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Wealth Management

YET ANOTHER WAY YOUR FINANCIAL ADVISOR CAN ENRICH HIMSELF AT YOUR EXPENSE

As if there wasn't enough in the way of mutual fund and broker scandals, the Wall Street Journal, in a January 9, 2004 article, highlighted yet another way your financial advisor might be motivated to place his or her own interests above your own.

Let me recap some of this past year's story lines. First, there was the broker recommendations scandal. Large brokerage firms, such as Merrill Lynch and Morgan Stanley, to name just 2 of many such firms, legally and legitimately engage both in retail brokerage and something known as "investment banking". The former involves advising people like you and me as to which stocks and bonds to buy or sell and then executing those transactions. In order to advise their clients in this regard, they employ research analysts, whose job it is to do in depth research and make buy / sell recommendations. These same large brokerage firms also help large corporations raise money to finance their growth through the issuance of new shares of stock. This is known as investment banking and it can be very lucrative, much more so than retail brokerage. It has been an open secret on Wall Street for as long as I worked there that research analysts were very wary of issuing a sell recommendation for fear of annoying a potential investment banking client. If you are a research analyst and you publish what you really think, it is a pretty good way to torpedo your year-end bonus and very possibly your job.

Second, we have learned that many otherwise well regarded mutual fund companies have been letting certain favored clients (always large institutional clients, never you or me) buy shares of the mutual fund after the market closed. Why is this a problem? Mutual fund shares are priced off the close of the major exchanges in New York. Other markets remain open. If these other markets go up or down in a significant way, someone trading after hours has an advantage. That puts money in their pocket and takes money out of the pockets of everyone else. Unlike the first issue above, this practice was news to me and I am still amazed that these mutual fund firms would risk their reputations in this way.

So what do we have so far? So far you can't trust the brokerage firms to give you an honest research opinion regarding stock recommendations and you can't trust the mutual fund companies to treat all their clients fairly. The latest revelation, also an open secret, is that your financial advisor at your brokerage firm may have a conflict of interest in recommending which mutual funds to buy. The Wall Street Journal article picks on Edward D Jones & Co, which had previously taken out full page ads touting their integrity over other large brokerage firms because they do not have an investment banking business. Therefore, the reasoning goes, they can provide you with an objective recommendation. Now we learn that Edward D Jones & Co, engages in a legal practice called "revenue sharing". Revenue sharing is when a mutual fund company agrees to pay a brokerage firm a fee (some might call this a "kick back") to be on that firm's preferred list. According to the

Wall Street Journal article, sometimes the mutual fund companies even pay for Caribbean cruises and African wild-animal tours. This creates a conflict of interest because your financial advisor now has a significant incentive to recommend funds on the preferred list. Edward D Jones & Co was singled out, not because they are the only firm to engage in this practice, but because they allegedly practice this to a greater degree than other firms. To pick on someone else, Morgan Stanley, for instance, recently agreed to a $50 million settlement with the SEC because its brokers did not disclosure to its customers revenue sharing and other broker incentives.

Under the security laws, brokers are theoretically held to the high standard of trusted advisor and, as such, must either offer truly objective advice, or disclose in clear language any conflicts of interest. In my opinion, the financial services industry has not done nearly enough to bring true integrity to its business. The industry doesn't want you to know how much you are paying them. They are afraid you will demand lower prices. They are afraid you will find something cheaper.

What should you do? First, don't stop investing. You need to continue to save and provide for your financial future. Don't use these scandals as an excuse to not invest. America probably has the fairest markets anywhere in the world. You wouldn't stop buying cars just because you got taken advantage of at a car lot. No, you would vow to be a better consumer the next time. Which leads me to the second thing you should do.

Be a better consumer. Ask questions. Ask why your advisor is recommending a certain fund and not some other fund. Try to find out what motivates him or her. Ask how your advisor is getting paid and how much. Make them put it both in dollar terms, not just percentages, and in writing. That way you know they will be very accurate. Have them explain anything you don't understand. If they can't do this for you, find a new advisor.

Lastly, consider hiring a fee-only advisor. A fee-only advisor's only compensation is what you pay him or her. They don't sell financial products, they don't accept commissions, and they don't accept referral fees. Their only source of revenue is the check you write. So you know exactly what it their advice costs. And don't be confused by "fee-based" advisors, they can charge a fee or collect commissions, sometimes both.

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