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Are you sure your adviser acts in your best interest?

ON INVESTING
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Imagine: You are ill and go to your doctor for help. Unbeknownst to you, your doctor is on the payroll of a pharmaceutical firm, and he gets a cut of all the sales he makes of a particular drug. You describe your symptoms, and the doctor prescribes medication. It happens to be the same medication that he gets a commission for. The medication won't quite kill you, but it won't help you either.

While this sounds like an unlikely scenario, it is precisely what happens every day in the investment industry. The Department of Labor, with backing from the White House, recently proposed a rule that would address at least part of this problem. The rule would make all those giving investment advice to retirement plans (employer-sponsored plans as well as individual retirement accounts) fiduciaries who would be legally required to act in the best interest of their clients.

It may seem obvious that investment professionals would be required to act in the best interest of their clients, but that is not always the case. Registered investment advisers are registered with and overseen by the Securities and Exchange Commission, and are required to live up to a fiduciary standard. Brokers and insurance agents, on the other hand, are held to a lesser standard of "suitability" that does not require them to act solely in the interest of their clients. Making things even more confusing, brokers often refer to themselves as financial advisers or investment advisers, but that does not mean they are always acting in a fiduciary capacity.

What this means from a practical perspective is that your broker, faced with recommending two similar investment offerings, will often choose the one that maximizes his compensation, which likely will result in reduced returns for you. While non-fiduciary investment professionals may argue that they are able to serve two masters, that is to simultaneously earn high fees for themselves and also provide solid returns to their clients, the evidence is not supportive.

Numerous studies, including those by finance research luminaries Burton Malkiel, Ken French, and Nobel Laureate Eugene Fama have found an inverse relationship between fees and returns. Higher costs, therefore, mostly just lead to lower returns for investors. This clearly presents a conflict of interest between brokers and their clients, which is precisely why there is a proposal to remedy the situation.

Interestingly, the fiduciary proposal will probably die without being brought to vote. The reason is most likely because of intense lobbying on the part of the brokerage and insurance industries. Many senators and congressmen have lined up with the industry, and the odds of a new law seem remote.

The arguments against a uniform fiduciary standard applied to all investment professionals include the fact that new liability and regulatory costs would be incurred by brokerage firms. This may be true, but the investment adviser industry already incurs those costs and liabilities, and seems to be thriving. In fact, there is evidence that investment advisers that are held to a fiduciary standard are growing faster than brokerage firms. Another argument is that higher regulatory costs will result in smaller investors not being able to find advice, given the relatively small amount of revenue their accounts would generate.

While it is true that most investment advisers have minimum account sizes of $500,000 or more, there are other viable alternatives for smaller accounts. For example, there are discount brokerage firms and mutual fund companies that offer most of the same services as the larger brokers, but at reduced costs. These providers may still not be fiduciaries, but at least you are paying less for their services. The advent of "robo-advisers" creates the best alternative in my view. Ultra low-cost firms that automate the investment process generally have no account minimums, and offer investment approaches that appear superior to those offered by the larger brokerage firms. Robo-advisers generally don't offer advice on financial planning, but that service may be purchased separately. There are several good financial planners in our area that offer conflict-free advice on college savings, estate planning, and tax minimization strategies.

The one good argument I have heard opposing a fiduciary standard, at least in theory, is that fee-based accounts could cost some investors more than commission-based accounts. The fiduciary standard would likely outlaw a commission-based structure, though that is still open to debate. For investors who do not need much advice and do not trade their accounts actively, paying commissions could work out to be less costly than paying an annual fee based on the value of their account. These types of accounts are probably a very small minority, but this is a valid concern nonetheless.

My take on this issue is that all investment professionals should work in the best interests of their clients, but that a change of law is not necessary and maybe not desirable. Rather, I think the same outcome could be achieved with a massive educational campaign. I believe most investors have no idea whether their investment adviser is acting in a fiduciary capacity. Most investors I meet make decisions about their advisers based on personality fit rather than professional competence. Education about criteria such as what credentials, experience and investment philosophy are likely to result in a successful investment experience would accomplish more than a new law.

I also believe that advisers and brokers should act in their clients' best interest for both retirement and non-retirement accounts. The current proposal is only for retirement accounts to be covered by the fiduciary standard. It seems ridiculous that

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only certain types of assets should be protected, while others remain open to shenanigans.

The Department of Labor estimates that brokers are siphoning $17 billion a year in unnecessary costs from their clients. While a law to correct this is unlikely, investors can take matters into their own hands. Find an adviser, whether broker or registered investment adviser, who truly meets your needs and investment style. A little due diligence up front can help ensure that your adviser, like your doctor, adheres to the maxim to first do no harm.

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