Your Complete Guide to Selecting a Financial Advisor

SAPIENT
INVESTMENTS

About the Author

Kevin Means, CFA, is the owner of Sapient Investments, a registered investor advisor. He has been managing money professionally for over 30 years. A former five-star mutual fund manager, hedge fund manager, and senior investment professional managing portfolios worth billions, Kevin is now focused on helping people near or in retirement with their investments.

Having spent his career in institutional money management, Kevin has a different background and perspective than that of most financial advisors. In short, he is critical of much that goes on in the industry. Like his hero Jack Bogle, he is a passionate advocate for investors.

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Selecting a financial advisor can be confusing and intimidating. Many of the questions I get from prospective clients have to do with how I compare with other financial advisors. I find that most people don't really know what questions to ask or what criteria to use when evaluating a financial advisor.

I hope that this guide will provide a helpful roadmap in your search for the right financial advisor for you. Finding the right person or firm may take time, but the investment should be well worth it in terms of peace of mind and, hopefully, portfolio performance.

Although I call myself an investment advisor rather than a financial advisor (FA), I am clearly a competitor in the market for financial advice. Consequently, writing an ebooklet like this one could easily be self-serving. Obviously, I think the right advisor for you is one that looks a lot like me, right? In some ways, such as with respect to selecting one that is both *trustworthy* and *competent*, yes. However, FAs tend to specialize in different areas, and I recognize that different clients need different kinds of expertise. In this guide I seek to be objective and even-handed.

That said, I should be up front about my own biases. I am an investments guy. While I recognize that all kinds of financial advice can be valuable and important, my focus is on adding value in the investment management function. Actually doing that is exceedingly difficult and extremely rare. Most actively managed mutual funds underperform their benchmarks. That's why low-cost index funds and ETFs are so popular.

I encourage clients and prospects to use these passively managed funds for their "core" exposures, that is, their basic investments in stocks and bonds. The odds of anyone adding much value in core portfolios are very low. When I provide "core" investment management for clients, I charge very little (essentially a "robo-advisor" level of fee) because I do not think I can add much value there.

My specialty is in offering what might be called "satellite" portfolios that are designed to diversify core exposures to stocks and bonds, lowering overall portfolio risk and boosting long-term expected return.

But enough about me. This ebooklet is meant to be helpful to just about anyone who is thinking about hiring a financial advisor. In it I'm giving you straightforward and unvarnished advice, just as I would if you were a relative or friend.

Do You Need a Financial Advisor?

In all honesty, a most people probably do not need a financial advisor. A recent survey by Northwestern Mutual found that only 31% of U.S. adults work with an advisor. Here are some questions that may help you decide if working with one is right for you at this time.

How Much Money Do You Have to Invest?

The reality is that unless you have at least $100,000 to invest, you are not going to satisfy the asset minimums for most traditional financial advisors (the ones who meet with you in person). And the best ones typically have minimums of at least $500,000 or $1 million. The reason that assets matter so much is that most advisors are paid a fee as a percentage of assets, so the more assets, the higher the fee.

Those of you with smaller assets are most likely to be attractive only to an advisor who is paid on *commission*. These days, the most commonly sold commission products are annuities. They typically have a fat up-front commission paid to the seller (the agent or broker) and hefty ongoing expenses paid by the buyer (you), which are often hard to understand. Other commission-based financial products include "load" mutual funds (that have a front-end fee), non-traded real estate investment trusts (REITs), and some types of insurance. Sadly, people of modest means with a limited understanding of financial matters are the ones most likely to be preyed upon with these products.

Fortunately, these days there are other ways of getting a basic level of sound financial advice even if your assets are small. My first recommendation is always *the do-it-yourself approach*. That is, with a little effort, you can educate yourself enough to get a basic understanding of the financial matters that are most pertinent to you. As with everything else, the internet is a wonderful resource. I'm a traditionalist, so I also like books. I'm going to list three of my favorites, which may well be available to borrow for free from your local library:

The Little Book of Common Sense Investing: The Only Way to Guarantee Your Fair Share of Stock Market Returns, 10th Anniversary Edition by Jack Bogle

A Random Walk Down Wall Street, 12th Edition: The Time Tested Strategy for Successful Investing by Burt Malkiel

The Only Investment Guide You'll Ever Need by Andrew Tobias

All three of these books focus on investing, and they are quite similar in terms of philosophy: use low-cost, diversified stock and bond funds to get "core" exposures to the primary asset classes. If you need to investigate other subjects, like saving for college, buying insurance, claiming Social Security benefits, or planning for your estate, there are many good books and internet resources on those and all other subjects.

For those who need help getting out from under a burden of debt (which is a very common situation), I'm afraid that the financial advisory industry is probably not a good fit for you. At least I certainly wouldn't recommend starting there. What you probably need is not a financial advisor, but what is sometimes called a "financial counselor." Beware of debt consolidation scams. The National Foundation for Credit Counseling is a nonprofit organization whose members are nonprofit agencies. The Financial Counseling Association of America is a similar organization. Members of these organizations are more likely to be trustworthy, have a charitable motivation, and provide low-cost or free services.

If you don't care for the do-it-yourself approach, and you aren't struggling under a mountain of debt, but you aren't ready for a traditional financial advisor or you just don't want to pay the fees involved, there are a number of so-called "*robo-advisors*" who have extremely low minimums and low fees. They tend to focus on providing low-cost investment portfolios as well as automated rebalancing and tax-loss harvesting, both very worthwhile services that would be hard to replicate yourself.

A notch up from the robo-advisors (and often offered by the same firms) would be the "*online financial planners*" who can offer more customized advice for a slightly higher fee. They usually do everything that the robo-advisors do, but also provide other financial advisory services, typically by phone or video-conference. For many people, this is a very attractive, cost-effective solution.

If you really want in-person financial advice but paying an advisor a percentage of your assets every quarter doesn't seem like a good deal to you, there are some financial planners who are willing to work on an hourly or project basis. However, they are few, so you might either have to travel to one or be willing to meet by phone or video-conference. The *Garrett Planning Network* maintains a directory of fee-only Certified Financial Planners (CFPs) that pledge to charge fees that make them "accessible." The National Association of Personal Financial Advisors also maintains several directories of fee-only financial planners. (Only a minority may offer hourly or project-based fees, however. The norm for fee-only planners is still an asset-based fee.)

How Close to Retirement Are You?

If your employer offers a defined contribution retirement plan, like a 401(k), chances are that there are several so-called "target date funds" in the offering. These are well-diversified combinations of stock and bond funds that are likely to be a good option for most of your working career. Better still if the underlying funds are index funds with low expenses. Even if you are self-employed and saving through your own IRA or other similar self-directed retirement account, you can use low-cost target date funds offered by a mutual fund company.

For most people, their need for a financial advisor does not become pressing until close to retirement, when most people roll over their 401(k) accounts into their own individual IRAs. Often by this time the assets have become substantial. This money must provide income for many years of retirement living. Making sure that it is wisely invested is of paramount importance. Chances are your need for investment advice is high if you are near, or in, retirement.

In addition to retirement, other life events may precipitate a need for financial advice, such as the receipt of a large inheritance, the sale of a business, the finalizing of a divorce settlement, or the liquidation of stock options. The common theme in all of these is the need to invest a large chunk of money.

Do You Have Financial Planning Needs?

Most financial advisors get paid for, and spend the bulk of their time on, managing your investments. Many people have the impression that if they need a financial advisor what they should be looking for is a “financial planner.” Financial planners can provide many different of types of financial advice. The focal point is usually a *financial plan* that combines an assessment of assets, sources of income, expense projections, and return forecasts. Because so many of the inputs are estimates, often the planning software includes a “Monte Carlo Simulation” which provides a sense of the spread of possible outcomes depending upon the variability of market returns and inflation rates.

The results of a financial plan can provide guidance on a variety of issues:

1. When you will have enough assets to retire
2. What savings will be required to get there
3. What your spending budget should be in retirement
4. What kind of investment portfolio will provide the returns required
5. What steps you should take to protect your assets through insurance
6. What steps you should take to plan for the tax-efficient disposal of your assets after you are gone with wills, trusts, and other estate-planning preparations

If you need advice on one or more of these topics, you should probably talk to a financial planner. Most financial planners will want to manage your investable assets, which is a much more lucrative arrangement than being paid for financial planning on an hourly or project basis. Many financial planners will throw in financial planning for free if you let them manage your assets. And they will usually tell you that it is important to meet regularly to review and update your financial plan and measure your progress. Thus, an ongoing relationship (and an ongoing fee) makes sense (at least for the planner).

However, as mentioned above, it is not always necessary to pay a financial planner a percentage of your assets on an ongoing basis. Particularly if what you really want is one-time, or periodic, advice, it may make more sense for you to pay for financial planning services as they are rendered.

Can You Invest on Your Own?

On the other hand, by its very nature, managing your portfolio is an ongoing task. Either you must do it or you must offload that responsibility to someone else. As mentioned above, I am a big fan of do-it-yourself investing when it comes to 1) building up your assets during your working career and 2) investing the "core" of your portfolio in low-cost, diversified stock and bond funds.

Practically anyone *can* invest on their own. It's as easy as picking up the phone or clicking on a web site. But many people find that they do not *want* to invest on their own. Some just do not want to spend the time that would be required. Often people feel overwhelmed by the complexity of the many decisions that are required when investing and realize that they do not have the knowledge or experience required to do a good job. Others realize that they do not want the emotional burden of having to decide what to invest in when. And it is a well-documented fact that many investors hurt themselves by making emotionally-based rather than evidence-based investment decisions.

Even if you are inclined to hand over portfolio management responsibility to an advisor, you should know that it does not have to be an "all or nothing" arrangement. Of course, most financial advisors *want* to manage *all* of your assets, so they may give you the impression that is a requirement. It's not. There may be good reasons to let an advisor know about all of your assets for financial planning purposes, but there is no requirement that you have only one advisor, nor even if you have only one advisor, that they manage all of your assets.

The Bottom Line

You probably don't need a traditional financial advisor until the cost of making mistakes with your investments starts to become significant. Typically, that point is reached once your investment portfolio has become large enough to be a significant source of future income. Often the trigger is a recent or impending retirement. At that point, how you invest your money matters a lot, and it might be worthwhile to retain professional advice.

What Kind of Financial Advisor is Right for You?

There are many different types of financial advisors. Here are some things to consider in selecting the right one for you.

Specialist vs Generalist

As mentioned above, many people have the impression that if they think they might need a "financial advisor" what they should be looking for is a "financial planner." In fact, some people even use the two terms interchangeably. And the CFP (Certified Financial Planner) credential has become so common that many people believe that they should only consider a financial advisor who is a CFP. A CFP is usually a generalist who can offer advice on a wide variety of financial planning topics.

Often people are unsure of what services they might need, so they like the idea of hiring a generalist who can provide wide-ranging advice. They may be looking for a kind of "financial checkup" that will provide a once-over of their financial health and provide recommendations for addressing any areas of concern that may be uncovered. In this situation, a financial planner (often a CFP) would be a logical choice

However, sometimes what is needed is a specialist. For example, if you know that you need help with tax planning, it might make sense to seek out someone with more training and experience in taxation. That person might be a financial advisor who is also a CPA. If you know that you need to do some estate planning, the best fit might be an estate planning attorney. If you believe that you might need more insurance, a licensed insurance salesperson might be a logical choice. If you are trying to get out from under a mountain of debt, a credit counselor has the right background for you.

If your primary need is for investment advice, you may want to emphasize investments expertise in your selection of an advisor. While nearly all financial advisors offer investment management among their services, not all are equally qualified. Far from it.

Nearly all financial advisors will attempt to portray themselves as strong in the area of investment management. The reason for this is practical: most financial advisors (including financial planners) make most of their fee income from, and spend the bulk of their time on, managing your investments. Financial plans are often provided for *free* if there is an ongoing asset management relationship.

However, it may not make sense to hire the same person for both financial planning and investment management. The training, experience, and orientation required for these two functions are quite different. Plus, it may not make sense to pay for ongoing investment management if what you really want is one-time or periodic financial planning. Some financial planners are willing to charge an hourly or project-based fee for their planning services. This kind of arrangement would typically be far more cost effective than paying an ongoing asset-based fee. It would also focus the planner's attention on the service of financial planning rather than on asset management.

Clientele Focus

Some financial advisors (FAs) tend to specialize in a certain *type of client*. Often, this may break down by stage of life. Many FAs focus on baby boomer clients who are in or near retirement. And for good reason: they tend to have a lot of assets! Other FAs, often FAs who are younger themselves, focus on a younger millennial, Gen X or Gen Y clientele.

Some FAs specialize in certain *industries*, such as technology or medicine. Some even concentrate on employees of a certain company and have built up deep knowledge of the retirement benefits, stock option plans, etc. for that employer.

You will want to make sure that your *level of investable assets* fits well with other clients at the firm. You would not want to be handed off to a junior associate because you are too small for the senior advisors.

It is usually best to select an advisor whose clients tend to look a lot like you.

Personal Chemistry

Most prospective clients know that feeling comfortable with their advisor is important, but they may not know what questions to ask to gauge their "fit". Here are some suggestions.

Ask why the advisor got into the business in the first place. What did he or she do before then? Where did they receive their training? The type of firm that formed him or her as an advisor often stays with them throughout their career. If they "grew up" at a firm that was focused on sales, that is likely to be their priority now. What *motivates* him or her? Is it making money for themselves or helping others? How much do you trust their answers?

Does the advisor share your same *values*? Political or religious convictions may be important to you, and you may even want your investments to reflect your values. Make sure that your advisor understands your values, even if he or she does not necessarily share them.

Ask about advisor *turnover* at the firm. The most productive relationships between financial advisors and their clients tend to be long-lived. Once you have established good chemistry with an advisor, you will want to make sure that he or she does not move on to another branch or another firm altogether.

Firm Culture

Does the advisor operate *alone or as part of a team*? If the latter, who does what on the team? Are there people other than the advisor with whom you will interact? You will want to meet them if possible and make sure that you are comfortable with them. How long have they been at the firm? Ask about non-advisor turnover.

What is the *culture* of the firm? Do you like it? Does the advisor fit in well with that culture?

What is the *physical environment* at the firm? Will review meetings take place at your location, theirs, or somewhere else? Or will they be by video-conference? Make sure that you are comfortable with the arrangement.

How Important is Investment Management to You?

Just as you would not want a general practitioner of medicine performing surgery on you, *you may not want a financial planner investing your money*. Even planners who have passed the certification requirements for the CFP designation have limited training in investment management. Only 17% of the CFP exam pertains to "investment planning." And passing the CFP exam is comparatively easy. The CFP exam is taken in one sitting and the first-time pass rate averages 65%-70%.

Most people who devote their careers to investment management are CFAs (Chartered Financial Analysts). The vast majority of mutual funds, pension funds, hedge funds, and other institutional portfolios are managed by CFAs. Compared to the CFP program, the CFA is much more rigorous and difficult. The CFA exam is given in three parts (Levels I, II, and III) over a period of at least three years. The entire focus of the material is investment management. At least 300 study hours are recommended for each level. The average pass rate for Level I is only 38%. Of the people who start the CFA program, only about 1 in 5 successfully pass all three exams and obtain the certification.

Of course, hiring a CFA to manage your money does not guarantee investment success. No credential can do that. Nor can credentials substitute for experience. And experience should be measured not just with time (how long have they managed money professionally?) but also with respect to scale (how much money have they managed?) and pedigree (for which organizations have they managed money?). Finally, although this tends to be much over-emphasized, a close examination of any available *performance record* can at least start a discussion about what levels and kinds of risk will be taken and what long-term average level of return is reasonable to expect.

The Bottom Line

Hiring an advisor is a big decision. The right one can make a significant and positive difference in your financial life. The wrong one can be a source of discomfort and anxiety. It’s worth being thorough and careful.

Selection Criteria #1: Trust

For most people, the single most important consideration in hiring a financial advisor is "can I trust him or her?" That is, will they act in my best interest? There are many conflicts of interest in the financial advice industry, and often they are hidden or difficult to understand. Here are some tips to help you scope out the lay of the land.

Fiduciary Standard vs Suitability Standard

Many clients assume that all financial advisors are professionals who will put their clients' interests ahead of their own. That is, they assume that all FAs are "fiduciaries." Although most FAs will tell themselves and their clients that they may "think of themselves" and try to "act like" fiduciaries, only a minority of them are legally able to honestly describe themselves as fiduciaries.

For a variety of mostly historical reasons, there are two different regulatory regimes under which financial advisors operate, depending upon the type of firm that employs them. Advisors who work for RIA firms (registered investment advisors) operate under a different regulatory standard than advisors who work for broker-dealer firms. This excerpt from Investopedia describes the difference:

> Investment advisers are regulated by the Securities and Exchange Commission (SEC) or state securities regulators, both of which hold advisers to a *fiduciary standard* that requires them to put their client's interests above their own.
>
> Brokers, however, serve the broker-dealers they work for and must only believe that recommendations are suitable for clients. This *suitability standard* is set by the Financial Industry Regulatory Authority (FINRA), an industry self-regulatory organization.

Essentially, this means that RIA-affiliated advisors are held to a higher, stricter standard. They work directly for their clients. Under the Investment Advisers Act of 1940, they must place their interests below that of their clients. "It also means advisers must do their best to make sure investment advice is made using accurate and complete information and that the analysis is thorough and as accurate as possible. Avoiding a conflict of interest is important when acting as a fiduciary, which means that advisers must disclose any potential conflicts." That is not true of broker-dealer (BD) affiliated advisors, who often have conflicts that are inherent to their affiliations.

Many financial advisory firms are "dually registered." This means that they can either sell commission-based products through affiliation with a broker-dealer (under the suitability standard) or collect investment advisory fees through their RIA. Many such firms are trying to book most of their new business through their RIA, but they continue their association with a BD in order to provide them the flexibility to collect commissions when selling certain products. Particularly for firms that have been in existence for a long time, this arrangement allows them to continue collecting commission trailers on products that they have sold in the past.

The problem for the investing public is that the same individual advisor may be operating under these two regulatory regimes at the same time. Because they can wear two different "hats," it is unclear when they are wearing which "hat."

Fee-Only vs Fee-Based

One great example of the obfuscation attempted by many broker-affiliated and dually registered advisors is that they may describe themselves as "fee-based." That sounds a lot like "fee-only" and it is very confusing to the investing public, but the difference is stark. As described by the Fee Only Network:

> A *fee-only* advisor is compensated only by the fees he or she directly charges to clients and not by commissions earned from a sale of a financial product. The fees could be hourly, a flat retainer or based on a percentage of your investment assets they manage. An advisor compensated *only* by fees is called "fee-only."
>
> A *fee-based* or "fee and commission" advisor is generally compensated by both fees for advice and commissions on the sale of financial products that may be used to implement their advice. Most fee-based advisors hold licenses that allow them to sell investment products or insurance for a commission. Fee-based advisors generally do not have a "duty to disclose" their method of compensation and this can confuse clients who may not understand their fee-based advisors are working for commissions. This potential for confusion is why it is important to understand how your advisor is compensated.

Independent vs Affiliated

Advisors who work for firms that are affiliated with a broker, bank, or insurance company often have internal pressures or financial incentives that are in conflict with the best interest of their clients. Even the most ethically-minded advisors may be influenced by these forces. True independence frees advisors to act solely in the best interest of their clients.

Some conflicts of interest are more obvious than others. For example, large "wire house" brokerage firms and banks (such as Morgan Stanley, Merrill Lynch, and Wells Fargo) often sponsor their own proprietary funds, engage in stock offerings, and sell syndicated private equity deals. These are obvious potential conflicts. But most conflicts are much more opaque. For example, not only wire houses, but also so-called "independent" custodians (such as Charles Schwab, TD Ameritrade, and LPL Financial) that cater to advisory firms have "revenue sharing" arrangements with mutual fund companies which may incentivize them to steer clients towards more expensive funds or share classes. Fund companies often sponsor "advisor education" sessions at swanky beach resorts. Mutual funds that do not “pay to play” are barred from the platforms of most wire houses and custodians. Nearly all custodians have eliminated money market cash sweep accounts in favor of bank accounts that pay customers little or no interest and may even charge them fees. Most large custodians make most of their profit from this arrangement, not from commissions, which have often gone to zero. When executing trades, custodians often get paid for “order flow” by exchanges who compete with one another for the custodians’ business. These payments do not typically flow through to the customers placing the orders, and indeed, the quality of their executions may be compromised by these arrangements.

Of course, advisors who are affiliated with large organizations will play up the “vast resources” this provides them with, which may prove useful to the client. This sounds good in theory but in my experience seldom materializes in practice.

Instead, the procedures at most large firms are largely driven by compliance requirements and litigation risk avoidance. Individual advisors typically have very limited flexibility in departing from what is considered accepted norms at the firm, even if doing so is in the client’s best interest.

Asset Manager vs Asset Gatherer

The economics of the financial advice-giving industry strongly incentivizes selling. For most financial advisors, success is all about gathering assets and fee income for themselves, not generating outstanding investment returns for their clients. Just because most financial advisors no longer make their money from commissions does not indicate that their mindset has changed.

The way for a financial advisor to maximize their fee income is to focus most of their time and energy on gathering new assets. Attracting a new client is enormously profitable. Attempting to eke out incrementally better investment performance is not.

FAs know that they just need to do well enough to hang on to their existing clients while they are searching for new ones. Nearly all FAs base their fees on assets under management, and they get paid whether investment performance is excellent or poor, and whether returns are positive or negative.

Most fee arrangements offer poor alignment of interest between clients and advisors. Economists call this the “principal-agent” problem. The clients are the *principals* whose money is at risk. They entrust their fortunes to advisors who are *agents* and do not share in the profits and losses. Agents have very different incentives than principals. For example, agents tend to avoid taking any “maverick risk” that would make them subject to later criticism and potentially get fired by their client. (J.M. Keynes observed this in his own money management activities.) Instead, they cling to whatever is perceived as “safe” and conventional, even if departing from that is in the client’s best interest. Ever wonder why so many strategic portfolio asset mixes are 60/40 stocks/bonds? Do you think that is based upon extensive research, deep insight into the client’s risk and return preferences, and an intelligent assessment of the current state of the capital markets? Think again.

Ideally, if you can't have a profit-sharing arrangement with your advisor (which is very rare and possible only for "qualified clients"), you would like him or her to be motivated by professional pride in their investment results and have enough empathy to "rejoice with those who rejoice and weep with those who weep." (Romans 12:15). The quality of their performance reporting will often distinguish an asset manager from an asset gatherer. An asset manager will 1) have a written investment policy statement that clearly lays out performance objectives, 2) evaluate performance relative to a sensible benchmark, and 3) provide performance attribution reports in enough detail to clearly reveal the sources of return, whether from risk taking or manager skill. An asset gatherer would rather not provide clients with this information. It could raise uncomfortable questions.

A Few Resources That May Help

The truly "bad apples" in the industry can sometimes be found out and avoided by investigating regulatory filings. Here we are only talking about a quick, easy, and cursory review of publicly available information online. You have two simple objectives: 1) make sure that the firm and the individual advisor you are considering are legally registered, and 2) see what, if any, client complaints or other regulatory disclosure items there may be regarding the firm and the advisor. Often you can get the relevant identifying information (CRD#s) or web page links from the advisors if you ask. Because RIAs and BDs have different regulators, the websites for checking them out are different. Also, remember that many firms and advisors are "dually registered," so in those cases you will want to check them out both ways.

Broker/dealers are regulated typically both by their states and by the Financial Industry Regulatory Authority (FINRA). Sometimes, the state regulators have more information about customer complaints, so you may want to start there. State regulators can be accessed through the North American Securities Administrators Association. Whether or not you find anything at the state level, you will definitely want to visit FINRA's BrokerCheck website. Remember to look for information on both the BD and the individual broker.

Registered investment advisors (RIAs) with assets under management of over $100 million are regulated by the Securities and Exchange Commission (SEC). Smaller firms are regulated by the state in which they are located. Both types of firms are required to file a "Form ADV" annually. Part 1 of the ADV contains tabular information about the adviser's business and whether they have had problems with regulators or clients. Part 2, the "brochure," is a narrative document that describes business practices, fees, conflicts of interest, and disciplinary information. This is well worth taking the time to read if you are serious about doing business with a firm. You can find both parts online by visiting the Investment Adviser Public Disclosure (IAPD) website. Again, be sure to investigate both the RIA firm and its individual "investment adviser representatives."

The Bottom Line

Be on your guard. Nearly all FAs appear to be “nice people” on the surface. Their employers reward them well for manipulating peoples’ emotions in their favor. They want you to believe that they will act in your best interest. They may believe it themselves. It may even be true. But it might not. You can and should ask a lot of questions and investigate thoroughly.

Selection Criteria #2: Competence

You should probably go about hiring a financial advisor in much the same way you would choose a physician, attorney, or accountant. In each case, the value of what they have to offer is the quality of their advice, which depends upon their knowledge, ability, and skill.

What Do All the Credentials Mean?

All financial advisors seem to have letters after their names. Some advisors seem to think the more letters the better. Hundreds of certifications are available to FAs to choose from. Many are not terribly rigorous or demanding. To help the public deal with this confusing jumble of letters, FINRA even has a web page dedicated to listing and providing brief information on each.

There are few *regulatory requirements* for becoming a financial advisor. One of the best-known commentators on financial advisors, Michael Kitces, observes that “the actual exam and educational requirements to be an advisor are remarkably low. In fact, the licensing exams for financial advisors do little more than test basic product knowledge and awareness of the applicable state and Federal laws.” Because many financial advisors were formerly stockbrokers or insurance salesmen, this is not surprising. “Advisors are really just product salespeople. And the bar to determine if someone is ‘capable’ of selling a product isn’t very high.” The result is “advisor ignorance” and “sheer lack of competency.”

But in fact, *credentials* should be important to clients in selecting an advisor because they indicate a certain level of knowledge and training in the various disciplines that comprise financial advice. Of the myriad possible certifications available to financial advisors, “the only three that truly matter” according to Kiplinger Magazine are: *CFP, CPA, and CFA*. Forbes agrees that these three credentials “stand apart from the hundreds of professional designations. All three designations require extensive knowledge, continued education and adherence to strict codes of ethics.”

A *Certified Financial Planner (CFP)* is a generalist who has demonstrated competence in a number of disciplines, including 1) retirement planning, 2) estate planning, 3) employee benefits, 4) budgeting, 5) insurance, 6) taxation, and 7) investments. When more in-depth expertise is required, many CFPs will sometimes work with specialists while functioning as the overall coordinator on behalf of the client. For example, an attorney may draw up wills, trusts, and other estate-planning documents. An accountant (usually a CPA) may file tax returns and help with tax planning. An insurance agent may sell the policies the client needs. An investment manager (usually a CFA) may manage the portfolios or funds in which the client invests.

Tax planning and advice is often an important component of financial advice, and the *Certified Public Accountant (CPA)* is the most widely recognized designation in this area. CPAs whose practice includes a lot of financial advice may obtain the Personal Financial Specialist (PFS) credential from the American Institute of Certified Public Accountants (AICPA) after passing certain educational and experience requirements.

A *Chartered Financial Analyst (CFA)* is an investment management specialist. Most money management professionals, including those who manage mutual funds, pension funds, and hedge funds, are CFAs. It is recognized around the world as "the gold standard" in investment management. *The Economist* magazine describes it as "equivalent to a specialized postgraduate finance degree, including a mixture of economics, ethics, law, and accountancy." To earn a CFA charter, a candidate must 1) pass three sequential, six-hour exams, 2) have at least four years of qualified professional investment experience, and 3) commit to abide by, and annually reaffirm, their adherence to CFA Institute Code of Ethics and Standards of Professional Conduct. The gauntlet is rigorous. Exam preparation typically takes over 1000 hours of study. Fewer than 1 in 5 candidates pass all three exams and ultimate become CFAs.

The Best Are Professionals

Of course, all FAs consider themselves to be "financial professionals." After all, they make their living by providing financial advice. Isn't that the definition?

Well, not exactly. Wikipedia defines a "profession" as "an occupation founded upon specialized educational training, the purpose of which is to supply disinterested objective counsel and service to others, for a direct and definite compensation." Examples include physician, attorney, architect, accountant, and clergyman. Perhaps not all of those attain to the ideal described in the definition, but "specialized educational training" and "disinterested objective counsel" for a "direct and definite compensation" are the key components.

For the most part, entry into the professions requires academic excellence within a highly competitive institution of higher learning, lengthy and rigorous training, and the successful completion of government-sanctioned qualifying examinations. Typically, ongoing professional training and education is also required.

This does not describe the typical financial advisor, in my experience.

Education, Experience, and Expertise Are What Matter

When I was a hedge fund manager, I used to hear a lot about "pedigree." That was how a lot of institutions quickly decided which hedge fund managers they would spend due diligence time on. *Pedigree* has to do with 1) the quality of your undergraduate and graduate educational institutions, 2) the reputation of your former employers, and 3) other indications of industry standing, such as books, articles, and speaking engagements. To be honest, I found myself at a slight disadvantage because 1) I attended William and Mary and the University of Virginia rather than Harvard and

Stanford, 2) I worked for Invesco rather than Goldman Sachs, and 3) I published only a few articles and was interviewed only occasionally on CNBC and Bloomberg. (I didn't like it or spend much time on it.)

But I understand the importance of all of that stuff. People need some indication that others have thoroughly investigated you and that you passed muster. Although the standards for financial advisors are not what they are for hedge fund managers, in general the same principles apply. *Pedigree matters*.

So does experience. Years in the industry and years as an advisor both matter. Someone with lengthy experience has faced more different kinds of clients, situations, and market environments.

Expertise is very hard to gauge. Sometimes you can get a sense for the depth of an advisor's knowledge about a subject area by asking probing questions, but that requires some knowledge on your part. Sometimes getting samples of someone's work product, such as a blanked-out financial plan or quarterly portfolio report, can provide the fodder you need to evaluate the quality of their service. For investment managers, past performance records can provide a good starting point for a discussion around investment style, risks assumed, and expected long-term results.

The Bottom Line

The value that a financial advisor will provide to you largely depends upon the quality of their advice. An advisor's credentials, background, and experience should give you at least a general sense of their competence.

Selection Criteria #3: Costs

Hiring a financial advisor is a very expensive proposition. Most advisors charge a 1% fee on assets they manage. For example, on a portfolio worth $500,000 that would be $5,000 per year. Even if there are no other hidden costs (which there can be), that is a significant ongoing cost. You should ask yourself if the value you expect to receive outweighs the costs.

What Are the Costs of Financial Advice?

It's amazing to me how little attention most people pay to the costs of their investments. Take 401(k) plans for example. Until their retirement, most people have most of their retirement savings in a 401(k) or similar plan, sponsored by their employer. Often the administrative costs are born by the employees through the expense ratios of the funds and/or through separate administrative fees and charges. But most employers and administrators do not make it easy to know what the fees are. A recent survey of employed baby boomers (people often with substantial investment portfolios) found that 46% believed that they were paying *no fees at all*, despite the fact that "the average employee had various fees of 1.5 percent each year deducted from his or her 401(k) account." Smaller plans have higher fees—2.5 percent on average.

High cost is one reason that most retiring employees roll over their 401(k) balances into their own IRA accounts. However, depending upon the fees charged by their financial advisor (if they have one), they may not be saving much, and may in fact be paying more in retirement than they did through their 401(k) while they were working.

There are two major types of fees paid by advisory clients: 1) advisory fees (charged by the advisor) and 2) fund expense ratios (charged by the funds). There can also be other costs, such as sales commissions, loads, and transaction costs.

By far the most common advisory fee is 1% of assets under management, though of course fees vary. Robo-advisors tend to charge .25% to .50%, and "online financial advisors" with more personalized advice range from .30 to .90%.

Regarding fund expense ratios, academic studies have shown that fees and expenses are the single best predictor of mutual fund performance. Performance fluctuates but costs persist. Lower is better. Thankfully, average expense ratios have been coming down for many years. The popularity of index funds and ETFs has further fueled this trend so that now it is possible to get broad exposure to major asset classes for less than .25%, and often for less than .10%.

How Much Do Costs Matter?

Costs of all kinds matter more in the current low expected return environment. With interest rates at all-time lows and stock prices at relatively lofty price/earnings ratios compared to long-term history*, the expected return from a balanced portfolio of stocks and bond is perhaps lower than it has ever been*. The yield to maturity (YTM) of the U.S. bond market is about 2.3%. For bonds, the YTM is the expected return. For stocks, expected return is the sum of current dividend yield and expected long-term growth rate in dividends. The S&P 500 dividend yield is currently 1.9%, and long-term dividend growth since 1990 has been about 6.1%, so adding the two gives an expected return on stocks of about 8.0%. Therefore, the expected return of a 60/40 stock/bond portfolio is about 5.7%. Assuming a long-term inflation rate of 2% leaves a real return of only 3.7%. A 1% advisory fee eats away 27% of that return year in, year out.

Does the typical advisor add that much in value? There is a free market for advisory services, so we must assume that in the eyes of their clients they do. Indeed, there is some good evidence for it.

The Value of Financial Advice

In 2013, Morningstar published a groundbreaking study attempting to rigorously estimate the value of an advisory relationship to the typical client. They concluded that "the additional value that can be achieved by an individual investor from making more intelligent financial planning decisions" would be about 1.59% per year on average. In 2016, Vanguard circulated a very influential study of a similar nature based upon data drawn from their own private wealth clientele. They asserted that an advisor following "best practices" could potentially add about 3% in net returns per year on average for their clients. Finally, in 2020, Russell Investments (a vary large investment consulting firm) put out their own study, finding that "the value of an advisor in the U.S. is calculated at 4.8%."

Each of these three studies broke the overall value-added into categories, and the categories they used do not line up with one another very neatly. However, in a later study published in 2019, Vanguard used three broad "dimensions" of advisor value-added:

- Portfolio value – investments
- Financial value – financial planning
- Emotional value – counseling

Using these three dimensions makes it somewhat easier to consistently group the categories used in the three studies, as I attempt to do in the table below:

The Value of a Financial Advisor

	Morningstar	Vanguard	Russell
Portfolio Value			
Asset allocation	0.45%	>0.00%	
Liability Relative Optimization	0.12%		
Cost-effective implementation		0.40%	0.29%
Rebalancing		0.35%	0.32%
Tax-smart investing			1.31%
Financial Value			
Financial planning			0.72%
Annuity allocation	0.10%		
Asset location and withdrawal sourcing	0.23%	0% to .75%	
Dynamic withdrawal strategy	0.70%	0% to 1.5%	
Emotional Value			
Behavioral coaching		1.50%	2.17%
Total-return versus income investing (education)		>0.00%	
TOTAL	1.59%	3.00%	4.81%

Portfolio value has to do with value added through investment management. In the table above , if you exclude tax-smart investing, the value of portfolio management is roughly consistent and relatively modest in all three studies: Morningstar - .57%, Vanguard - .75%, and Russel - .61%. All three studies assume that an advisor following best practices would use a "core" type of investment portfolio using low-cost index funds and ETFs. Not much knowledge, expertise, or creativity is required to invest in such a "plain vanilla" portfolio of core stocks and bonds. Indeed, almost no financial advisors claim to add much, if any, value in their *tactical* management of portfolios, that is, in their active decisions to over- or under-weight allocations relative to the long-term strategic asset mix. So how do the studies get positive value from such basic *portfolio implementation*? It really has to do with the "default" mix of funds that they assume (or actually found in the case of Vanguard) the client would otherwise be invested in. No doubt many clients started out with expensive, tax-inefficient actively managed funds.

Also as shown in the table, about half of the value-added in the portfolio dimension is from *rebalancing*, which is typically a fairly rote process of shifting assets based upon percentage deviations from strategic targets. For example, assume that the long-term strategic asset mix between stocks and bonds for a particular client is 60/40 stocks/bonds. Let's say that because stocks have outperformed bonds over time, the actual asset mix has become 70/30. Rebalancing is the buying and selling necessary to shift the allocation back to its 60/40 target. Because over time stocks tend to dramatically outperform bonds, usually stock allocations must be trimmed back, and bond allocations increased when rebalancing. But because stock returns exceed bond returns, rebalancing usually *reduces* portfolio returns. How do the studies get a positive return contribution? It's a bit complicated, but essentially they statistically normalize return relative to risk levels in order to derive a positive value from rebalancing to a lower level of risk.

Taxes certainly do matter and given the 1.31% value assigned to *tax-smart investing* in the Russell study, it seems odd that it is missing as a separate category in the other two studies. However, tax implications are much of what drive the positive returns from asset location and withdrawal strategies in the Morningstar and Vanguard studies, so all three agree that there is substantial value to be gained from tax-smart investing.

Financial value measures value added from financial planning. The Russell study lumps everything into one category labeled "Financial planning." The other two cut it more finely, but in all three studies, the categories under the *financial value* dimension in the table above have mostly to do with *asset location* and *withdrawal strategies*. *Asset location* amounts to putting tax-efficient assets (with low realized taxable income, such as stock index funds) in your taxable portfolio and tax-inefficient assets (with high realized taxable income, such as bonds, REITs, MLPs, and actively managed funds) in your IRA. *Withdrawal strategies* have to do with being tax-smart and prudent regarding the *withdrawal/spending rate* and the *source of funds* for spending in retirement. Regarding *spending rate*, the usual recommendation is to spend no more than about 4% of the portfolio value at retirement, and then adjust the spending rate for inflation, changes in life expectancy, and capital market returns along the way. Regarding the *source of funds*, it is generally best to withdraw from taxable sources first to maximize the tax-deferred buildup within an IRA. Later spending would typically be drawn from IRAs.

Emotional value sounds pretty subjective, but the three studies did their best to try to quantify the value added in this dimension, which is largely described by the category of "*behavioral coaching*." It is interesting that the oldest study, from Morningstar, did not assign an explicit value to *behavioral coaching*, whereas the other two studies allotted roughly *half* of the value of having a financial advisor to this function alone. The actual activity behind this category is the proverbial keeping the client from selling at the bottom or chasing performance at the top. Vanguard and Russell (and many others) have objective and substantial evidence that, without the steadying influence of an advisor, many investors can really hurt themselves with their ill-timed trading activity. Clearly there is value in this function.

And, it seems, *if* you are like the typical client, there is considerable value overall in working with a financial advisor—well above the usual fee of 1% of assets.

The Bottom Line

Yes, financial advice is expensive. Only you can decide if the value provided is worth the cost. Financial mistakes can be very costly, and the studies cited above show that for many clients, the objective, dollars-and-cents benefits exceed the costs, on average over time. For some people, the psychological benefit of having someone experienced and knowledgeable in their corner, thinking about their financial situation, and providing ongoing advice and counsel is well worth the cost. For others, the main benefit is the time savings. They just don’t want to be bothered having to think about financial matters and paying someone to do that for them is well worth it. Only you can decide.

How Can I Find a Financial Advisor?

Financial advisors have a strong economic incentive to find *you* if you have substantial investable assets. Chances are you have seen advertisements from Fisher Investments, been invited to an “educational” dinner at a local restaurant, or even received a cold call. However, the best advisory firms are usually not so sales oriented, and to find them you will have to seek them out.

Referrals

You can often find good financial advisors by asking around among your friends, neighbors, and co-workers. Many people find an advisor this way, the same way they find a physician, an accountant or an attorney. In fact, these professionals themselves can be a good source of referrals for financial advisors. Often the best referrals will come from those who are most similar to you in stage of life, financial circumstances, and personality.

Google

As with most goods and services these days, a lot of people are using the internet to shop. Simply type “financial advisor near me” into your Google search engine and no doubt you will find plenty of candidates. This allows you to do some research on the firms clandestinely and without them having your contact information. You probably do not want FAs hounding you for your business.

Many people rely heavily on the *reviews* that are available online for most products and services. Google often does a good job of collecting reviews, even those obtained from other sources. However, investment advisors are legally prohibited by the SEC from using “testimonials” in their advertising. A testimonial is a statement of a client’s experience with, or endorsement of, an investment adviser. The SEC considers testimonials inherently misleading because they highlight favorable client experiences while ignoring unfavorable ones. On the other hand, FINRA takes the opposite approach and allows broker-dealers and their representatives to use customer testimonials in some circumstances with proper disclosure. Here again, RIAs (regulated by the SEC) are held to a stricter standard than broker-dealers (regulated by FINRA).

Recent clarifications by the SEC allow investment advisors testimonial reviews on third-party websites so long as the advisors do not have any control over the forum in which the testimonial is presented. For example, Google reviews are controlled by Google, and reviewers are free to say anything they want, positive or negative. These are allowed. However, perhaps because of the history of concern about testimonials, very few advisory firms have Google reviews.

Credentialing Organizations

I mentioned above that three credentials stand out above all others among financial advisors: *1) CFP, 2) CPA, and 3) CFA.* One good way to find advisors with these credentials is to query the websites of the organizations that offer those credentials. They all have member directories.

The *Certified Financial Planner (CFP)* credential is offer by the CFP Board of Standards, and you can find members at letsmakeaplan.org. The Financial Planning Association is another member organization for CFPs, and they also have a search tool. If you would prefer to work with a fee-only financial planner (most of them CFPs), you can find several lists of them at the National Association of Personal Financial Advisors. For fee-only CFPs that are more likely to work on an hourly or project basis, a good place to look would be The Garrett Planning Network.

Some *Certified Public Accountants (CPAs)* have a special credential, *Personal Financial Specialist (PFS),* indicating their expertise in working with individuals regarding financial planning and wealth management. CPAs who have the PFS credential can be found on the AICPA website directory.

The *Chartered Financial Analyst (CFA)* designation is offered by the CFA Institute. Its website is designed for members rather than the public. However, there is a portal that provides a public entrance to the CFA membership directory.

Advisor Matching Services

Kind of like a Match.com for financial advisors and their prospective clients, advisor matching services are free to use and make their money by charging advisors, typically on a price per lead basis. They source leads through the internet by providing interesting and useful content on all kinds of financial topics. They also pay a lot to advertise on the internet. The two largest of these services are SmartAsset and WiserAdvisor (which in 2019 acquired the lead generation service Paladin Registry and continues to operate it independently).

Although these services do varying amounts of “vetting” of advisors, they do not provide enough detailed information on advisors to allow for sharply focused matching. As a practical matter, most of the matching is based on geography—how close the advisor is to you.

The Bottom Line

The best advisors are usually the ones that you find, not the ones that find you. Yes, it will require some work, but the end result will likely be much more satisfactory.

Parting Words

I hope that you found this ebooklet helpful. If so, feel free to forward it on to others that you think might benefit from it. Also, if you have any questions or comments for me, you can reach me at Kevin@SapientInv.com. If you are curious about what else I've written, please check out our website's resources section at https://sapientinv.com/.