selection (what are the actual investment vehicles to be utilized). Full disclosure regarding the rationale for recommendations at every step of the process is critical.

Utilizing security selection as an example, it is commonplace for under-performing mutual funds to be utilized when significantly better options exist. As a point of reference, a recent real-life example of poor security selection resulted in just over a 10% missed opportunity in 2013 or a $50,000 real dollar cost on a $500,000 portfolio.

Why would the underperforming fund have been recommended or sold? Most likely it is some combination of: 1) the advisor being limited to proprietary (in-house) funds, 2) the advisor wanting to earn a higher rate of compensation (disclosed or undisclosed) or 3) some type of soft-dollar compensation (trips or prizes for contests).

The Solution Is Simple

Rarely will a one-word solution suffice; however, in this case it will, and the one-word solution is transparency. A lack of transparency, in compensation, in portfolio management or any facet of a relationship, will lead to uncertainty and the ultimate deterioration of any relationship.

To avoid the end result of the headline-news I referenced earlier, be certain that you are engaged in fully transparent relationships. If you don't feel comfortable that the relationship is fully transparent, push for full disclosure about everything: compensation, investment strategy, and anything that has not been explained to your full satisfaction. If you still don't feel that you have a crystal clear understanding, it is time to interview new advisors.

Bradley R. Newman, CFP® is with Roof Advisory Group, Inc., an independent investment management and financial advisory firm based in Harrisburg. The firm is a fee-only Registered Investment Advisor that provides portfolio management and financial planning services for individual and institutional clientele. The firm's email address is invest@roofadvisory.com.