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WEALTH MANAGEMENT

We Put Financial Advisers to the Test–and They Failed

WSJ Wealth Expert Antoinette Schoar of MIT discusses her research on the quality of financial advice commonly given to clients. PHOTO: GETTY IMAGES/VETTA

By

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The world we live in asks us to make an abundance of financial decisions every day. These range from the inane, such as whether to risk a parking ticket when you stop for one minute to drop off your dry-cleaning; to the highly complex, such as which funds and investment products to pick for your retirement savings.

All of these decisions require risk-return tradeoffs. Unfortunately, while people have many opportunities in life to perfect their strategy concerning parking tickets, the same is not true for the complex and all-important decisions of how to invest retirement savings. By the time you learn whether a retirement strategy was the right choice, it is usually too late to change it.

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Not surprisingly then, much research shows that a large fraction of the population is poorly prepared to make these financial decisions by themselves. Typically, when faced with complex and important decisions we rely on trusted experts for advice. Sick people turn to doctors, those accused of crimes seek the help of lawyers, and the list goes on. These cases all have a common feature: The expert adviser must abide by a strict code of conduct that puts the interest of the client first.

Surprisingly, the same is not always true for financial experts who advise people on their retirement savings. A majority of these professionals are not registered as financial

advisers who have a fiduciary responsibility to their clients, which means putting their clients' interest first. Instead, they are registered as brokers who only adhere to what is known as a "suitability" standard, which is much vaguer and only asks brokers to make recommendations that are consistent with the client's interest.

In addition, the majority of brokers are not paid on the basis of the quality of their advice, but rather on the fee income they generate from their clients. To resort to a medical analogy, this is equivalent to simply prohibiting doctors from recommending drugs that kill you, while not actually requiring they prescribe the best drugs to cure your disease.

To better align the interest of advisers with their clients the Department of Labor issued rules earlier this year that require any investment professional who advises clients on their individual retirement accounts (rollover IRA) to act as fiduciaries, meaning they have to put their clients' interests before their own. The new DOL rules only come into effect next year, but the industry has been aflutter with debates over these new rules. And there is still a lot of room for brokers who fall outside of the 401(k) and the rollover IRA area. So what should we expect?

THE EXPERTS

The Experts are a group of industry and academic thought leaders who weigh in on topics covered in the The Journal Report.

In a study with my co-authors Sendhil Mullainathan at Harvard University and Markus Noeth at Hamburg University, we set out to analyze the quality of financial advice commonly given to clients. We sent "mystery shoppers" to financial advisers in the greater Boston area who impersonated regular customers seeking advice on how to invest their retirement savings outside of their 401(k) plans. The mystery shoppers also represent different levels of bias or misinformation about financial markets. What we learned is highly troubling.

By and large, the advice our shoppers received did not correct any of their misconceptions. Even more troubling, the advisers seemed to exaggerate the existing misconceptions of clients if it made it easier to sell more expensive and higher fee products.In addition, advisers strongly favored actively managed funds over index funds. In only 7.5% of sessions did advisers encourage investing in index funds.This is exactly counter to insights from finance research, which suggests that the average investor should choose low-cost index funds over actively managed funds. If advisers did happen to mention fees, they usually downplayed their importance.

Of course, no one expects financial advisers to work pro-bono. But what is alarming is that adviser incentives seem to be set in such a way as to move clients away from the existing strategy regardless of its merit, i.e., even when they looked at a low-fee-diversified portfolio. As a result, we found that advisers appeared willing to make their clients worse off in order to secure financial gain for themselves. This is bad new for savers–including the many baby boomers–seeking to boost their retirement nest egg.

But our research also suggests that the proposed fiduciary standard can be beneficial. Indeed, we found that advisers who have a fiduciary responsibility toward their clients provided better and less biased advice than those that were merely registered as brokers. The former were less likely to move people away from index funds and to reinforce erroneous beliefs about the market.

There is an important additional benefit to a policy that reduces conflicts of interest between clients and their advisers. It also helps in harnessing the market's competitive forces to the benefit of consumers rather than to their detriment. As many responsible financial advisers will point out, if retail investors are poorly informed, advisers who

provide sound financial advice often find it difficult to compete with less sanguine competitors.

So holding financial advisers to higher fiduciary standards is not only good consumer financial protection but is also good market economics.

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