THOUGHTS ON THINGS FINANCIAL

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YOUR GUIDE TO A CHAOTIC MONEY WORLD

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Chapter 5

WHO'S WHO IN THE ZOO? A PLAIN ENGLISH EXPLANATION OF THE PLAYERS IN THE MONEY WORLD

Just How Big Is the Financial Universe Anyway?

There's big money in the financial services industry. When I say big, I mean really big, as in bigger than anything the world has ever seen. It's a universe all unto itself. Nearly all large corporations trade as a stock on the stock market, and those that don't still rely on some sort of financing or funding, privately or otherwise, that falls squarely into the behemoth financial services industry. All of the expensive spots during televised sports events, paid programming on Saturday morning radio, and massive media conglomerates (Bloomberg, WSJ, Forbes, CNBC) that are all dedicated to providing investment and finance information should tell us something.

There are two parts to the financial industry: B to B and B to C. Banks, insurance companies, pension funds, and other financial institutions trade with each other at a frantic, high-volume pace and with extreme efficiency. These folks know what they're doing and know the folks on the other side of the table know what *they* are doing. We call this B to B (business to business), and this part of the industry hums along efficiently behind the scenes with very little fanfare or media attention. Then there's B to C (business to consumer), and this is where it gets interesting. It should come as no surprise that the largest margins to be had in the financial sector are in the B to C segment. It's been estimated that over 17 billion dollars[2] in excess fees and expenses are charged to consumers by financial services companies every year just in IRAs alone. When I use the term "excess," what I mean are fees that savvy industry insiders and veterans (i.e. B to B professionals) know how to avoid.

Excessive investment expenses will directly affect your investment performance, which can steer you off course. Even more detrimental to consumers is the fact that these excess fees drive the industry to aggressively pursue you as a customer through their marketing, advertising, and salespeople. If you want to be financially successful, you have to know how to avoid these excess fees and expenses, and the easiest way to avoid them is to avoid the companies and salespeople who charge them.

In this B to C world, it's really difficult to tell who is who, who they work for, and what kinds of products they are selling. Because of the complexity, we need to go over who's who, what their roles are, and if they are necessary in your quest for financial security. Without better understanding, it's easy to fall prey to the salespeople of the industry or the emotional angst of the media or to just let everything fall by the wayside as you struggle to find the time on weekends and after work to try to manage your investments on your own.

Alphabet Soup

In my industry, as in many others, designations are used by advisors to learn and demonstrate their qualifications. These can be complicated. There are a couple of things you need to know about designations. Most designations are not licenses; rather, they are usually governed and administered by some separate, non-govern-

2 "The Effects of Conflicted Investment Advice on Retirement Savings," Executive Office of the President of the United States, February 2015, https://obamawhitehouse.archives.gov/sites/default/files/docs/cea_coi_report_final.pdf

ment entity. Secondly, just because an advisor has a designation does not necessarily mean he or she is looking out for your best interests. For instance, a Certified Financial Planner™, or CFP® professional, can receive commissions on sales of products all day long, so don't use this as your sole screening criteria. Always ask clear, specific questions.

But the most common designation for a financial planner or investment advisor *is* the CFP®. I have a couple of decades of experience in the realm of CFP® practitioners, and I believe it to be excellent training for providing sound financial advice to consumers. The CFP® certification has been around for over 45 years and has been managed by the same organizational structure, Certified Financial Planner Board of Standards, Inc. (CFP Board), since 1985. A CFP® must meet minimal education requirements that include a bachelor's degree and completion of either college-level, self-study, or classroom equivalent education in the following principal topics:

- Professional Conduct and Regulation
- General Principles of Financial Planning
- Education Planning
- Risk Management and Insurance Planning
- Investment Planning
- Tax Planning
- Retirement Savings and Income Planning
- Estate Planning

After completing the coursework or equivalent education requirements, they must pass a comprehensive examination. The CFP® exam is given three times per year and is a difficult, six-hour long, 170-question, computer-based test. The pass rate generally ranges between 50% and 60%. On average, a candidate studies around 1,000 hours for the exam. In addition to passing the exam, candidates must document 6,000 standard hours of experience "acquired through a variety of activities and professional settings including personal delivery, supervision, direct support, indirect support or teaching," according to the CFP Board website. Finally, a CFP® certificant must uphold the ethics outlined by the CFP Board in their Standard of Professional Conduct. If they don't, the certificant can get their designation suspended or revoked. Certificants also have to do 30 hours of continuing education every two years.

Another highly regarded designation is the Chartered Financial Analyst, or CFA. The CFA Institute acts as the governing body for what many consider to be the most difficult and arduous designation in the financial services industry. CFA candidates must attain 4,000 hours of specific work experience "[a]pplying or evaluating economic, financial, and/or statistical data in making investment decisions about securities or similar investments" prior to obtaining a CFA charter.[3] A bachelor's degree is also required, but it's the CFA education and testing process that really makes this designation tough.

There are three exams, called Level I, Level II, and Level III. Each exam coincides with a self-study, graduate-level curriculum comprised of 18 sections. The pass rate for each section historically hovers right around or just under 50%, but since you have to pass them in order of succession, the completion rate from Level I through Level III is a miniscule 12.9%.

CFA's are *the* investment experts in my industry, in my humble opinion. As such, many gravitate more toward being analysts and portfolio managers at large institutions. That being said, the curriculum fits extremely well with the knowledge and skills needed for personal portfolio management, so CFAs make great financial advisors.

3 "Work Experience Guide," CFA Institute, accessed January 30, 2020, https://www.cfainstitute.org/membership/join/work-experience

Finally, there is the Chartered Financial Consultant, or ChFC, credential that can be attained through self-study material and testing provided and administered by the American College. Candidates must:

1. Attain three years of industry work experience.
2. Pass nine courses of instruction (seven core and two elective) within five years.
3. Complete 30 hours of continuing education every two years thereafter.

The ChFC course material is excellent and closely resembles the CFP® certification modules. Because of the excellent American College curriculum, ChFCs generally have an adequate amount of knowledge for providing financial advice.

Use an Investment Advisor Representative, Not a Salesperson

In my world, there are two hats advisors wear: the Investment Advisor Representative (IAR) hat and the Registered Representative hat. As a consumer, you will rarely hear or see the Registered Rep title; rather, Registered Reps prefer to call themselves "advisors." I know that's confusing, but for whatever reason, industry regulators continue to allow Registered Reps to pretend like there are no distinctions. But there are; believe me.

Investment Advisor Representatives provide advice. Registered Reps provide products. That's the difference. These days, those in the industry who get a kick out of running financial plans and providing investment advice (like me) can do so without the confines and constrictions of a large Wall Street firm or insurance company "encouraging" us to sell their products.

I don't know why anybody, if given the choice, would choose to work with an advisor who is selling them products for their firm over an advisor who is providing advice. But the stodgy old ways of doing business die hard, mainly because they are still, even after so much disruption, insanely profitable to these firms. Why change anything if you can still make money hand over fist?

Beware of Hat Switchers

Registered Representatives and insurance agents sell their products using a consultative approach that makes it very difficult to distinguish from the real, actual, unbiased advice of modern-day Investment Advisor Representatives. Also, since there is little to no regulation regarding what Registered Representatives and insurance agents call themselves, it's difficult for the average consumer to make a distinction.

But get this: a Registered Representative and an Investment Advisor Representative *can be the same person*. This makes it nearly impossible to make a distinction unless, of course, you read this book. Amazingly, the regulators allow large financial services firms, like Merrill Lynch, UBS, Ameriprise, Edward Jones, and LPL, to employ salespeople who can be registered both ways, as Registered Representatives *and* Investment Advisory Representatives.

Let's call them hat switchers because the regulations allow representatives to take off their salesperson hat and provide advice for a fee, say in a managed account, then remove their advice hat and sell a lucrative, high-commission product for the firm. They can switch between hats at any time, multiple times, and even in the same meeting, all without the client knowing.

The Trouble with Hat Switchers

Do you think this sounds conflicted? If so, you're not alone. In recent years there has been a huge wave of money movement from these firms to smaller, stand-alone RIA firms. But as more and more money and clients move away from the large financial services firms, their salespeople follow.

A few make the move for the right reasons and drop their commission licenses in order to provide unbiased fee-only advice. However, most are maintaining their securities and insurance licenses in low-key arrangements. Beware; this advisor is the same conflicted hat switcher he was when employed at Ameriprise or LPL: a wolf in sheep's clothing. When evaluating advisor relationships, here are a few key questions to ask:

- **Are you affiliated with a broker/dealer or brokerage firm?** *Any* affiliation is a no-go, no matter how persuasive their answers may be. The name of their company may be something like XYZ Wealth, which could be a Registered Investment Advisory Firm where only advice and no product sales can occur. But you turn their card over or look at the fine print at the bottom of their website, and it will say something like, "Securities offered through ABC Financial, Member FINRA/SIPC. Investment advice offered through XYZ Financial, a registered investment advisor and separate entity from LPL Financial." If you see this, move on. The key words to avoid are "broker/dealer" and "FINRA."
- **How are you compensated?** Registered investment advisors are paid by the client, so this is the answer you are looking for. It could be a percentage of assets managed, a retainer, or a planning fee. The bottom line is that you pay it. Any answer like, "I get paid three ways," "It should not be a concern," or some other mumbo jumbo is unacceptable.
- **Do commissions make up any part of your compensation?** The answer should be "no." Many RIAs maintain an insurance license even if they don't have an affiliation with a broker/dealer for the sale of securities. Ask specifically about insurance commissions they may receive in relation to the recommendations they are providing.

It's important to note that some consumers believe they are getting unbiased advice when working with a discount brokerage firm like Schwab or Fidelity. Well, think again. These firms are providing transactional support for the buying and selling of securities and other financial products. Therefore, if or when they provide advice, it should *not* be considered unbiased or free from conflict. If you are relying on recommendations from your discount brokerage firm, understand there could be profit motives behind what they recommend.

There Is a Permanent Record, and It's Public

You may not know it, but yes, everyone in my industry has a record. And it can be easily verified a few ways. Remember, if you choose an advisor now, they could be with you for 30 years or more as you work toward and complete your long-term financial goals. Take the time to check out his or her service record.

A great way to check an advisor's record is through FINRA's BrokerCheck website. Go to https://brokercheck.finra.org and type in the advisor's name. Once you find him or her, here is what you are looking for:

- **PR – Previously Registered:** This means the advisor at one time held a securities license but is no longer registered. That's a good thing.
- **B – Broker:** This means the advisor currently holds a securities license of some type. As we discussed previously, this is not what you are looking for. Move on.
- **IA – Investment Advisor:** This means this advisor is an Investment Advisor Representative. Perfect!

Next there is a disclosures section. Disclosures are bad, so ideally the advisor you're looking into won't have any. But sometimes bad things happen to good advisors, so if there are disclosures, read them carefully and ask the advisor about them to better determine the circumstances.

Finally, there is an experience section where you can verify the advisor's work history and years of experience. Generally, of course, you are looking for a bigger number for years of experience and a smaller number for firms your advisor has worked for. An advisor who has bounced around a lot can mean a number of things, so you want to ask questions if you see a lot of firms listed.

From there, you can click over to www.adviserinfo.sec.gov and check out your investment advisor on the SEC website. This is where more information on RIAs and their representatives can be found. Most of the representative information is the same, but on the SEC website, you can get more detailed firm information. Search by your advisor's firm name and click on "Part 2 Brochures." This is the RIA firm's ADV Part II, and it has some fantastic information. Here you will find any disclosed conflicts of interest and verify the dollar amount of assets the firm manages, as well as their types of clients, number of accounts, fee schedules, and on and on.

It should take you all of about 15 minutes to quickly review the FINRA BrokerCheck and SEC Investment Adviser Public Disclosure sites for any red flags. If you see something that concerns you or that you don't understand, don't hesitate to take it up with the advisor. If, when you ask questions, the advisor becomes defensive, that's a bad sign. A good advisor will welcome your questions and concerns and should go out of their way to help you better understand their background and experience.

A Note About NAPFA

NAPFA stands for the National Association of Personal Financial Advisors, and their website is hands down the best place to find a truly independent, fee-only fiduciary advisor, which is exactly what you should be looking for.

Why? Because NAPFA is the exclusive association of these rare cats. To put this in context, let's throw in some numbers. There are approximately 300,000 investment advisors in the United States. Of those, about 80,000 are CFP® certificants, the most recognized distinction of profession expertise, as we discussed. Of those 80,000 CFP® certificants, less than 3,000 are willing to operate under the strict requirements and criteria of NAPFA.

That's because NAPFA takes it to the next level. To become a full member of NAPFA, you have to first be a CFP® certificant, and you must submit a comprehensive financial plan that you personally developed for peer review. Then, you have to meet NAPFA's strict criteria and definition as a fee-only advisor. This means you are disallowed from selling any financial products, including life insurance, for a commission. In addition, you cannot receive any referral fees from commission agents, or have any ownership in any financial services or insurance company or agency that sells commission products. You can easily use their website to search for a NAPFA member near you, and if I did my math correctly from the numbers of advisors illustrated above, you just eliminated 99% of the advisors out there in one fell swoop.

Where and How Advisors Get Paid

Believe it or not, you'll have to pay good money for good financial advice. You get what you pay for. However, you should know how much it costs you and where the money comes from, so you can evaluate whether the advice you're getting is worth it. We already know the cost of not having any advice at all. It could cost you everything if you end up lost at sea, with no guidance on how to get where you need to go financially. But not all advisors charge the same rate or the same way, so their cost can be difficult to evaluate.

Here are some very general guidelines of what to reasonably expect with regard to your advisor's compensation:

- **AUM Fee:** AUM means "assets under management" in my world. In English, this is the amount of money your advisor is managing for you. It is most common for you to be charged a percentage on these assets as compensation for your advisor and his or her firm. Generally, most people should expect this fee to be around 1%, meaning if your assets at the firm are around one million dollars, you should expect to be charged around $10,000 per year. It can be more or less, depending on the size of your portfolio and/or the services being provided. In my opinion, for 1% of one million dollars, you should be getting a full wealth management experience that includes not only investment management but also comprehensive financial planning. Under no circumstances should an AUM fee exceed 1.5% of assets.
- **Financial Planning Fee:** An advisor may want to charge for all of the upfront preparations and time needed to create an initial financial plan. If so, this could be a one-time fee that pays for all of the upfront work associated with creating an initial comprehensive financial plan. This charge is going to vary widely, based upon the complexity of your situation and the comprehensiveness of the plan. The fee could possibly be as low as $500 for a young couple but could also exceed $80,000 for an extremely wealthy family with complex estate and tax planning issues. In my opinion, a reasonable planning fee for an average family should run between $3,000 and $8,000.
- **Retainer or Ongoing Planning Fee:** Instead of charging upfront or on assets, an advisor may charge a retainer or ongoing fee for as long as the engagement lasts. This could be a monthly charge or done on any preferred

schedule. Just like the one-time planning fee, it could vary widely based upon the scope of work. Generally, this is a good way to go if all you want is ongoing financial planning advice without asset management.

- **Combo:** In today's environment, expect to see combinations of the three fee options used in conjunction with each other. For example: an advisor may charge only 40 basis points (0.4%) on assets managed but also a $3,000 semi-annual financial planning fee. On a $1 million portfolio, that's still 1% of assets, but charged differently. This is fine and can work to your advantage because it separates out the two services being provided a little (investment management and financial planning). However, make sure that you can add it all up and that it still makes sense, as a total charge, with respect to the services you are being provided.

The Wrong Way to Pay an Advisor

Nearly everybody in the financial services industry, regardless of how they get paid or what they call themselves, provides service in the way of consultative advice and assistance. This consultative sales technique looks, sounds, and feels like advice. Many times, it's useful and relevant, but at other times, it can be manipulative and detrimental to a client's long-term plan.

How do you tell the difference between good advice and bad advice? Well, you probably can't. The best salespeople in my industry are *that* good. They are extremely personable and likeable, so you will trust what they say. The stakes, in the form of commissions, are beyond lucrative in many cases. They have the opportunity to make upwards of $100,000 on a single transaction, payable up front at the time of sale. Stakes at this level create very, very good salespeople and can, unfortunately, encourage unscrupulous behavior. There are more than a few otherwise good people who will do or say the wrong thing for this kind of money.

Let's say you have a million dollars to invest. A commission-based advisor can sell you a loaded mutual fund and get paid around $10,000 on the transaction or write a variable annuity and make $60,000 or more on the transaction. The variable annuity will be the right choice in very few instances, mainly due to the high cost. But more often than you might believe, they sell the annuity. Go figure. And if you think you're smart enough to figure all of this out on your own, think again. Some of the most intelligent people I know have walked into my office with some of the absolute worst commission investment products in their portfolios. Remember, these salespeople are highly motivated and very good at what they do, so you won't see it coming.

Your golfing buddy who works for Merrill Lynch, Northwestern Mutual, or [insert financial services firm name here] is probably a nice guy and extremely successful. It's tempting, but you should not under any circumstances hire him to provide financial advice. He may be a good insurance agent or stock trader, but his advice is conflicted. Many times, we may need an insurance agent or stockbroker to assist us in purchasing financial products. But you should rely on a fee-only advisor to provide advice, make recommendations, and help you navigate toward your intended destination.

There is way too much at stake to rely on conflicted advice. We have to be ready and prepared at all times for whatever life throws at us, as illustrated in the next chapter.