MISTAKE #5

Working with the Wrong Advisor

Many investors choose to work with a financial advisor. High-net-worth investors tend to use financial advisors more than the general population. There are many different theories as to why this may be the case. Many high-net-worth households have concluded any of the following:

- They have too much to lose by making a major mistake.
- They are more likely to benefit from even minor improvements of after-tax, after-cost results.
- They are more likely to substantially benefit from noninvestment planning advice.
- They are more accustomed to utilizing professionals and paying for advice.
- They are far more likely to value their time.
- They want someone to serve as a resource to them or their family for ongoing issues.
- They want someone to provide continuity of advice in the event of an incapacity or death.

Many Americans wait until they have substantial assets and then look primarily for investment help. This is a mistake. Laying out a roadmap for success will help an investor get on the right track, pointing all efforts in the right direction. While it is true that incremental benefits do not have as much of an impact on, say someone with $100,000 to invest, it can still

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make a big difference toward reaching your goals if you have a strong advisor by your side. Whether you want to utilize an advisor is up to you, of course. If you are going to use one though, beware of the pitfalls.

Most Advisors Will Do Far More Harm Than Good

If you can, help others; if you cannot do that, at least do no harm to them.

—Dalai Lama XIV

Let me let you in on a big financial services industry secret: Most advisors will do far more harm than good. The vast majority of advisors fall into one of three camps:

1. They take custody of your money as part of the regular course of business.
2. They are salespeople in disguise.
3. They utilize strategies that cause more harm than good because they are trying to sell you something that you want to hear. They do this even though they know it won't work or because they don't know what they are doing.*

There are many things to look for in an advisor, but if you can navigate the three core issues of custody, conflict, and competence, you will eliminate about 90 percent of advisors, and your odds of ending up with someone competent who won't steal your money or work you over will be much higher.

Advisor Selection Issue #1—Custody

Brokerages and advisers should have independent custodians and the government should have forced me to have an independent custodian. Client funds should be held by independent custodians. If they had, I would have been caught long ago. If I had had an inspection by the SEC, they would have looked at the custodian

* I am so not looking forward to the hate mail I will receive from some financial advisors, but so be it.

accounts and seen the funds on my books did not match the funds in the accounts, and I would have been caught.

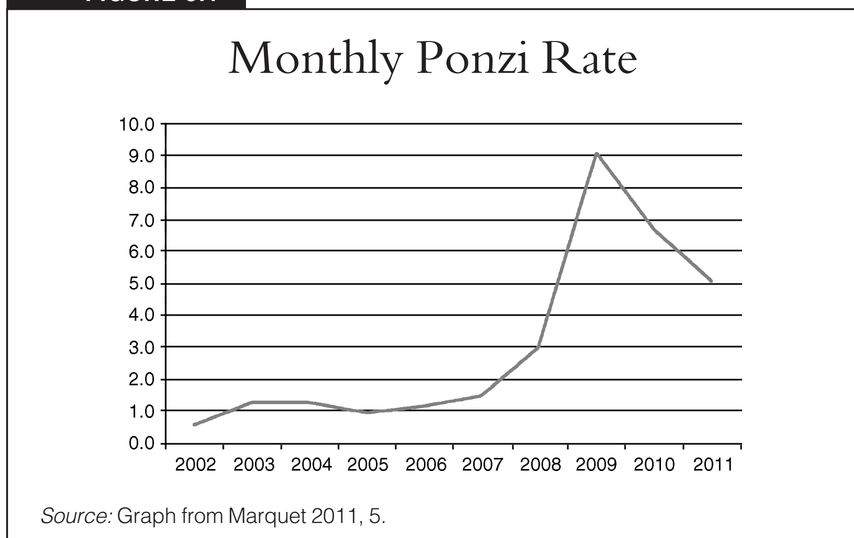
—Bernie Madoff (Patel 2013)

The Bernie Madoff scandal received an enormous amount of press coverage. For those not familiar with the scandal, Bernie Madoff, considered one of the nation's top money managers, admitted that he was running the biggest Ponzi scheme in history. He paid for client withdrawals out of money transferring in from new clients. The only reason Madoff was exposed is because he was faced with massive withdrawal requests from investors as the market plummeted. Because Madoff had spent or hidden most of his clients' money long ago, he didn't have any money to meet the new requests. With the stock market panic, the new deposits couldn't meet the demand for new withdrawals. With no new money left to hide the greatest financial fraud in history, Madoff confessed.

What Bernie Madoff did was despicable on a variety of levels. He not only stole money from the super wealthy and celebrities, but he bankrupted the "millionaire next door" and robbed hundreds of millions of dollars from charities and foundations. Rene-Thierry Magon de la Villehuchet, a wealthy businessman who referred clients to Madoff, committed suicide from the shame of association. Many of Madoff's former clients sold their homes and furniture. Very high profile foundations lost most of their money, and some were even forced to shut down.

The media coverage reached a fever pitch, largely because of the scale of the fraud, and because Madoff was not the only money manager stealing from clients. It is estimated that the SEC is usually investigating several hundred possible Ponzi schemes at any given time. Ponzi schemes come to light most frequently during market crashes, like 2008/2009 (see Figure 5.1). This is not because there are more crooks during those periods; it is simply because it is easier for them to get caught. During bear markets, many investors panic and ask for their money back, but because the money has been stolen and spent and no new money is coming in due to the shaky markets, the advisor is unable to meet the withdrawal request

FIGURE 5.1



Source: Graph from Marquet 2011, 5.

and is exposed. As Warren Buffett said, "It is when the tide rolls out that we see who has been swimming naked."

Some people in the media have blamed the investors for not investigating their advisor. This misses the point. How could an investor possibly have known what Bernie Madoff was doing? A background check would have shown a man who was a member of many exclusive clubs, served on the boards of charities and hospitals, and was actively involved in his religious community and causes. He gave millions to various charities, and his clients included some of the world's most sophisticated investors. Madoff even served as the chairman of NASDAQ. Yes, there were red flags. His funds were audited by a single accountant with two assistants. His investment returns, up about 10 percent every year, did not behave the way returns work in the real world. Nevertheless, it is difficult to fault the investors.

The real issue is custody. When an investor speaks with their advisor, one of the top questions that should be asked is: "Who has custody my money?"

If a client hired Madoff, he or she wrote a check to "Madoff Investments" and the money was deposited in the Madoff Investments account. This means Madoff had custody of his clients' assets. If he

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withdrew all the money from one investor's account and gave it to another investor making a withdrawal, no one would know the difference. Madoff's clients received reports created only by Madoff's own firm reflecting their returns (which, somehow, never went down).

The ideal way to work with an advisor is to have a separation of assets. For example, use an advisor who opens an account for you at a national brokerage firm. You can then sign a Limited Power of Attorney giving the advisor the right to place trades and bill the account only. The advisor should not have the authority to make other withdrawals. Furthermore, if your advisor provides reports to you, note that you should get the statement from the brokerage firm as well.

There are literally thousands of investment managers across the country advising clients in this manner. Because of this, it is especially imprudent for an investor to work with an advisor who insists on taking custody of all the client's investable assets.

Now, to be clear, an advisor that custodies assets at a third party can still have various forms of legal custody. For example, if the advisor is also a law firm and serves as a trustee, a trustee by definition has custody. If you are working with a trust company, for example, the trust company, by law, has custody. That is part of why you are hiring them—to entrust your funds with them rather than the beneficiary. Also, all advisors have custody to the extent that they can bill your account.

While we can slice and dice the custody rules, the point here is that your money should be held at a third party at all times. Certain types of investments lead themselves to you giving up custody of your money. These include some hedge funds, private equity funds, and real estate funds (see Figure 5.2). If you are not in a position to perform tremendous due diligence on these funds, ask yourself if you really need this type of investment.

It is fairly common for a client to bring me a "deal" and tell me that they are comfortable giving up custody because the person running the investment is at the same place of worship, from the same ethnic group, or the like. Well, that doesn't mean anything. Most Ponzi schemes (see Figure 5.3) are in fact affinity scams, where the promoter is preying on their own people, just like Madoff did.

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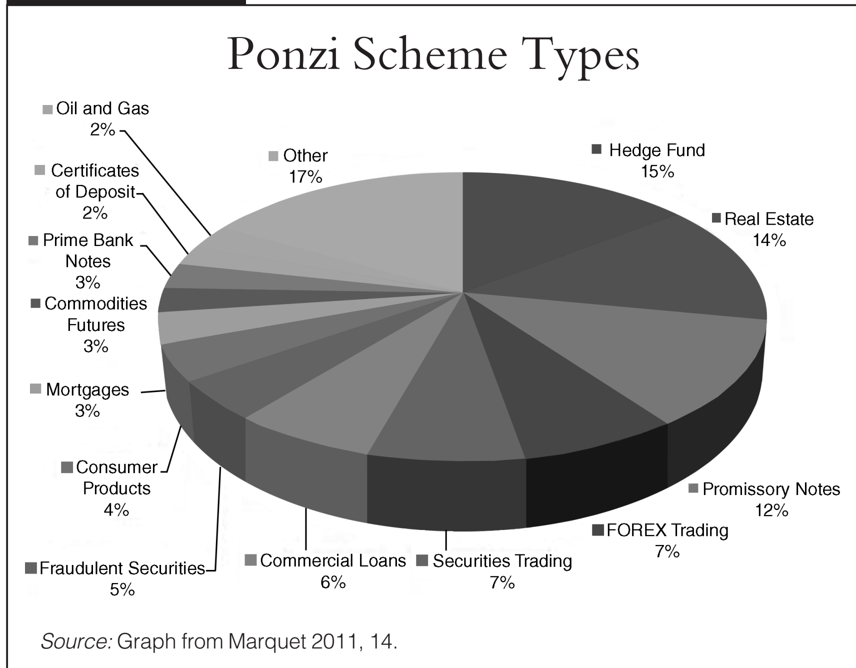
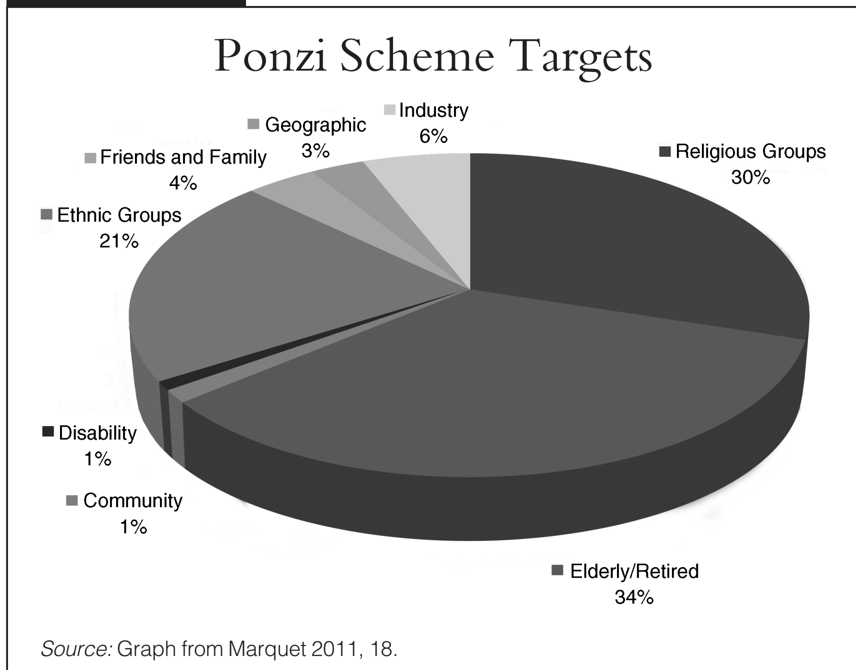
FIGURE 5.2



Source: Graph from Marquet 2011, 14.

FIGURE 5.3



Source: Graph from Marquet 2011, 18.

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The biggest mistake Madoff's investors' made was not failing to conduct a background check, as they keep mentioning in the media. *The biggest mistake was giving him custody of all their money*. The first question you and your family should ask before entrusting everything you've worked for to an advisor is: "Who will take custody of my assets?" If the answer is the advisor, look elsewhere. If you get the right answer, *then* move on to the other important issues of conflict and competence. If you don't want someone to be able to steal your money, don't give it to them. It's that simple. Also, don't give it to an advisor who will then turn around and hand your money to hedge funds or other funds that will take custody of your money. Many of Madoff's victims didn't hire Madoff directly, but rather had paid advisors who in turn handed over custody of their money to Madoff.

Advisor Selection Issue #2—Conflict

Conflict of Interest: A conflict between the private interests and the official responsibilities of a person in a position of trust.

—Merriam-Webster Dictionary*

There are so many ways to get worked over by an advisor that it is, quite frankly, incredible. I am aware of no other industry where people go to a professional to get help and, more often than not, end up worse off than when they started. That's not a very nice thing to say, and will ruffle the feathers of quite a few in the industry, but the reality is that the financial services industry is broken. If you have a typical advisor, the odds are you would be better off without one. The reason is simple: The overwhelming majority of advisors are not on your side of the table. *They get paid more if they sell you products, they don't have a fiduciary duty to act in your best interests, or they work for a company that sells its own funds. If any of these apply to your situation, it is time to look for a new advisor, the sooner the better.*

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* For an example, see the financial services industry.

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The financial services landscape is very confusing, and this makes it easy for your advisor to mislead you. Here, I will break out this issue into three parts, to make it as easy as possible for you to determine if your advisor passes this absolutely critical test.

Test #1—Independent Advisor or Broker?

Unfortunately, only a small proportion of "financial advisors" are federally or state-registered RIAs. Most so-called financial advisors are considered "Broker-Dealers" by the Securities and Exchange Commission (SEC). Brokers are not held to a Fiduciary Standard; they are held to the lower Suitability Standard. In fact, they are required by federal law to act in the best interest of their employer, not in the best interest of their clients.

—The National Association of Personal Financial Planners, 6

Investment Advisor Defined

The Investment Advisors Act of 1940 defines a "registered investment advisor" as "a person or firm that, for compensation, is engaged in the act of providing advice, making recommendations, issuing reports or furnishing analyses on securities, either directly or through publications."

Advisors provide advice and recommendations, and are paid a fee. Investment advisors follow the fiduciary standard. *An investment advisor has a fiduciary duty to his or her clients, which means that he or she has a fundamental obligation to always act in the clients' best interests.* Investment advisors must disclose any and all conflicts of interest and are prohibited from making trades that will result in more revenue for them or their firm. Registered investment advisors are governed by the SEC.

Brokers Defined

The Securities Exchange Act of 1934 defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others."

Brokers are paid commissions tied to investments that they select for their clients. *A broker follows the suitability standard.* The suitability standard says the broker must believe that any recommendations made are suitable

for clients. A broker's primary obligation is to the firm he or she works for, not to the client, and the broker therefore does not have to place his or her interests below that of the client. Brokers are governed by FINRA.

So What's the Difference?

The bottom line is this: If your advisor is an investment advisor and governed by the SEC, then the advisor serves as a fiduciary to you, must put your interests above his own, and must act in your best interests. If your advisor is a broker and governed by FINRA, then the broker has no fiduciary duty to act in your best interests. *Why in the world would you ever pay for advice from someone who doesn't need to act in your best interests?* This is an absolutely crazy concept! Would you hire a lawyer who didn't need to act in your best interests? A doctor? An engineer? An architect? Of course not! This is the only professional field I am aware of where people seek out an advisor and pay them to *not* have an obligation to act in their best interests.

Most advisors operate under vague titles like "financial advisor." To determine if the financial advisor is an investment advisor or broker, you will need to ask questions and investigate. It won't be easy, because many advisors will try to mislead you.

As Americans have started to wise up a bit and move from brokers to investment advisors, the brokerage industry has tried to confuse the consumer further. In what became known as the "Merrill Lynch Rule," primarily because brokers lobbied for it, a proposal was put forth to allow fee-based brokers to offer financial advice that is "incidental" without registering as investment advisors with the SEC. The goal of the brokerage industry was to offer the service while still operating as a broker and without being held to the fiduciary standard. Now why would they want to do that? The reason is simple: When a broker is taken to arbitration or sued, they primarily use the defense that they have no legal obligation to act in the client's best interests. They simply "brokered" the transaction, much like a real estate agent brokers the sale of the house. You wouldn't sue your real estate broker if the roof caved in after you bought a home. You are responsible for making sure you have an inspection. The realtor just brokers the deal. Brokers want to use titles

that make them appear as if they are on your side of the table. They use titles like "financial advisor," "financial planner," "wealth advisor," and "wealth manager." At the end of the day, a broker has no fiduciary duty to act in your best interest. They are actually lobbying Congress to keep it that way. Keep that in mind.*

The investment advisor is obligated to disclose conflicts and put your interests first. The broker is not required to disclose conflicts and puts his interests or his firm's interests first. This is an easy way to screen an advisor. There are approximately 300,000 financial advisors in the United States. Most of them are brokers. That means most of the financial services industry doesn't need to act in your best interests. Fascinating, right? Well, eliminate the brokers by asking a few questions:

1. Are you a broker or investment advisor? Correct answer: Investment advisor only.
2. Are you registered with the SEC or FINRA? Correct answer: SEC only, not both, and not just FINRA.
3. Do you have the Series 7 or 65 license? Correct answer: The 65, not both, and not just the 7.

Note that all of the above are really the same question. An investment advisor is always regulated by the SEC. A broker will have the Series 7. Now that we have narrowed the field by eliminating approximately 85 percent of the financial advisors, let's narrow the field further† (PBS 2013).

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*Imagine this: You pay a financial advisor and he shares the fee with his firm. That firm then spends some of that money lobbying Congress to allow them to advise you without having to act in your best interests. That sums up the majority of the financial services industry, and it's totally ridiculous.

†Note that I am not saying that all brokers are bad. That is certainly not the case. There are ethical and unethical brokers just like there are ethical and unethical investment advisors. I am simply saying that you should, at a minimum, require that the person you hire to help you has a fiduciary obligation to act in your best interests at all times, and brokers don't meet that requirement.

Test #2—Pure Independent versus Independent and Broker

The dually registered advisor is the ultimate wolf in sheep's clothing.

So far we have divided the financial advisory field into two main categories: independent investment advisors and brokers. However, we need to go one more step to make sure you are always dealing with someone that must *always* act in your best interests. Some independent investment advisors are dually registered. This means that they are both an independent advisor and a broker.

This is an extremely dangerous advisor because this advisor can say they are an investment advisor and is held to the fiduciary standard and would be telling the truth. However—and this is a *huge* however—*the same person can switch from being an investment advisor with a fiduciary duty to act in your best interests to a broker who can sell you something and not act in your best interests in the same conversation*. You read that right. By dually registering, an advisor can operate under the fiduciary standard sometimes and as a broker avoiding the standard sometimes. Good luck figuring out which is which. The dually registered advisor is the ultimate wolf in sheep's clothing.

There are two ways to see if an "independent investment advisor" is also operating as a broker. First, ask. Second, look at their business card or website. If it says "securities offered by ABC broker dealer," then you are dealing with someone who is also a broker. If you are working with a dually registered advisor, don't be surprised if your investment portfolio ends up owning commissionable investments or proprietary funds (funds that the company owns).

Test # 3—Proprietary Funds versus No Proprietary Funds

It is highly unlikely that your advisor happens to work for the company that has the absolute best investment for you for any allocation in your portfolio.

Advisors who are brokers or who are dually registered often work for a company whose parent company or sister company offers proprietary

funds. This means that the company owns funds, and often it will sell those funds to its clients. For example, in a common setup, an investment firm owns two sub-firms: a registered investment advisor (RIA) as well as a brokerage that owns mutual funds, hedge funds, and the like. The financial advisors are then dually registered. The advisors then market themselves as "independent advisors." The client signs an agreement they never read or wouldn't understand anyway. The "independent advisor" then puts the sister company's mutual funds, separately managed accounts, and hedge funds into the client's portfolio. Often, these funds operate under different names, making it even harder for the client to know they are being sold proprietary funds. In my opinion, *this is the worst type of setup for a client because the client has gone through the effort to seek out an independent advisor and instead ended up with a salesperson in disguise*. And make no mistake, when you hire a broker, you are hiring a salesperson, not an advisor. If you are going to pay an advisor to give you advice, the least you should ask for is that they don't have a product to sell you and that they have to act in your best interests.

You don't go to a Honda dealership and pay someone to tell you what kind of car to buy. They are going to recommend a Honda, regardless. Likewise, you should never work with an advisor whose company or affiliated company has proprietary funds. If you do, don't be surprised when they end up in your portfolio.

If you are working with a broker or dually registered advisor, take a look at your portfolio. Examine what you own. You will likely find that you own some of the funds owned by the affiliated company. Ask yourself this: Are these the absolute best funds in the world for me? The answer is no. It is highly unlikely that your advisor happens to work for the company that has the absolute best investment for you for any allocation in your portfolio. It may happen at times, but it is unlikely. If an advisor works for a company that has its own funds, or is affiliated with a company that has its own funds, move on with your search.

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A Final Thought on Conflicts

I have often heard people say that although they work with an advisor who has a conflict, it doesn't matter because their particular advisor is trustworthy or because they are always checking the advice of the advisor. To those of you who feel this way, keep in mind that you might not be around one day. What sort of advice will your spouse or kids receive when you are gone? As an estate planning attorney, I have seen many instances of a surviving spouse being sold an annuity by an advisor before they even get to my office. Also, you might be around a long time but not have your wits about you for part of your life. When you and your family are facing the toughest personal struggles, it's ideal to have a financial advisor who has no incentive to do anything differently. Warren Buffett is fond of saying he likes to buy a company that can be run by an idiot, because one day it will be. I recommend always having an independent advisor who is not a broker, because while the conflict of interest a broker brings to the table may not present itself today, one day it likely may.

Advisor Selection Issue #3—Competence

Never ascribe to malice that which adequately can be explained by incompetence.
—Napoleon Bonaparte

It's quite sad that we have eliminated most advisors simply because the overwhelming majority of them have a conflict of interest. They simply are salespeople, sometimes in bad disguises and other times in very good disguises. We have now moved on to the thousands of independent advisors governed by the SEC who are not also registered as brokers. While this group has a duty to act in your best interests, they still need to be weeded out for competence and relevance.

The financial advisory field is quite different than other professions like medicine, law, engineering, education, and the like. If you want to be a doctor, you go to medical school. Lawyers go to law school. Engineers get a degree in engineering. Teachers get a degree in education. The overwhelming majority of financial advisors, I would speculate

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well over 95 percent, have no college education in financial planning or investment management because (until recently) there wasn't a college-level program offered. They learn it on the job. Since that is the case, how do you identify an advisor with competence and relevance?

Competence Check #1—Do the Advisor's Credentials Meet Your Needs?

As of July 2014, there are 142 professional designations on the FINRA website for the financial services industry. Most of them are worthless. If you are looking for financial planning help, be sure your advisor or someone on their team is a Certified Financial Planner (CFP). If you are seeking advanced tax advice, get it from a CPA. If estate planning is required, utilize an estate planning attorney. These designations and degrees require a college degree, advanced studies, a formal exam, and continuing education. Set the bar at least at this level.

Competence Check #2—Is the Advisor Right for You?

An advisor can be an independent advisor with no conflicts, not have any proprietary funds, have the CFP, and still not make sense for you. Be sure the advisor you choose works with people like you. If you are going to have heart surgery, you want to go to a doctor who successfully performs heart surgery all the time. If you are wrongfully accused of a crime,* you will look for a criminal defense attorney who has had prior success working with people in your situation. Likewise, when choosing a financial advisor, choose one who successfully works with people in your situation, all the time. If you are just getting started, find an advisor who works primarily with clients at your stage of life. If you are high net worth, choose an advisor who works primarily with high-net-worth households. You don't want your advisor learning at the expense of your

* Or not wrongfully. I'm giving you the benefit of the doubt here!

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financial well-being. When an issue comes up, you want your advisor to have “been there, done that.”

Competence Check #3—Is the Advisor Following a Process That You Agree With?

There are still thousands of advisors who are independent with no conflicts, don’t sell proprietary funds, and work with your type of situation.* The final screen is to make sure that what they are selling actually works and fits your personal philosophy.

The financial services industry is a mess. Most advisors are not aligned with the client’s best interests. Most advisors are in the business of selling something, whether it is clear to the client or not. Even those who are truly independent often sell a strategy they know people want to buy. It’s easy for a financial advisor to sign on a client by telling the prospective client there is a way to participate in the upside of the market and at the same time get out of the way before a downturn. Whenever there is something people want to buy, someone will sell it. A competent and ethical advisor knows that this cannot be systemically done and won’t sell it. A competent but unethical advisor knows it can’t be done, but will sell it anyway.

According to a recent study, an advisor following the principles set forth in this book can provide added value of about 3 percent per year, with some years adding negligible value and others adding value of well over 10 percent, notably during periods of large market swings (Kinniry, Jaconetti, DiJoseph, and Zilbering 2014). If the principles of this book ring true to you, then you should seek out an advisor who is focused on avoiding market timing, active trading, and selling performance and instead is focused on building a plan to develop a roadmap, focused on an allocation that makes sense for you, keeping costs and taxes low, and following a disciplined repeatable approach to investing that avoids behavioral missteps.

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* Though, sadly, the field is getting quite thin.

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A Final Thought on Advisors—Principles

It's good to stand for something, believe in something, and base your business on values.

—Jerry Greenfield, Ben & Jerry's

Many advisors offer strategies like the one in this book but at the same time offer market timing strategies, tactical strategies, active trading, hedge funds, and the like. Select an advisor with principles and values. One who has something they believe in and actually implement for their clients rather than a firm with a bunch of various "products and packages" trying to compete in every space. If a firm offers an approach like the one outlined in this book, but also offers a tactical strategy, downside protection strategy, or market timing strategy, then they are telling you they will do anything to make a buck, because they are selling strategies that directly contradict each other. It doesn't matter to them if something works or not. All that matters to them is selling you on becoming a client, no matter what strategy you want. You wouldn't choose a doctor who firmly believes in one approach to healing, and believes another approach will actually harm you but would take that approach anyway.

If a prospective client comes to me looking for active options trading, hedge funds, market timing, and the like, I tell them I am not the advisor for them. I don't set up another fund to take them on. You should demand the same from an advisor. Once you determine the approach that's right for you, find an advisor who follows that approach as a matter of discipline and principle. Require that your advisor have a philosophical soul.

Avoiding Mistake #5—Choosing the Wrong Advisor

Be sure you put your feet in the right place, then stand firm.

—Abraham Lincoln

In my career, I have witnessed the unfortunate aftermath of many investment mistakes. It is always unfortunate when I see a client who blew up their portfolio. It is *tragic* when a financial advisor has caused the damage. I always feel the most sympathy for those who knew they

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needed help, sought it out, then ended up with an advisor who either put the client in commissionable products, sold the client proprietary funds, missed out on gains because of a stupid market timing strategy, or blew up the portfolio with an active strategy.

A good list of questions to ask your advisor will include the following:

1. Where will my money be held? Right answer: Somewhere else!
2. Are you a broker? Right answer: No!
3. Are you a dually registered advisor? Right answer: No!
4. Do you or any affiliate have proprietary investments of any kind? Right answer: No!
5. How are you compensated? Right answer: Total disclosure in writing and never make commissions on any investment product.
6. What are the credentials of you and/or your team? Right answer: If planning is involved, a CFP is ideal to have on the team.
7. What is your planning and investment management approach? Right answer: The firm should follow a coherent philosophy rather than a bunch of different strategies (unprincipled) and should follow an approach that does not involve market timing or active trading.

If an advisor is the right solution for you, make your decision carefully. Understand the importance of custody and competence, but most importantly, *make sure your advisor has no conflict and follows the investment philosophy that makes sense for you*. Put your requirements in writing, and stick to them. Do not be swayed in the meeting with a prospective advisor. Once you have put your feet in place, stand firm.

A financial advisor can greatly increase the odds of you attaining your financial goals by providing peace of mind, offering continuity of advice for your family, partnering with you to make better financial decisions, and likely helping your portfolio perform better—that is, if you have the right advisor.