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Aligning Financial Advisor Motives With Yours

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Have you experienced a situation where you lack knowledge in an area but need to judge whether an "expert" in that area is providing you with good advice? Usually the expert is knowledgeable and truly looking out for your best interests, but there is always the chance that the expert is lining their own pockets at the expense of your ignorance.

For example, it is difficult, if not impossible, for you to find the time needed to determine how to structure your estate, minimize your tax liability, optimize your asset allocation, let alone investigate a company you are interested in investing in by analyzing their income statement, balance sheet, management, industry trends and competition. Because of this many of you use one of the multitude of brokers, financial advisors, accountants and lawyers who promise to provide you with a financial helping hand, whether you want to make a small investment in a mutual fund or develop a comprehensive wealth management strategy.

However, given your lack of specialized financial knowledge, how can you tell if these professionals are sincere or if they are only interested in finding a way to stick their hands in your wallet? While the majority of financial professionals are ethical, recent scandals involving tainted research (Merrill Lynch, Smith Barney, J.P. Morgan Chase) or mutual fund sales practices (Morgan Stanley) indicate that many of the professionals at the so-called top-tier investment firms are not necessarily looking out for your best interests. So, how can a medical professional without the time to teach oneself accounting or financial analysis hope to understand when they are getting valuable advice, and when they are getting fleeced?

While only deep research and due diligence can allow you to definitely determine whether a financial professional is looking out for your best interests, there is a simple test you can use to narrow the field and find financial professionals whose objectives are aligned with yours: examine their pay structure very closely. Generally, if their pay structure rewards them for serving your interests, it is more likely that they will be looking out for these interests. However, if their pay structure is unrelated to the satisfaction of your financial needs, often you will find them recommending actions that make them (and not necessarily you) wealthier. You need to make sure that their compensation plan drives them to deliver results that benefit you. After all, it is your hard-earned money, not theirs.

For instance, most brokers are paid on commission, meaning whenever you buy or sell a stock they charge you a fee. They get paid whether you make money on the investment or not. Not surprisingly, this pay structure encourages brokers to recommend that their clients buy and sell often, despite the fact that a buy and hold investment strategy historically creates more wealth in the long run (as demonstrated by numerous academic studies as well as the success of buy and hold investors such as Warren Buffet). A commission-based fee structure can often easily lead a financial advisor to encourage you to be very active in both bull and bear markets, whether it makes sense for your overall wealth management strategy or not.

Another aspect of financial professionals' pay structure you should examine closely is how much they are paid when you invest in the investment products they offer, such as mutual funds and life insurance policies. For instance, in the case of mutual funds, their rosy performance figures often do not take into account the "loads" or other sales fees charged to invest in them. However, taking these fees into account can quickly turn a superior return into an inferior return.

If, for example, a fund charges a five percent fee per year and its gross performance for the year was 10 percent, you will only end up seeing around five percent of that performance. Moreover, if the gross performance for the fund is down 10 percent you are hit with a double whammy: not only has your investment shrunk by 10 percent, but also you still have to pay the same five percent fee for the privilege of investing in the fund. Whether they pick good stocks or bad stocks, the mutual fund (and the person who sold it to you) makes money. Is it really fair to pay someone to destroy the wealth you created?

Another pay structure used by many financial professionals is the flat-fee or asset based fee approach. In this case they are paid a flat fee for their investment advice, or are paid a fee based on the total amount of assets that you invest with them. These approaches avoid many of the conflicts resulting from commissions and sales fees, since there is no financial incentive for the professional to recommend trades or products that are not in their client's best interest. However, these flat-fee pay structures do bring with them a whole new set of problems. If the financial professional is charging a flat fee or percentage of assets fee, they have little to motivate them to deliver you superior results. This can lead them to under-service clients, or offer cutter" financial plans rather than a plan customized for the investor's specific needs. It also does not encourage them to move beyond well-known mediocre investments to find hidden excellent investment products or opportunities for their clients. After all, they are paid pretty much the same whether their clients' investments perform well or do not. Competition from other fee-based professionals can mitigate this tendency, but it doesn't change the overall problem in flat-fee or asset-based fee arrangements: the financial professional has little incentive to provide superior services or find superior investments.

There is a pay structure that does generally eliminate these conflicts: performance-based pay structures. In a performance-based pay structure the financial professional only profits if their client profits. There are two ways to accomplish this. The first is to require that financial professionals also invest in any stocks, bonds or other products they recommend to their clients. If the client's investment increases in value, so does their own. However, if they recommend a bad product, they also lose their own money along with his client. Financial professionals are forced to eat their own cooking.

The second manner to accomplish this is to link all fees paid to financial professionals to the performance of the investments they recommend to you. For instance, while financial professionals might collect a commission if the stock he recommends to his client increases in value, if the stock stays the same or decreases, they receive no commission. This approach can be used with brokers for stock recommendations or portfolio managers at private investment partnerships.

For example, some financial advisors require that their principals invest at least 50 percent of their net worth in their investment partnerships and only collect fees if the partnership's investments increase in value. Such an arrangement makes financial analysts doubly motivated to provide their clients with the best possible advice and guidance. There are also brokers who use a similar performance-based structure. If the broker recommends that you buy a stock and it increases in value, you pay a regular commission fee. However, if the stock stays the same or goes down, there is no commission, ever. Moreover, the brokers have to invest in the same stocks they recommend to their clients. After all, if it is good enough for you, shouldn't it also be good enough for them?

When you seek out an expert for advice, you want them to give you the same advice they themselves would follow in a similar situation. While commission and flat-fee based compensation structures do not necessarily encourage this kind of behavior, performance-based compensation structures do by only rewarding those financial professionals whose clients' see results. Performance-based pay for financial professionals forces them to treat your money like their own which, in the end, is exactly what you are looking for in an expert.

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