How to Evaluate a Financial Advisor

You hire a financial advisor to protect, sustain, and grow your wealth. This is a critical professional relationship and you must have confidence in her/his expertise, honesty, and commitment to you.

This guide will show you how to select a new financial advisor, or evaluate your existing one. To do so, you will learn the following:

1. where financial advisors add value – and where they do not
2. advisor fees and investment expenses you incur – and how much these matter to your long-term wealth creation
3. a checklist to evaluate your financial advisor

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How Financial Advisors Add Value

When considering whether to engage the services of a financial advisor, you should first understand the ways in which they can add value and provide insight. To do so, let’s first recognize the ways in which advisors do not add value and may even be value-reducing.

How financial advisors do not add value

The two most important ways that advisors do not add value to their clients are often the primary reasons for which clients seek them out.

1. Investment selection ("stock picking"). Advisors do not possess magical abilities to select stocks, bonds, mutual funds, or other investment securities that will consistently outperform the market. Do not be fooled into believing that advisors have some inherent advantage that will produce outsized returns for you. Disappointment and excessive fees will only ensue. You are better served by investing in low cost index funds based on your appropriate asset allocation.

2. Market forecasting (“market timing”). Similarly, advisors possess no accurate crystal balls that enable them to be able to predict future movements of the various investment markets – stocks, bonds, foreign exchange, commodities, etc. As with sports radio, everyone is an ex post expert but no one can consistently make those judgments in advance. Yogi Berra may have said, “It’s tough to make predictions, especially about the future.”

Investment markets are efficient – simply put, that means that future prices changes are unpredictable. If hiring someone to “beat the market” is your primary requirement for a financial advisor, you will be ill-served and ultimately, disappointed.
So, if this is not how financial advisors create value for clients, what important roles do they play?

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Financial advisors don’t add value from investment selection and market forecasting.
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How financial advisors add value
Advisors can play four important value-creating roles.

1. **Asset allocation.** This refers to the mix of different asset classes (e.g., stocks, bonds, cash, real estate, etc.) that make up an investor’s portfolio. The asset allocation balances the trade-offs between risks and expected returns and should be calibrated based on your age, goals, available assets, income, and risk tolerance. This is a critical need, not well understood by most clients, and not intuitive for many people.

2. **Removing emotion from investment decisions.** When left to our own devices, we all often make poor investment decisions. We panic when we should be steady and jump on the bandwagon when we should step aside. Our emotions can cause us to buy high and sell low. A financial advisor can insulate you from these emotional gut reactions and remove the urge to do *something* when it is probably best to do *nothing*. Just as a lawyer is not well served by having himself as a client, and a doctor should not treat his relatives, you will benefit from insulating your emotional self from your investment decisions.

3. **Minimizing taxes and investment expenses.** Seemingly small expenses become significant over long periods. A financial advisor who is committed to putting your interests first will minimize all of your investment-related taxes and fees as these are dead-weight losses to you. Your advisor should: invest in low-cost mutual funds, optimize your investments between your retirement and taxable accounts, and avoid unnecessary trading and short-term capital gains.

4. **Other financial planning needs.** Managing investment assets is only one facet of what a financial advisor can offer. For many clients, there are other vitally important needs such as determining how much to save, how to budget, college funding, insurance guidance, retirement planning and Social Security claiming strategies. If you have questions on these topics, a well-skilled advisor can help.

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Financial advisors add value by guiding asset allocation, removing emotion from investment decisions, and minimizing fees and taxes.
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Understanding Advisor Fees and Investment Expenses

As a client of a financial advisor, you incur both advisor fees and investment expenses. These fees and expenses directly detract from your wealth creation and so it is important to identify, understand, and minimize all of them. Let’s begin with advisor fees and then follow with investment expenses.

Advisor Fees
Advisors generally charge clients for their services in one of three manners:

1. **Commissions** from selling clients financial services and products. These could include stocks, bonds, insurance, annuities, etc. These commissions may be implicit and hidden (such as how a car salesperson is compensated) or explicit (such as how residential real estate is typically transacted with a broker).

2. **Asset under management** (“AUM”) fee. The advisor charges the client a percentage of the assets being managed. A typical fee may be in the range of 1%. Generally, when a client pays an AUM fee, all transactions are made on a commission-free basis, but that is not always the case.

3. **Hourly rate.** Like other professional services such as lawyers, accountants, and tradespeople, the advisor simply charges by the hour, based on the time incurred.

The first two fee models are the most common, yet they are also conflicted, hidden, and almost certainly, the most expensive. The conflicts inherent in the first model are straightforward in that the advisor’s income is maximized based on the amount of products sold to you, rather than necessarily doing what is in your best interest. The conflicts in the AUM model are not as clear at first.

The AUM model may seem like your interests and the advisor’s are aligned but it too, can result in meaningful conflict between the two parties. For example, let’s imagine the client has $800,000 of assets under management with the advisor and is facing a decision about how to finance a $200,000 college expense for her daughter – either draw down assets and pay cash or take out a loan. If you pay for college by drawing down assets, the advisor’s fees will immediately decline by 25%! That is an awkward decision for the advisor to make.

From the advisor’s standpoint, the first two models have another advantage – the fees are nearly perfectly hidden. Many clients neither know how they compensate their advisor, nor how much. These commissions and fees may not clearly appear on a monthly invoice but instead are deducted from the account, thus requiring forensic accounting expertise to determine their amount. By keeping these fees hidden, it is easier for advisors to avoid a conversation about them.

The hourly rate model is the best option for most clients. However, many advisors, especially those employed by the Wall Street banks, may be unwilling to provide their services on that basis. Some clients are even reluctant because it may seem that the fees are
higher because they now become visible and are explicitly paid. Don’t be fooled by this – opt for an hourly (or flat) fee model with your advisor, if possible.

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An hourly or flat fee model for advisor fees is typically the best approach.
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Investment Expenses

Investment expenses are incurred when transacting in or owning various investment securities. In some cases, they may be partially rebated to your advisor as a fee but in other cases, your advisor does not benefit from these expenses. They generally appear in four broad categories:

1. **Commissions from buying and selling securities such as stocks and bonds.** For clients who engage an advisor and pay an AUM fee, these commissions are often waived.

2. **Bid-ask spread.** This is the difference in price between what you pay to purchase a security and what you receive when you sell it. The size of this spread varies depending on the liquidity of the security you trade.

3. **Mutual fund operating expense ratio.** This fee is expressed as a percentage of invested money and is paid to the management company of the mutual fund. These fees range widely – from as low as 0.10% to greater than 2.00%, depending on a wide variety of factors. ETFs (exchange-traded funds) operate very similarly to mutual funds and also charge these fees.

4. **Mutual fund sales loads.** This is a funny name for what are essentially commissions that are paid either when you purchase the fund (i.e., front-end loads) or when you sell the fund (i.e., back-end loads). These loads are in addition to the operating expenses described above. The fees can be as high as 5% but are becoming less common. Often, loads are used to compensate a financial advisor and serve a purpose very similar to a commission.

For most investors, the key expense on which to focus is the mutual fund operating expense ratio. Every fund discloses this information and, in the age of Google, it is relatively easy to track down this number. However, many mutual funds have multiple share classes, with each of these classes incorporating a different expense ratio. Be sure that you check the share class that you own.

How much do these fees and expenses matter? In short, they can have a substantial effect on your total wealth accumulation.

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Investment expenses have multiple forms and are often hidden.
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Fees and Expenses Matter Greatly

Advisor fees and other investment expenses can *significantly* affect your wealth accumulation over the long term.

To understand the magnitude, let’s consider three investor personas:

1. *Ms. Thrifty* is a do-it-yourselfer when it comes to her investing. She does not engage an advisor and only invests in low cost index funds that have an average operating expense ratio of 0.15%. That is, she pays 0.15% in fees and expenses.

2. *Mr. Average* engages a financial advisor to whom he pays a 1% AUM fee. His advisor invests in mainly low cost funds that have an average operating expense ratio of 0.25%. That is, he pays 1.25% in fees and expenses in total.

3. *Mr. Big Spender* is just that. He engages a financial advisor to whom he pays a 1% AUM fee. However, his advisor has selected some higher cost mutual funds, as well as investing in some individual stocks and bond that incur some trading costs. On average, he is paying another 1% in these various investment expenses. He pays 2.0% in fees and expenses in total.

**The difference in wealth accumulation over long periods is substantial.** For example, after 40 years, Mr. Big Spender has only 64% of what Ms. Thrifty has amassed. Even Mr. Average manages to accumulate on 77% as much as Ms. Thrifty after forty years. Fees and expenses matter tremendously – play close attention to them.

You can see this in the charts below:

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Fees can *significantly* affect your wealth accumulation over the long term.

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How to Evaluate a Financial Advisor

Evaluating – or selecting – a financial advisor presents the same challenges as selecting any other professional services such as lawyers, doctors, mechanics, and plumbers. You lack the expertise that you seek and thus need to make a judgment based on your limited knowledge and instincts.

To evaluate financial advisors, we recommend a systematic framework based on the following approach:

1. **Investment strategy**
   - What is the advisor’s approach and philosophy regarding asset allocation, diversification, and minimizing investment expenses?
   - Does the advisor regard stock selection as the pre-eminent value or is she focused on determining optimal asset allocation, given the client’s particular situation?
   - Is the advisor sensitive to minimizing all investment expenses or is that not an area of concern?

2. **Fees**
   - Are the advisor’s interests aligned with yours regarding the fee structure?
   - Are the fees reasonable?
   - Are the fees and other expenses transparent and understandable?
   - Does the advisor offer an option for an hourly fee structure or is a percent of assets under management the only option?

3. **Tax strategy**
   - What is the advisor’s approach to minimizing taxes?
   - Is there a strategy to defer capital gains and realize losses?
   - Is the advisor aware of the client’s year-to-year fluctuations in income so she can take advantage of when to realize losses?
   - Does the advisor minimize short-term capital gains?
   - Are there short-term capital gains? This may be a yellow flag indicating that there is too much churn in the account.
   - Does the advisor use retirement accounts optimally?
4. **Fiduciary role and financial expertise**
   - Does the advisor act as your fiduciary? This obligates the advisor to act in your best interests, rather than her own. This may be described as a duty of care and a duty of loyalty.
   - Does the advisor have relevant credentials such as a CFP (certified financial planner)? A CFP indicates that the advisor has achieved a certain level of experience and knowledge in the industry regarding investments, tax, insurance, estate planning, etc.

5. **Other financial planning services**
   - Does the advisor offer other complementary services and guidance around budgeting, retirement planning, college financing, insurance, and estate planning?
   - Is the advisor qualified in these areas?
   - Are these additional areas of guidance services for which you seek assistance?

You should understand all of these factors before you make a commitment to a new financial advisor relationship or as you evaluate an existing one.

I can help with this process. You can learn more at financiallyspeaking.org.