



CWMI INSIGHTS
News Perspectives Ideas
for the inquisitive investor

The Rare Five Percent:
What is it? Why does it matter?

**What “Financial Adviser” Means
95 Percent of the Time**

*By Scott Burns,
Personal Finance Columnist
Daily Herald Newspaper*

"My financial adviser says that I should..."

That may be the most common phrase in all the reader mail I receive. The suggestion may be about mutual funds, stocks or bonds, CDs at a bank, variable annuities, equity-index annuities (or other insurance-based products), or portfolio management. But someone gets called a financial adviser for making a suggestion. Lots of people wear that hat. I mean lots.

Want to guess how many people are called financial advisers? Cerulli Associates, a Boston firm that studies the financial services industry, recently put the number at nearly 250,000. That's in the ballpark with the population of Plano, Texas or St. Petersburg, Florida. Cerulli Associates can also tell us where we're most likely to find someone who calls himself a financial adviser. But two things are unclear. First, who is the adviser working for--- you, or the firm that provides the business cards, telephone and desk? Second, should he or she really be called a financial adviser?

A recent study by the RAND Corp. for the Securities and Exchange Commission found that most individual investors weren't aware of the difference between broker/dealers and investment advisers. Cerulli Associates says

CWMI Commentary

We think this article does a good job of describing the types of advisors you can choose among for investment help.

There are nearly 250,000 investment professionals. But, only 5% of them are registered investment advisers.

Here's a very important fact: A registered investment adviser is the only person in the investment industry who has a sworn fiduciary duty to put your interest first.

Does that matter? We say, yes.

Read the full article and see what you think.

you can find people called financial advisers in six major places. Each place represents a channel of distribution. Here are the basic numbers:

National full-service brokerage. There are 69,000 advisers at national full-service brokerage firms such as Merrill Lynch, Smith Barney and UBS.

Regional full-service brokerage. There are another 14,000 at the smaller regional brokerage firms such as RBC Dain Rauscher or Morgan Keegan.

Independent broker/dealers. There are 98,000 at independent broker/dealers such as Raymond James Financial and Mutual Service Corp.

Bank brokerage. There are nearly 16,000 at bank brokerage operations such as Wells Fargo and Bank of America.

Insurance broker/dealers. Insurance broker/dealers add another 34,800 at firms like AXA advisors, NYLIFE Securities and Mass Mutual Investor Services.

Add them all up, and you've got 232,000 salespeople who work for their firm, not you. Another 23,000 are registered investment advisors. But nearly 10,000 of those are also broker/dealers included in the 98,000 count above.

That leaves about 13,000 registered investment advisers.

In other words, of all the people who may call themselves financial advisers, about 5 percent are registered investment advisers alone.

This is an important fact. A registered investment adviser is the only person in this group who has a sworn fiduciary duty to put your interest first. The others provide what is deemed "suitable" investments. Micro print contract documents may even tell you that your interest and the interest of their firm may not always be the same.

What does this mean for most of us? It means about 95 percent of all the people who are called "financial adviser" are working on commission. More important, they are part of what I call the Legacy Investment Distribution System. Like the legacy telephone system, legacy investment providers have a system to protect--- their system. It has treated them well for decades.

By itself, this isn't an evil plot. I know some very fine brokers who have built their book of business by guiding investors into low-expense mutual funds, such as the American Funds family. But they are a rarity. Most "financial advisers" peddle the anointed garbage of the week--- witness the sub-prime loan packages sold a few years ago, Internet IPOs in the late '90s, option/income funds, portfolio insurance, and disappearing premium life insurance in the mid-'80s, etc.

It's good to understand that most of this army of financial advisers is organized to extract about 2 percentage points a year, often more, from your money. About half of that money goes to the, er, financial adviser. The other half goes to support the Sultans of Finance who run the marketing machinery of brokerage and insurance firms. If these folks were doctors, researchers would observe that the cost of their prescriptions is more harmful than doing nothing.

In fact, that's exactly what researchers have found. A Harvard Business School study on the costs and benefits of brokers in the mutual fund industry found that the average annual return from 1996 through 2002 of funds purchased through intermediaries was 2.9 percent--- without considering the additional cost of upfront loads or redemption fees. During the same period, funds purchased directly by independent investors returned an average of 6.6 percent. That doesn't say much for the

legacy distribution system "financial advisers," does it? Will getting your advice through a registered investment adviser guarantee better investment advice? No. But it will guarantee a fiduciary relationship. That's one where the adviser has sworn to put your interest first at all times, one where making a sale isn't what stands between him and a top-producer trip to Hawaii. But, do your homework because some registered investment advisers are nearly as expensive as the legacy distribution system. As a consequence, your long-term after-expenses return can be reduced.

What's the solution?

Be educated. Choose wisely. Learn enough to use the right systems. Learn directly from the research:

SEC Publishes Text of RAND Report on Investment Adviser, Broker-Dealer Industries:

<http://www.sec.gov/news/press/2008/2008-1.htm>

Technical Report:

Investor and Industry Perspectives on Investment Advisers and Broker-Dealers

http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf

Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry:

Harvard Business School

PhD Authors: Daniel Bergstresser, John M.R. Chalmers, Peter Tufano

http://www.people.hbs.edu/ptufano/bbenefits_Nov2004.pdf