

FRANK MOORE, MS, CFP

FRANK ADVICE ON  
CHOOSING AN  
ADVISOR



# IN THE ENVIRONMENT WE'RE IN, MANY PEOPLE NEED ADVICE JUST ON CHOOSING AN ADVISOR.

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*Today there are financial advisors everywhere you look. Banks, brokerage firms, insurance agencies, credit unions, and accounting firms all seem to offer financial advice.*

Which advisor is right for you? Or should you simply do it yourself? Below we'll outline the various types of advisors, the value they may offer, and how to avoid the smooth-talking salespeople who are much more interested in their own finances than yours.

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# Understanding the Alphabet Soup of Financial Planning

It's difficult to count the number of financial advisors in the U.S. because there are a number of regulatory bodies that license them. And understanding all the regulatory bodies is sometimes like staring into a bowl of alphabet soup — you're never sure about what comes up or what it means.

Ideally, this section will help clear all this up for you — so it's at least more like a broth and not so soupy.

The most prominent regulator is FINRA, the Financial Industry Regulatory Authority, formerly known as the National Association of Securities Dealers, or NASD. This self-regulatory organization is overseen by the SEC but is directed by its members. Their role is essentially to ensure that investors are treated fairly and not abused so badly that the SEC needs to step in.

FINRA oversees about 650,000 licensed salespeople, most officially known as Registered Representatives, though the advisors use a variety of other titles, too. These reps have passed at least one securities exam in order to receive commissions on the sale of some investment products.

*You can tell a FINRA-licensed representative by his business card, which must disclose “Securities offered through [Securities Firm], member FINRA.”*

The FINRA-licensed advisors are tightly regulated but they are salespeople and are only required to sell their clients “suitable” investments. Suitability is a somewhat subjective term. The term doesn't mean it's the best investment for a client or that there's good reason to think it will do well in the future. It doesn't mean that it's the lowest cost investment either. Suitability typically means that the investment recommended is not egregiously expensive and that it could fit reasonably well into a client's portfolio.

Another large group of financial advisors is regulated under the insurance departments of the states. Each state has licensing requirements for its agents in order to sell insurance products and some investment products like annuities. Many financial advisors are licensed by both their state insurance department and FINRA. Some insurance-only advisors, though, can only sell annuities because they are not FINRA licensed. They may push fixed annuities or equity-indexed annuities because they can't sell mutual funds or other securities.

The third regulatory area is for investment advisory firms. These may be registered with the SEC if they manage over \$25 million or may be registered with a state if they fall under that level. There are about 11,000 firms registered with the SEC as Registered Investment Advisors. Some of these firms manage billions of dollars but about half are small firms with just five or fewer employees.

Registered Investment Advisory firms, or RIAs, are not compensated by commissions. Instead they charge fees that are typically based on the assets that they manage, though some firms may charge by the hour.

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## *RIAs must act as fiduciaries and put their clients' interests first.*

The RIAs are held to a higher standard in dealing with their clients than the FINRA-licensed reps or insurance agents. RIAs must act as fiduciaries and put their clients' interests first. Generally, this is pretty easy for them to do as their only compensation comes from the clients rather than from products they sell.

In theory, anyone can call himself a financial advisor without falling under the regulations of FINRA, a state insurance bureau, or the SEC. If he wants to get paid, though, any fees or commissions he receives will place him under the jurisdiction of one or more regulators. Many financial advisors are actually regulated by FINRA, a state insurance department, and the SEC, and must comply with various regulations and requirements from all three.

## What's Your Advisor's Incentive?

Today at least 90% of financial advisors are commissioned salespeople licensed by their state insurance department or FINRA. While most are ethical and may attempt to put their clients' interests first, their financial incentives are often in conflict with their clients.

The big banks' and brokerage firms' advertisements portray them as trusted advisors that will help their clients achieve their financial dreams. Yet their culture is one of sales. Their advisors are trained first in sales and the vast majority are paid strictly on commission. The advisors usually have quotas of sales commissions in order to keep their jobs and the firms celebrate and reward the "top producers". The salespeople with the most commissions earn trips and are lauded as the pinnacle of success at the firms. Whether their clients make any money is never a consideration.

One of the key problems in the industry today is that the commission-based financial advisors have a variety of investment products to sell and the commission levels vary from one product to another. Some products pay little to nothing in the way of commissions while others can pay 5%, 7%, or even 10% or more of the client's investment dollars. Often the commissions are paid up front on the sale so there's little incentive to service the client unless the client has additional funds to invest.

Advisors who work with a Registered Investment Advisory (RIA) firm will typically work on a fee that's based on the assets under management (AUM). These fees are usually 1%–2% of the portfolio each year and are lower for larger portfolios.

The benefits of the AUM type of arrangement are numerous. The first is that the advisor's compensation is tied to the performance of the investments. If the portfolio rises, the advisor makes more money and if it falls the advisor makes less. Next, there's an incentive to continue servicing the client as there is an ongoing fee to compensate him. An AUM arrangement also doesn't have any significant upfront costs so if the client isn't happy he or she can leave without incurring substantial transaction costs or penalties.

# Credentials and Designations

Unlike the medical and legal professions which require the passing of a standard exam, the financial services field is filled with various licensing levels and professional designations. The licensed salespeople need to pass at least one of several different exams required by FINRA or their state securities agency in order to receive commissions.

Some advisors will go above and beyond the basic licensing requirements to earn a professional designation. Some designations require little more than a week or two of studying and the passing of some multiple-choice exams, while others, like the Certified Financial Planner (CFP®) designation, may take 2–3 years and require the passing of a tough two-day comprehensive exam.

The more common designations include:

**CFP® Certified Financial Planner** This is the most widely respected certification for financial planning. It requires the passing of five courses plus the comprehensive two-day board exam. Pass rates are usually in the 50%–60% range on the board exam even after successful passage of the course work. CFPs are also required to have a bachelor's degree and three years of industry experience, adhere to a code of ethics, and complete continuing-education credits to maintain the designation.

**CLU Chartered Life Underwriter** This designation is for insurance salespeople and requires the successful completion of eight courses through the American College.

**ChFC Chartered Financial Consultant** This designation is similar in scope to the CFP but is often earned by insurance salespeople. One way to achieve it is by becoming a CLU and then taking three more courses. Like the CFP it also requires three years' experience, adherence to a code of ethics, and continuing education. It is also offered through the American College, and you'll see many of the better qualified insurance salespeople with the CLU and ChFC designations.

**CFA Chartered Financial Analyst** The CFA is earned by passing three exams and it usually takes three years to earn, as exams are given each June. The coursework is focused on investment analysis and is often geared to analysts who work in portfolio management rather than broader financial planning for individuals.

**CFS Certified Fund Specialist** The CFS designation requires the simple passage of three 50-question exams and can be completed in weeks rather than years. It covers some of the basics of mutual fund investing.

**CIMA Certified Investment Management Analyst** Offered by the Investment Management Consultants Association, the CIMA designation requires the passage of two exams. The second exam is administered after an intensive week of courses offered at the Wharton School of Business at the University of Pennsylvania. The coursework covers investment management, asset allocation, investment policy, and performance reporting.

**EA Enrolled Agent** An Enrolled Agent is authorized by the IRS to represent taxpayers during audits. It requires the passage of a comprehensive tax exam or five years' experience working with the IRS.

**CPA Certified Public Accountant** Each state has different requirements for experience and continuing education, but CPAs have generally passed the Uniform CPA exam. The title is regulated differently by the states but CPAs can also represent taxpayers before the IRS, though some may specialize in corporate audits as opposed to income taxes.

## Checking Out an Advisor

Some people seem to take solace in working with an advisor from a large, brand-name firm. They may think that if they are mistreated by the salespeople, they can sue the deep-pocket firms for restitution. Unfortunately, as soon as they become clients they typically sign away their right to sue and instead agree to arbitration.

During 2008 many of Wall Street's largest firms ended up in bankruptcy or were forced to sell themselves, often in mergers arranged by the government. While their investors generally avoided the loss of their securities, the investment losses were tremendous.

The former titans of Wall Street seemed to choke on their own cooking in 2008. In addition to the toxic mortgage-backed securities, their investors were also stuck with other exotic products like auction rate securities that didn't turn out quite as advertised by their salespeople.

Despite hundreds of millions of dollars in fines and countless lawsuits, these firms still continue to operate today with virtually the same commission-based model that helped contribute to the financial disaster. Yet, after Bernie Madoff, many investors are afraid to leave the big firms in fear of even worse losses.

Smaller independent firms are home to some of the top advisors in the country. These advisors don't have pressure to sell their firm's proprietary products and may be more client-focused with many working on a fee-only basis. Unfortunately, some of the smaller firms also may have less oversight and may house smooth-talking salespeople selling some of the most expensive financial products. It may take a little more work to check out these smaller firms but the rewards can be excellent if you find a good advisor.

You can learn about any regulatory actions taken against a licensed advisor at the [SEC's website](#).

# References

You can ask an advisor for the names of clients you can contact to discuss their experience with the advisor. Keep in mind that the advisor will give you names of clients that he knows are happy and they may not be representative of the advisor's overall clientele. It may help, though, to hear about the advisor from a client's perspective.

Professional references from accountants or attorneys may be better but, in many cases, the professional only knows the advisor personally. They may not have a good sense of the advisor's expertise unless they are also a client, so you may want to inquire further to learn if the professional works with the advisor.

Note that you won't see any client testimonials as these are against industry regulations.

## Avoiding the Madoffs of the World

Even if your prospective advisor is registered and doesn't have any disciplinary issues from the regulators that doesn't mean that he isn't a crook. The Madoff situation and many like it often have numerous red flags including returns that are too good to believe, some exclusivity, and a lack of clear answers on the investment process. A simple way to avoid these criminals is to ensure that your funds are held by a third party custodian that may be a large, reputable firm.

The FINRA licensed reps will use their brokerage firm or a large clearing firm like Pershing to hold their clients' funds. Most RIA firms will use a large firm like Charles Schwab, Fidelity, or TD Ameritrade to custody their clients' funds. Either way you should be able to view your accounts online and receive monthly statements from these large firms. The key is to have confidence in the firm to which your investment checks are payable.

## Annuities: A Big Red Flag

Most investment vehicles and investment classes are neither good nor bad. They go through cycles and there are good times to buy them and bad times to buy them. If you buy low and sell high it really doesn't matter what kind of investment it is. Annuities, though, are usually a mediocre and expensive investment sold by salespeople looking for a big commission.

There are two basic kinds of annuities. Fixed annuities pay a fixed rate of interest set by the insurance company and variable annuities invest into "separate accounts" that are similar to mutual funds and may invest in stocks, bonds, or other securities.

Fixed annuities are often sold as an alternative to bank CDs and often have a higher initial yield. Unfortunately, investors typically find out later that the interest rate is set by the insurance company and not the markets. After an initial period of a year or two at the high rate, many companies drop the rate sharply. Investors who want to cash out then learn about the back-end charge or “penalty” to get out. Often the penalty will exceed the interest paid resulting in a loss if liquidated.

The fixed annuities and their interest rate policies vary from one insurance company to another. Some companies are more reputable but many are not. Commissions can range from 5% to 10% or even more on these products and they are typically not disclosed to investors.

Variable annuities theoretically behave more like mutual fund investments but are usually sold with no front-end commission and instead have a back-end charge that may begin at 7%–8% and declines over the years. While the back-end charges or penalties are usually easy to find, the 7% or so commission paid to the agent typically is not.

Commissioned salespeople often prefer to sell annuities versus mutual funds because the commissions are higher. If investors have a large amount, \$100,000 or more, mutual funds offer significant discounts but the annuities do not, resulting in a commission that may be 2–3 times as high.

One argument for annuities is that they enjoy special tax treatment where the gains are deferred until withdrawn. Unfortunately, under current tax laws they make little sense as mutual fund gains and dividends may be taxed at lower rates than the income withdrawn from an annuity. The elderly are often sold fixed annuities even though they are in a low tax bracket and their heirs may end up paying income taxes on all the gains at a much higher tax rate. The more aggressive salespeople even recommend annuities for tax deferred investments like IRAs or 403(b)s when they offer no tax benefit at all.

Generally, if someone is recommending annuity investments for you it’s a clear sign they are simply looking for their own big commission and have little regard for your financial well-being. There may be exceptions, but it’s best to get a second opinion before buying these expensive products.

## Finding the Right Investment Advisor

Investors generally fall into three broad groups when it comes to their portfolios. Some enjoy the investment process and will manage their own funds without a financial advisor. A second group likes the support and recommendations of a financial advisor but likes to maintain control and only buy investments that sound good to them. The last group recognizes that professionals can probably earn more for them than they can on their own and they let the advisor make the investment decisions. There is no right or wrong group to join and net investment results can be good or bad with any of the options.

The do-it-yourselfers may find lower cost investments but their lack of expertise and their emotions may lead to poor choices that cost them much more than the fee savings. And, at the other end, the investors who trust their advisor may be letting the fox watch the henhouse if the advisor is compensated only on commissions.

The key to getting good investment returns is to understand the financial motivations of the advisor and also to measure the investment results.

## Results

The most important assessment of an advisor is how well your portfolio performs net of all the fees and commissions. Unfortunately, it's often difficult to determine whether an advisor has a good track record. The vast majority of advisors are salespeople who sell investment products managed by others.

Too many investors don't take the investment results seriously enough or they attribute the gains or losses to the advisor when the markets are really responsible.

Dalbar, a research firm, has analyzed investor returns over the past couple decades and annually updates its report, *Quantitative Analysis of Investor Behavior*. For the 20 years ending in December, 2008, they found that the average stock mutual fund investor earned just 1.87% annually versus the S&P 500 index average return of 8.35%. While your returns may be similar to your neighbors or the national average, you may be missing out on substantial gains if you don't consistently monitor your results.

Many investors don't know their investment results and are happy to believe the assurances of their advisor. But the results matter a lot. Consider that a \$100,000 investment at Dalbar's average stock fund investor return of 1.87% for 20 years grows to \$144,850. At the 8.35% return of the S&P 500 index the same \$100,000 grows to \$497,250! Then consider taking income of 1.87% from the \$144,850 account and the annual income is \$2,709. Taking 8.35% income from the \$497,250 generates income of \$41,520. Which retirement income would you like to live on? (Note that these figures don't account for fees or commissions and that you can't invest directly into an index.)

The investment markets go in cycles, so it is very difficult to assess how well your portfolio is performing without sophisticated reporting software and an appropriate benchmark to measure the performance. Your advisor should be able to give you accurate reporting and a good benchmark, but they often don't volunteer the information. If you request this and insist on reviewing the numbers periodically, the advisor will generally consider you to be a more sophisticated investor and they may pay more attention to your returns.

Investment managers will have good and bad performance periods, so you shouldn't simply fire a manager or advisor because of a bad quarter. Generally, you'll want to monitor the investment results against a manager's peers or an index over a period of at least three years.

# Behavior

The Dalbar study found a huge disparity in investment returns due to investor behavior. They attributed it to one simple reason: “When the going gets tough, investors panic.” It is during these periods that professional financial advisors can provide the most value.

The do-it-yourselfers don’t have anyone to turn to during these crisis periods, and many of them will make poor decisions that will decimate their returns. The little they may have saved in commissions or fees may be overwhelmed by the massive losses if they sell near a market bottom.

The investors who deal with a salesperson advisor and wait for that good sales pitch to buy may also have poor results. Often the investor wants to maintain control but they may tend to buy the latest hot story. Think NASDAQ stocks in 1999 or early 2000. Brokers had a field day selling technology stock mutual funds and other ridiculously expensive but popular investments back then. Or think about investors that gobbled up 10-year U.S. Treasury bonds that yielded just 2.2% at the beginning of 2009 and promptly suffered double-digit losses in the next six months (interest rates rose and the bond prices fell sharply).

Investors who regularly follow their advisors’ recommendations may steer clear of some bad investment decisions but they still need to watch the investment results carefully.

# Costs

Investors often focus more on costs than they should. While some investments and investment advisors are more expensive than others, the cost differences are usually very minor compared to the differences in investment performance.

You’ll want to avoid investments with large up-front or back-end costs that would significantly reduce your return over a three-year period. Three years is long enough to learn whether your advisor is performing well.

The key is to monitor your net investment returns. A more expensive advisor may be well worth the extra cost if you are earning consistently good net results.

The costs for financial planning can vary wildly, and the price isn’t necessarily indicative of the quality of the plan. Find out if these costs are included with the investment management fees, may be covered by commissions, or are separate additional fees.

# Advisor Value

A good advisor can outperform an appropriate benchmark with your portfolio net of his fees, but there are other aspects of the service that can add a lot of value. Even if your net returns are near the benchmark, the advisor has probably increased your returns well above what you may have done on your own. In addition, advisors may offer advice on tax savings, guidance on how much to save, and help in dealing with the large financial service firms that may hold your funds.

## AUM vs. Hourly

Some investors do a little math on the investment management fees and learn they'll pay several thousand dollars or more a year if they have a large portfolio. They may feel that they can get some good advice on where to invest by paying someone an hourly rate to recommend some investments for them. Unfortunately, this is often penny-wise and pound-foolish.

The investment markets are dynamic, and today's recommendations could change next year or even next week. The hourly advisor won't likely call one-time clients when his outlook changes, and if he does, then he's essentially working just like the commissioned salesman. Is he changing his outlook because he needs to charge another fee or is it because things really have changed?

## 401(k) Management

If you work at a company with a 401(k) plan (or similar retirement account), chances are you get little in the way of ongoing investment advice from the firm that handles the company plan. Most firms offer some past-performance figures on the investment options and some generic asset-allocation suggestions. It's up to you to manage the portfolio yourself. Unfortunately, few people have the expertise to do it well and the results can be awful (see the Dalbar study results above).

Even if you approach a bank or brokerage firm about managing your 401(k) plan, most can't do it because the assets are still in your employer's plan. They can't earn a commission on it or deduct a fee, so they can't help.

Some firms, especially RIAs, do have the systems to incorporate your 401(k) plan into your overall portfolio and can manage it alongside your other assets. You'll need to pay their fee from assets outside the 401(k), but it could be money well spent if they can improve your investment results.

# Conclusion

By now you may have determined that finding a fee-only RIA firm is a good place to start. The fee-only advisors don't have the conflict of interest of sales commissions so they can work to reduce your investment costs and they owe you a fiduciary duty to put your interests first.

Unfortunately, most of the best fee-only firms have significant minimums that put them out of the reach of smaller investors. Their minimum portfolio size may range from \$100,000 to \$1,000,000 or more.

The RIA firms often don't advertise very much, so you'll need to seek them out. The National Association of Personal Financial Advisors (NAPFA) is the largest organization of fee-only financial planners in the U.S. They offer a [Find an advisor search on their website](#).

Smaller investors who don't meet the minimums may want to seek out independent advisors who don't have proprietary products that their firms encourage them to sell. Consider the numerous factors above and remember that your investment performance is your primary concern.

You'll likely do best to follow a professional's advice through the cycles, but keep tabs on how they are doing against an appropriate benchmark. Maybe you'll save enough to grow your portfolio large enough to move to a fee-only advisor down the road, but if you've got a good relationship with an advisor that has made you good returns you may want to stay with him. There are lots of smooth-talking salesmen out there, and finding a trusted advisor that performs well can take a long time.

# Resources

Check out individual brokers or RIA firms through links from the SEC  
<http://www.sec.gov/investor/brokers.htm>

Find fee only financial planners through NAPFA  
[www.napfa.org](http://www.napfa.org)

Find Certified Financial Planners or confirm their certification  
<http://www.cfp.net/search/>

Find financial planners that are members of the Financial Planning Association  
<http://www.fpaforfinancialplanning.org/PlannerSearch/PlannerSearch.aspx>

The Dalbar study summary is available at its website  
<http://www.qaib.com/showresource.aspx?URI=advisorreditionfreelook&Type=FreeLook>

# Questions to Ask a Financial Advisor

Financial advisors are generally happy to answer these kinds of questions. Very rarely will a financial advisor lie to you, but be careful how you word your question, as they may answer it in a way that is technically accurate but could be misleading. Feel free to press them if the answer is not clear to you.

Are they a current CFP® licensee (Certified Financial Planner)?

What will your financial plan cover and is there a separate charge for the plan?

How often will they update your plan? What does it cost for an update?

How are they compensated?

Are they licensed to sell securities or insurance products?

Will they always act in a fiduciary capacity with you or will there be times when they act in a sales capacity?

What is their investment strategy? How long have they used it? What kind of results has it generated?

If they use outside advisors, how long have they worked with the firms they are currently recommending?

Will they provide you with a net investment return for your portfolio each year along with an appropriate benchmark?

What benchmark would be appropriate for you?

How often will they review your personal portfolio and what systems do they have to monitor it?

Can they manage your 401(k) or other assets not held with their firm?

How often should you expect to hear from them and in what form; e.g., letter, phone call, e-mail, meeting?

Are they currently engaged in any other businesses?

Will they need your permission for all investment moves? If so, will they call you first or last when they see a new opportunity?

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## *About the Author*

*Frank Moore, MS, CFP®, started in the investment industry in 1983 following a year in banking. He began selling mutual funds for a Wall Street-based firm with their own proprietary products. After about a year he left to found Vintage Financial Services, a Registered Investment Advisory firm. He continued to earn commissions through an independent broker/dealer firm but directed the firm into a fee-based practice in the late 1980s. He changed broker/dealer firms a couple times after both were acquired by large insurance companies, and in 2005 he dropped his securities licenses and began working exclusively on a fee-only basis.*

*Frank has spoken at national conferences for financial advisors on topics from technology to practice management and the investment management process. He is often quoted in national financial publications including the Wall Street Journal, Business Week, and Financial Planning. Frank has three children and lives in Ann Arbor with his wife and Vintage co-founder, Jennifer.*