HOW TO SELECT A FINANCIAL ADVISOR

THE LEAST YOU SHOULD KNOW

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ISBN: 978-0-9850424-0-0

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FOREWORD

In 2006, Ed Mahaffy made a career-changing decision. He decided to abandon the hybrid commission and fee-based investment advice model he had followed for years to become a Fee-Only investment advisor—charging his clients based on their assets-under-management.

In Ed's mind, all individual investors must make a choice that comes down to two key questions:

- Do you wish to receive financial recommendations from a financial advisor and firm that have no fiduciary obligation, and whose recommendations may be influenced by commissions?
- Or would you rather pay an advisory fee for ongoing financial advice from a person and firm legally obligated to act in your best interests?

These questions seem pretty straightforward—who wouldn't want to be guided by someone who must place their clients' interests first and foremost? But what kind of advisor must do that?

That's the challenge. Investors can't answer these questions without understanding how the person who guides them is compensated. That's a tall order when trying to figure out how the system works, what the pitfalls are, and what questions to ask.

Ultimately, Ed's choice led to the book you're reading now—but according to Securities and Exchange Commission rules, he first had to apply for (and receive) SEC approval to do business as an investment advisor. That is how Ed and I met. He was seeking assistance with the required federal registration that would permit him to follow the business model he now believed to be the best for his clients, and for himself.

As a CPA and Personal Financial Specialist, my business focuses solely on providing investment advisors with this kind of registration guidance. I've worked with about 250 clients in this area over the years, and have held many volunteer leadership roles with the American Institute of Certified Public

Accountants. Ed is truly passionate about the subject of investor fees, and about making sure people understand basic information about personal investment business models. He's also a gentleman and a straight-shooter who doesn't mince words about what he sees as the burning issue in investing today.

More people are agreeing with Ed, too. There is an entire movement afoot to harmonize the fiduciary standards throughout the industry. It's even gotten to the level of congressional testimony. Change is coming, and this book is Ed's contribution to this important movement.

While writing this foreword, I had the pleasure of visiting my retired aunt, Terry and my uncle, Tim. They both saved money well during their working years as a school teacher and industrial salesman, and are now living comfortably. While chatting over coffee, I discovered that they did not know what credentials their "financial advisor" held, nor how he was compensated.

I quickly learned that they had invested the bulk of their savings in a variable annuity with high up-front hidden commissions, sold to them by a registered representative who was not bound by a fiduciary standard. They would have been well served by this book, as would many others not "in the business." My hope is that you read this book to begin a journey of learning how best to invest your hard-earned dollars.

This book is for all the Aunt Terrys and Uncle Tims out there. Once you read it, you'll have a great blueprint for deciding whether your investments are in the right place. More importantly, you'll know what to do if you decide they're not. What I love most about Ed's book is that I could hand it to anyone who needs help with their investments. He has spelled things out so clearly that any reader should be able to understand the implications of various decisions for their portfolios. Time spent with Ed's book is time very well spent, indeed.

Ellen M. Bruno, CPA/PFS
President, Compliance Advisor Professionals, LLC

INTRODUCTION

Although many good do-it-yourself investment books have been written, managing our investments and personal finances has become increasingly complex. Many people do not want to take the do-it-yourself approach because they lack the interest, the background, the time, or some combination of the three. They seek the support of a financial advisor.

People are seeking trustworthy financial advice, but they do not know where to begin. What I've seen in the last few years is that investors no longer trust Wall Street. They have lost faith, and they have lost money. Many of them feel that the markets are rigged, and that they are at a huge disadvantage.

I have often encountered people with no financial plan who are unaware of exactly what investments they own, or their true costs of ownership. They lack the knowledge necessary to evaluate their financial advisor with respect to investment performance, cost-effectiveness, and whether the advisor has a legal obligation to always act in their best interests.

My mission is to explain what you should be seeking in a financial advisor, and to empower you to find an advisor who will work in your best interests. Among the issues that should matter are: the advisor's disciplinary history, knowledge of a broad range of financial issues, industry experience, and expertise in the areas that the investor's particular situation demands.

However, differentiating among the many types of financial advisors is very difficult. My goal is to cut through the fog of advertising and vague promises.

If you can't answer these basic questions about your investments, then you probably need assistance. If you have a financial advisor, and he can't (or won't) answer these questions, then you need another advisor:

1. *What investments do you own?*
2. *Why do you own those investments?*
3. *What is the true cost of ownership of those investments?*

4. *Does your financial advisor have a legal obligation to* ***always*** *act in your best interests?*
5. *What is your true cost of receiving financial advice?*
6. *What are your alternatives for investment products? What are their costs?*

I look forward to explaining how you can take control of your investments, your financial future, and your relationship with your financial advisor.

WHO'S WHO

In this book, all broker-dealers are referred to as "brokerage firms." All financial services professionals are referred to as "financial advisors," and to simplify for the reader, will be referred to as "he" or "him." The term does not distinguish among retail brokers, independent brokers, investment advisors or insurance agents licensed to sell securities. "Adviser" appears only when referencing the Investment Advisers Act of 1940.

However, industry professionals understand that retail brokers, independent brokers, and independent investment advisors operate very differently. Those crucial differences will be explained in detail in this book. Explaining those differences—in compensation, in motivation, in regulation, in expertise—is at the heart of this book. With that information, the average person can make an informed decision.

“

Let our advance worrying
become advance thinking and planning.

Sir Winston Churchill

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This too shall pass.

Unknown

Update from the Author: March 2020

As I write this on March 26, 2020, we have seen both the U.S. stock and bond markets register new all-time highs only to suffer a 38% downturn in stocks. International markets have also experienced severe downturns.

At the same time, bond prices utterly collapsed under the weight of forced liquidation from panic selling in a rush for liquidity as opposed to benefiting from a flight to quality as we have often witnessed in past stock market corrections.

The federal reserve lowered rates to zero in response to the markets and Congress authorized a two trillion dollar relief package in part to address the spike in expected unemployment caused by layoffs and business closings, due to the Covid-19 virus. Obviously, the damage to financial markets pale in comparison to human suffering caused by Covid-19.

Commodity prices also collapsed—especially crude oil—as the global economic picture worsened. Even gold, which one might expect to be a safe haven, sold off violently. We now face the likelihood of the first recession in over a decade.

In response to monetary stimulus from the Fed as well as fiscal stimulus from Congress, stocks and bonds experienced significant price improvement only days after making new lows.

In my thirty-five years in the securities industry, I have experienced the 1987 stock market crash, the dot-com crash in 2002, the 2008 financial crises as well as other severe corrections in both stocks and bonds, but never anything like what I have witnessed—and traded through—in the past thirty-five days. Reporters have been searching for explanations. This week alone, I was interviewed by both the *Wall Street Journal* about municipal bonds, and *Business Insider* about high-yield savings accounts.

History may not repeat itself, but it often rhymes and human nature does not change. In challenging market conditions, it is important to keep things in perspective.

The following exhibits are intended to offer this perspective. They are also intended to serve as a reminder of the importance of having a sensible financial plan—one that reflects your true risk tolerance—and sticking to it in times of market turmoil. This is when advisors should earn their keep.

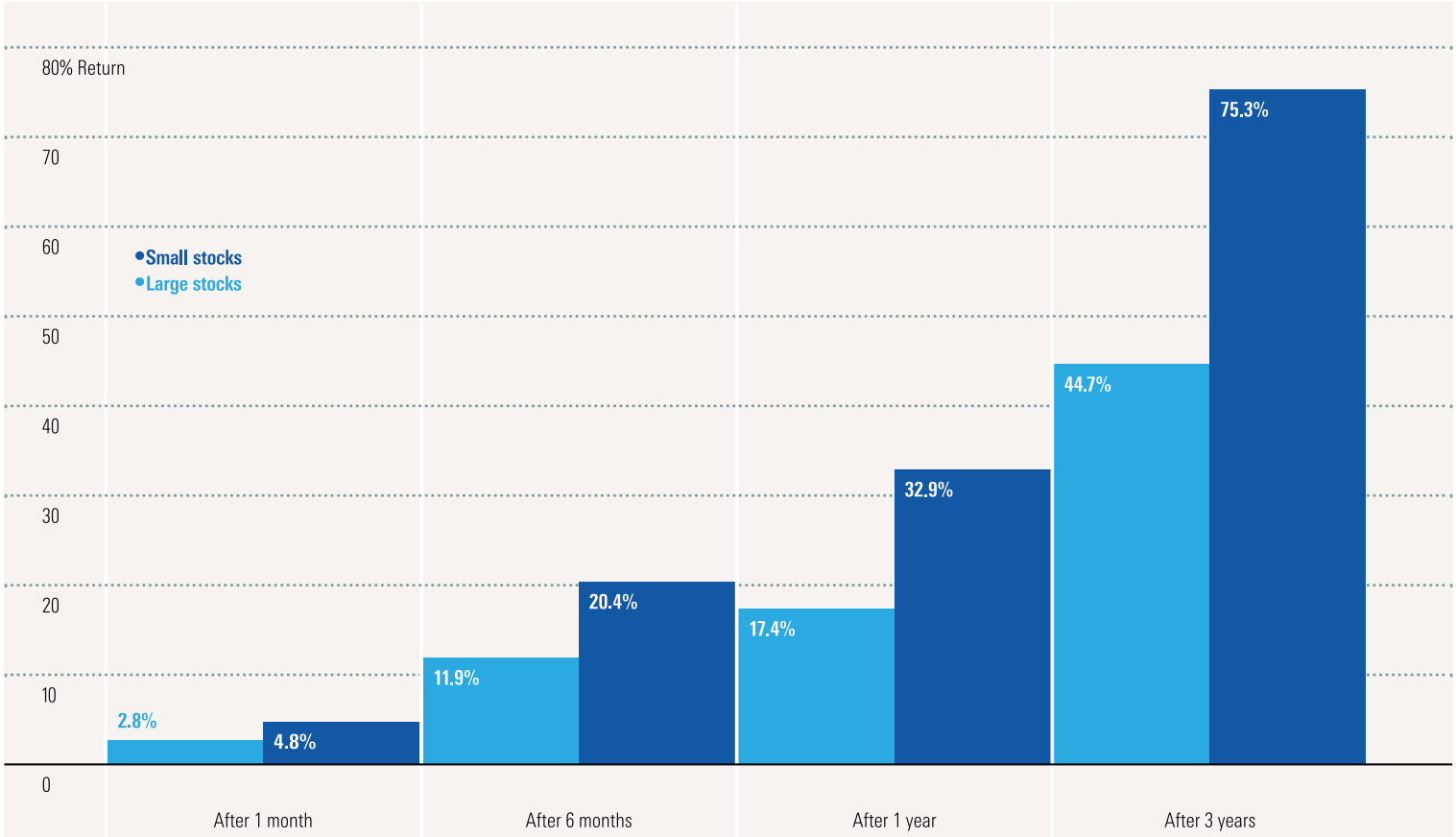
Market Downturns and Recoveries • 1926-2019

Downturn	% Loss		Recovery
34 months	–83.4	Sep 1929–June 1932 / July 1932–Jan 1945	151 months
6 months	–21.8	June 1946–Nov 1946 / Dec 1946–Oct 1949	35 months
7 months	–10.2	Aug 1956–Feb 1957 / March 1957–July 1957	5 months
5 months	–15.0	Aug 1957–Dec 1957 / Jan 1958–July 1958	7 months
6 months	–22.3	Jan 1962–June 1962 / July 1962–April 1963	10 months
8 months	–15.6	Feb 1966–Sep 1966 / Oct 1966–March 1967	6 months
19 months	–29.3	Dec 1968–June 1970 / July 1970–March 1971	9 months
21 months	–42.6	Jan 1973–Sep 1974 / Oct 1974–June 1976	21 months
14 months	–14.3	Jan 1977–Feb 1978 / March 1978–July 1978	5 months
20 months	–16.5	Dec 1980–July 1982 / Aug 1982–Oct 1982	3 months
3 months	–29.6	Sep 1987–Nov 1987 / Dec 1987–May 1989	18 months
5 months	–14.7	June 1990–Oct 1990 / Nov 1990–Feb 1991	4 months
2 months	–15.4	July 1998–Aug 1998 / Sep 1998–Nov 1998	3 months
25 months	–44.7	Sep 2000–Sep 2002 / Oct 2002–Oct 2006	49 months
16 months	–50.9	Nov 2007–Feb 2009 / March 2009–March 2012	37 months
3 months	–13.5	Oct 2018–Dec 2018 / Jan 2019–Apr 2019	4 months

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Downturns are defined by a time period when the stock market value declined by 10% or more from its peak.

MORNINGSTAR®

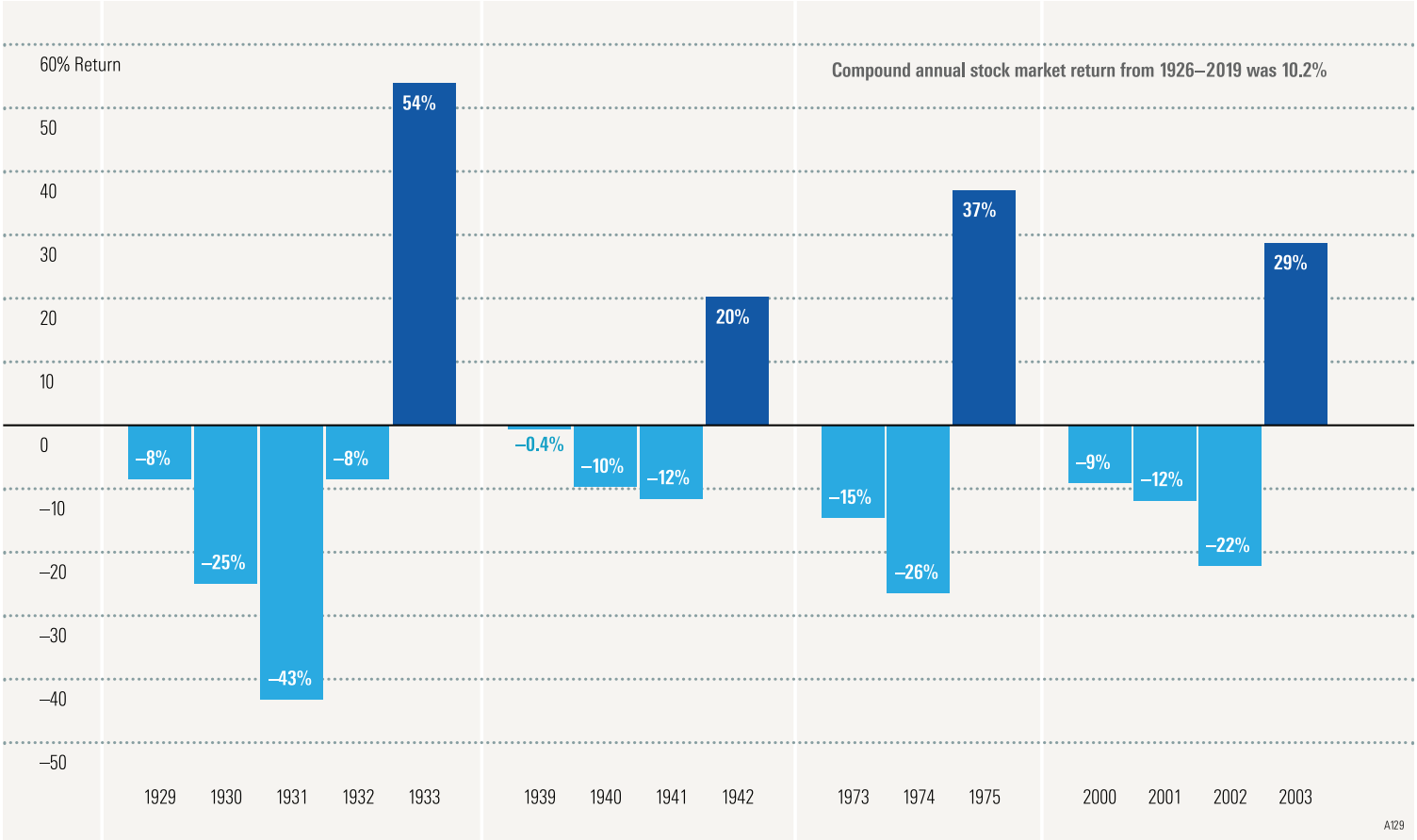
Stock Perofrmance After Recessions • 1953–2019



Past performance is no guarantee of future results. Cumulative returns of large and small stocks after recessions 1953–2019. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

MORNINGSTAR®

Periods of Consecutive Negative Stock Returns • 1926–2019

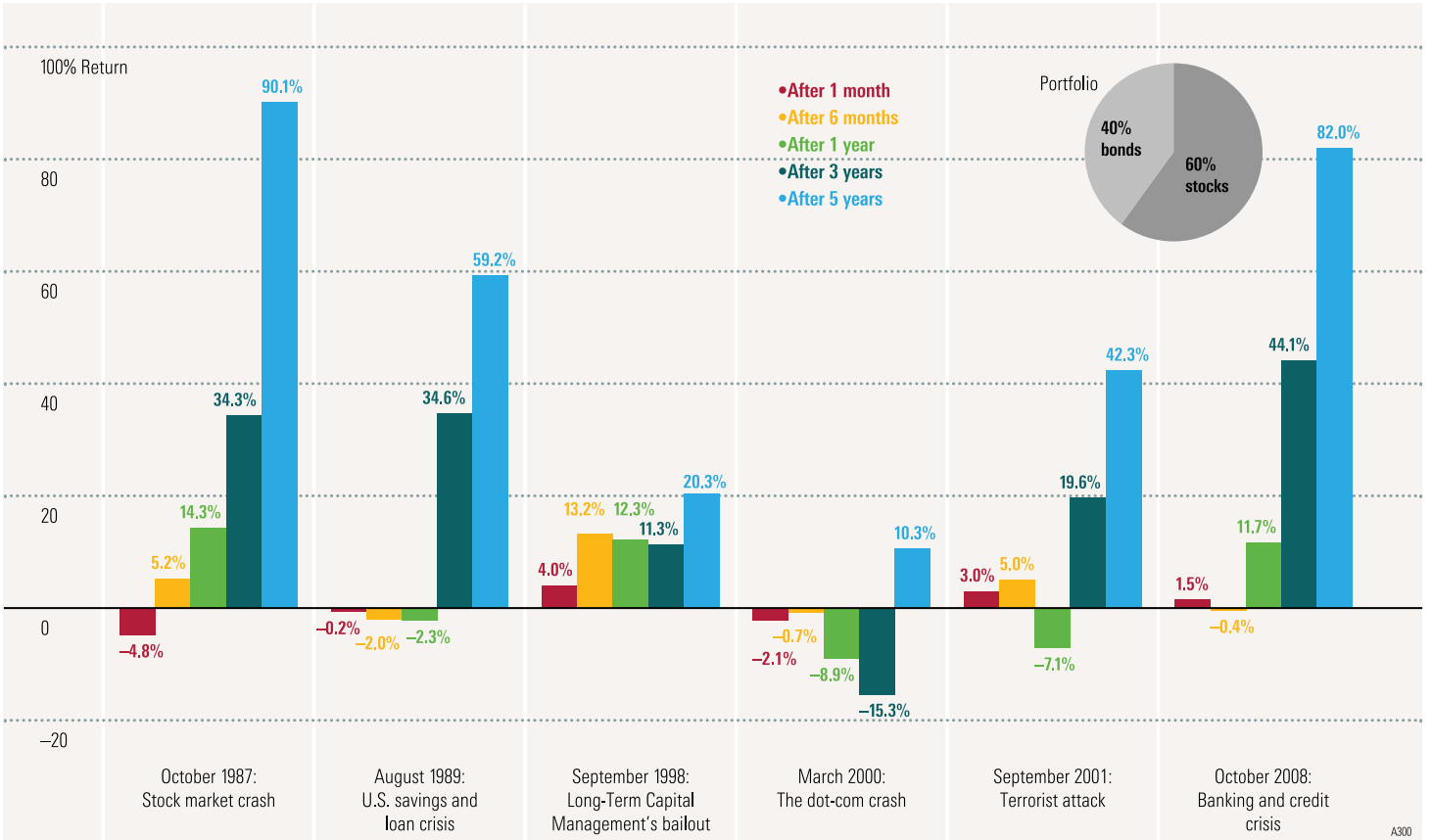


Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment.
An investment cannot be made directly in an index.

MORNINGSTAR®

U.S. Market Recovery After Financial Crises

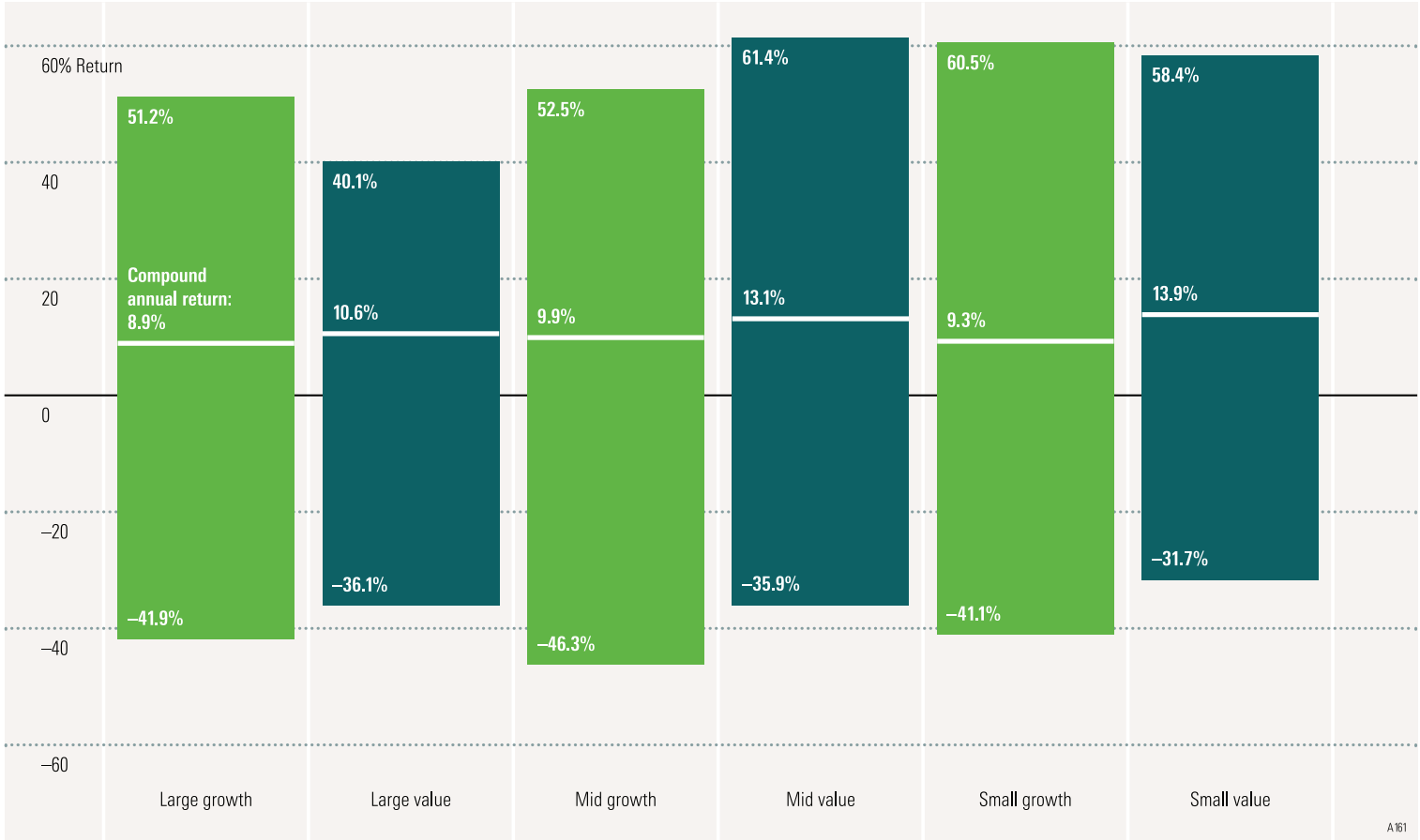
Cumulative Return of Balanced Portfolio After Various Events



Past performance is no guarantee of future results. Returns reflect the percentage change in the index level from the end of the month in which the event occurred to one month, six months, one year, three years and five years after. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. •

MORNINGSTAR®

Range of Annual Returns • Growth and value stocks 1970–2019

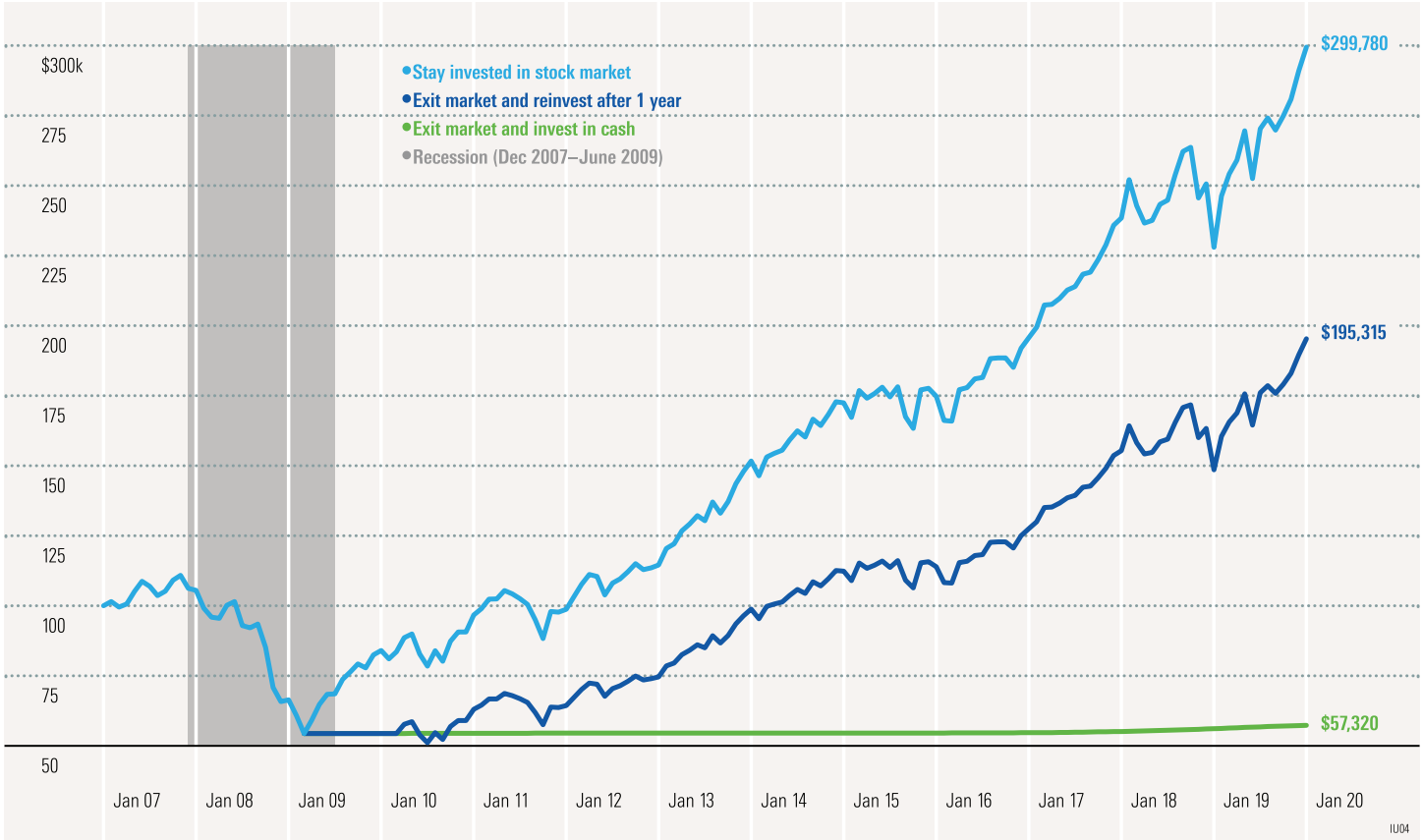


Past performance is no guarantee of future results. Each bar shows the range of compound annual returns for each asset class over the time period analyzed. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

MORNINGSTAR®

The Importance of Staying Invested

Ending Wealth Values After a Market Decline



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. •

MORNINGSTAR®

Aside from recent market turmoil, there have been some other significant developments since I first wrote this book in 2012:

- Commissions for stocks and exchange-traded funds (ETFs) are now at zero, as well as the operating expenses for certain ETFs. Fees have even fallen a bit for certain actively-managed open-end mutual funds.
- The original Department of Labor Rule (DOL Rule) was introduced in 2017, imposing a fiduciary legal obligation upon all professionals advising retirement accounts to always place their clients' interests first.
- In 2018, the DOL rule was overturned in court.
- In October 2019, the new Certified Financial Planner (CFP®) Board practice standard took effect.
- Also in 2019, the SEC voted on a new set of rules as well as guidance for the so-called Regulation Best Interest (or Reg BI).

Barbara Roper's September 2019 article in *NAPFA Advisor* magazine is the most cogent and succinct summary that I know of. Barbara is the director of investor protection for the nonprofit Consumer Federation of America. Her article is reprinted on the next page.

It should go without saying that nobody's financial picture is complete without a solid financial plan. Not a cookie-cutter plan that merely checks the boxes as part of some quota system or a plan done as a means of selling financial products. I am referring to a solid, comprehensive financial plan that encompasses every facet of your life, all contingencies and variables as well as stress-testing for efficacy.

Effective planning is a collaborative effort between planner and client. The result, including periodic updates, should be greater peace of mind.

Hopefully, you are already working with a CFP®. By all means, you should be working with a fiduciary. How do you know if the advisor is always acting as fiduciary and therefore, always placing your interests first? Insist that they sign the Fiduciary Oath found on page 34. If they refuse to sign it, find an advisor who already adheres to it at NAPFA.org. There are only a few thousand NAPFA members nationwide, but it's well worth the effort to find one in your area.

How to Protect Investors When the SEC Won't

Amid great fanfare, the SEC voted in June 2019 on a package of rules and guidance that it claimed would significantly enhance and clarify the standards that apply when broker-dealers and investment advisors provide advice and recommendations to retail investors. While securities lawyers will be parsing the words of the new standards for many months, it is apparent that, under the new rules, neither brokers nor advisors will be required to recommend the investments they reasonably believe are the best available option for the client.

As a result, instead of strengthening protections for investors, the new standards will place them at greater risk—misled into expecting best interest advice that the rules do not require. Particularly shocking to many observers is that the SEC weakened the Investment Advisers Act of 1940's fiduciary standard, instead of raising the bar on broker-dealer conduct.

The good news is that many financial professionals, include NAPFA members, take seriously their obligations as professionals to do what's best for their clients. As investor advocates, our job in the coming months will be to help steer investors toward advisors who voluntarily adhere to a higher standard than the SEC is willing to impose.

One way to accomplish that will be to steer investors toward those financial professionals who design their practices to minimize conflicts of interest. Eliminating conflicts associated with revenue-sharing payments, differential compensation, 12b-1 fees, and the like is obviously easier for investment advisors than for broker-dealers, though advisory accounts at dual registrant firms in particular are not immune to such conflicts. NAPFA's Fee-Only commitment will make it a critical resource in our investor education efforts going forward.

While the challenge for brokers to rein in conflicts is greater, a well-meaning brokerage firm could go a long way toward reducing particularly problematic conflicts of interest. It could do so by adopting some of the reforms and innovations, such as "clean shares," that had begun to take hold before the DOL fiduciary rule was overturned in court.

Voluntary certifications will also play a role in our investor education efforts. These include the CEFEX certification, which documents adherence to a set of fiduciary best practices, as well as the new CFP® Board practice standards taking effect October 1. The CFP® Board standard takes a tougher stance on conflicts than either Regulation Best Interest or the SEC's interpretation of the Advisers Act fiduciary standard. It makes clear that, even after conflicts of interest have been disclosed and consented to, the CFP® certificant still has an obligation to set those conflicts aside and put the client's interests first. That's what investors reasonably expect from someone pledged to act in their best interests.

Because the CFP® standard is compensation neutral, it offers broker-dealers a way to demonstrate that their commitment to a best interest standard is more than just lip service. On the flip side, however, if a firm were to prohibit its reps from using their CFP® credentials, as some have reportedly considered doing, that would be a huge red flag for investors. Similarly, investors can ask their investment professional to sign a fiduciary oath, since a willingness to put that fiduciary commitment in writing will be another way to identify professionals whose commitment to client best interest isn't just for show.

Ultimately, an investor education campaign is not enough. Investors need the protections that only a strong legal standard can provide. So, our long-term strategy will combine reaching out to FINRA and the states to encourage the strongest possible enforcement of the new standard, supporting adoption of stronger state laws, and laying the groundwork to reopen the SEC rules in a new administration.

When the time comes to reopen this debate, we will look to NAPFA members to work with us, as they have in the past, to ensure that brokers and advisors alike are held to the high standards investors expect and deserve from the advisors they trust with their financial well-being.

Written by Barbara Roper, as seen in the September 2019 issue of NAPFA Advisor magazine. Barbara Roper is director of investor protection for the nonprofit Consumer Federation of America. Since publishing a report on financial planning abuses in 1987, she has sought to strengthen protections investors receive when they turn to investment professionals for advice.

Barbara Roper's article on the previous page mentioned that some brokerage firms have reportedly considered prohibiting their reps from using their CFP® credentials, adding that such behavior would be a "huge red flag for investors." Why would a brokerage firm do such a thing? And why now? Because the new CFP® Board standard takes a tougher stance on conflicts or interest than Regulation Best Interest, which can make it much more difficult for brokerage firms to sell their products. Once investors are made aware of all the conflicts, they may choose not to purchase what the brokerage firm is selling, or may even seek a new firm—perhaps a Fee-Only registered investment advisor and fiduciary.

Morever, a December 2019 article in Financial Planning magazine—A Path to Disclosure—reports that "CFPs at Northwestern Mutual have a template to follow in explaining their conflicts of interest to planning clients." "The insurer and broker-dealer has created a disclosure document intended to comply with the CFP® Board's new code of ethics and standards of conduct. In the document, advisors tell planning clients outright that they're incentivized to 'sell' Northwestern Mutual insurance to a client often, and for the highest possible commissions."

There are more than 1,000 CFPs affiliated with Northwestern Mutual, and over 85,000 in total. Compare this situation to a Fee-Only registered investment advisor and fiduciary that offers insurance products—an advisor whose guidance is not conflicted by commissions or sales quotas.

“

An investment in knowledge
pays the best interest.

Benjamin Franklin

Chapter 1: Doing Your Homework

Many people are uncomfortable managing their own investments. They may be overwhelmed by the myriad of unfamiliar terms and investment vehicles, and they may lack the confidence to select their own investments.

Selecting a financial advisor can be equally difficult. There are many different choices—from the large publicly held Wall Street brokerage firms (also known as "wire-houses") with well-known brand names and offices on every corner, to the small independent boutiques comprised of financial planners and/or investment managers. As the industry has expanded in the last 30 years, financial advisors have adopted many job titles, and they can earn many different credentials. Distinguishing among all the choices of firms and financial advisors can be bewildering—like sorting through all the makes, models, and options on a new vehicle. At least with vehicles, it's easy to obtain an apples-to-apples comparison. Not so with financial advice.

Many begin their search for an advisor by consulting with a friend or relative about a referral. That's certainly one way to go, but what is right for your friends or relatives may not be right for you. Some people may believe that their financial advisor is doing a great job strictly based upon how much their account grew last year or last quarter. They may not have compared the risk-based returns (after all fees and expenses) to the proper **benchmark index**—which is a common way to evaluate investment performance. This does not mean that one should disregard absolute return—whether or not the investment made money, regardless of index performance.

Investment managers typically identify a particular index to use as a benchmark against which to compare their performance. For stocks, the S&P 500 is probably the best-known index. It represents the 500 companies with the largest market value that are traded in U.S. stock markets, so it is considered a good approximation of the stock market.

Even if your friend or relative makes the right comparison to a benchmark, he or she might still misunderstand the investment performance. For example, their financial advisor might be exposing them to greater risk than necessary, or greater expense than necessary through the choice of investment vehicles. During the dot-com bubble, many people were impressed with their financial advisors who put them heavily into technology stocks. It turned out that the short-term boost came crashing down.

Each investor should do his own homework and his own due diligence when selecting a financial advisor. A referral is a good start, but it is just a start. Also, it is a mistake to believe that bigger is better. It is a mistake to believe that a financial advisor working for a large company knows more, has access to better research, or is held to a higher standard of care than an independent advisor at a smaller firm. In fact, as will be discussed in later chapters, the exact opposite is often the case.

Advisors' credentials are featured on their business cards, but what do they mean?

Understanding Professional Designations

There are many different job titles used by financial professionals: financial advisor, financial consultant, financial planner, investment consultant, investment manager, wealth advisor, wealth manager, and the list goes on and on. Amazingly, there are no educational requirements and no licensing requirements to use any of these titles. There are also more than 100 professional designations. All of them sound impressive. Some of these designations require years of study and a comprehensive examination, but others require little more than a weekend seminar.

Continued...

Understanding Professional Designations, cont.

Here are three designations requiring extensive study of many topics:

Chartered Financial Analyst (CFA) charter-holders are experts in analysis of financial statements. Often, they provide advice to other financial professionals, rather than work directly with retail clients. CFAs are required to complete three years of study and take a final exam before advancing to the next year of material.

Certified Public Accountant/Personal Financial Specialists (CPA/PFS) are commonly known as accountants. The PFS designation represents additional training and education in financial planning. The Financial Industry Regulatory Authority (FINRA) provides a comprehensive list of professional designations along with complete descriptions of the necessary requirements to attain and maintain each designation at www.finra.org. Just type "professional designations" in the search box.

The Certified Financial Planner (CFP®) designation requires extensive course work and examinations, including a comprehensive final exam covering the following topics: financial planning, investments, insurance, taxes, retirement and estate planning. CFP® certificants must also have several years of work experience and must adhere to a code of ethics.

FINANCIAL PROFESSIONAL DESIGNATIONS

AAI— Accredited Advisor in Insurance
AAMS—Accredited Asset Management Specialist
ADPA— Accredited Domestic Partnership Advisor
AEP—Accredited Estate Planner
AFC— Accredited Financial Counselor
AFSI— Associate, Financial Services Institute
AIF—Accredited Investment Fiduciary
AIFA—Accredited Investment Fiduciary Analyst
AINS— Associate in Insurance Services
ALMI—Associate, Life Management Institute
API— Associate in Personal Insurance
APMA— Accredited Portfolio Management Advisor
APP—Asset Protection Planner

FINANCIAL PROFESSIONAL DESIGNATIONS, continued

APR— Accredited Pension Representative
ARPC— Accredited Retirement Plan Consultant
AWMA—Accredited Wealth Management Advisor
BCA— Board Certified in Annuities
BCAA— Board Certified in Asset Allocation
BCE—Board Certified in Estate Planning
BCM—Board Certified in Mutual Funds
BCS— Board Certified in Securities
C(k)P— Certified 401(k) Professional
C3DWP— Certified 3 Dimensional Wealth Practitioner
CAA— Certified Annuity Advisor
CAC— Certified Annuity Consultant
CAIA— Chartered Alternative Investment Analyst
CAM—Chartered Asset Manager
CAMS— Certified Anti-Money Laundering Specialist
CAPP— Certified Asset Protection Planner
CAS— Certified Annuity Specialist
CASL— Chartered Advisor for Senior Living
CCPS— Certified College Planning Specialist
CDFA— Certified Divorce Financial Analyst
CEA— Certified Estate Advisor
CEBS— Certified Employee Benefit Specialist
CEIAS— Certified Index Annuity Specialist
CEP— Certified Estate Planner
CEPA—Certified Exit Planning Advisor
CEPF— Certified Educator in Personal Finance
CEPP— Chartered Estate Planning Practitioner
CES— Certified Estates and Trust Specialist
CFA— Chartered Financial Analyst
CFEd— Certified Financial Educator
CFG — Certified Financial Gerontologist
CFP®— Certified Financial Planner
CFPN— Christian Financial Professional Network Certified Member
CFS— Certified Fund Specialist

FINANCIAL PROFESSIONAL DESIGNATIONS, continued

ChFC®— Chartered Financial Consultant
ChFE— Chartered Financial Engineer
ChFEBC— Chartered Federal Employee Benefits Consultant
CIC— Chartered Investment Counselor
CIMA— Certified Investment Management Analyst
CIMC— Certified Investment Management Consultant
CIS— Certified Income Specialist
CLTC— Certified Long-Term Care
CLU— Chartered Life Underwriter
CMA— Chartered Market Analyst
CMAA—Certified Merger and Acquisition Advisor
CMFC— Chartered Mutual Fund Counselor
CPC— Certified Planner Consultant
CPCU— Chartered Property Casualty Underwriter
CPFC— Certified Personal Finance Counselor
CPIA— Certified Professional Insurance Agent
CPIW/M— Certified Professional Insurance Woman/Man
CPM—Chartered Portfolio Manager
CPWA— Certified Private Wealth Advisor
CRA— Certified Retirement Administrator
CRC— Certified Retirement Counselor
CRFA— Certified Retirement Financial Advisor
CRP—Certified Retirement Financial Planner
CRPC— Chartered Retirement Planning Counselor
CRPS— Chartered Retirement Plan Specialist
CRSP— Certified Retirement Services Professional
CSA—Certified Senior Advisor
CSC— Certified Senior Consultant
CSEP— Certified Specialist in Estate Planning
CSFP— Chartered Senior Financial Specialist
CSRP—Certified Specialist in Retirement Planning
CTEP—Chartered Trust and Estate Planner
CTFA—Certified Trust and Financial Advisor
CTP— Certified Treasury Professional

FINANCIAL PROFESSIONAL DESIGNATIONS, continued

CTS— Certified Tax Specialist
CWC— Certified Wealth Consultant
CWM—Chartered Wealth Manager
CWMC—Certified Workplace Money Coach
CWPP— Certified Wealth Preservation Planner
CWS—Certified Wealth Strategist
DAE— Diversified Advanced Education
DIA—Disability Income Associate
EA—Enrolled Agent
EHBA—Employee Healthcare Benefits Associate
FAD—Financial Analyst Designate
FALU— Fellow of the Academy of Life Underwriting
FFSI— Fellow, Financial Services Institute
FLMI—Fellow, Life Management Institute
FRM—Financial Risk Manager
FSS—Financial Services Specialist
MCEP— Master Certified Estate Planner
MFP—Master Financial Professional
PFS— Personal Financial Specialist
PPC—Professional Plan Consultant
PRP—Plansponsor Retirement Professional
PRPS—Professional Retirement Planning Specialist
QFP— Qualified Financial Planner
QPFC— Qualified Plan Financial Consultant
RF— Registered Fiduciary
RFA—Registered Fiduciary Financial Associate
RFC— Registered Fiduciary Financial Consultant
RFP—Registered Financial Planner
RFS— Registered Financial Specialist
RIS—Registered Income Specialist
RP—Registered Paraplanner
RPA—Registered Plans Associate
WMS—Wealth Management Specialist

The following is a description of the necessary requirements for the Certified Financial Planner designation—financial planning's most respected certification.

A description of each designation may be found at www.finra.org (obtained with permission from FINRA).

CFP®

Designation	Certified Financial Planner
Designation Status	Currently offered and recognized by the issuing organization
Issuing Organization	Certified Financial Planner Board of Standards, Inc.
Prerequisites/Experience Required	Candidate must meet the following requirements: • A bachelor's degree (or higher) from an accredited college or university, and • Three years of full-time personal financial planning experience
Educational Requirements	Candidate must complete a CFP®-board registered program, or hold one of the following: • CPA • ChFC • CFA • Chartered Life Underwriter (CLU) • Ph.D. in business or economics • Doctor of Business Administration • Attorney's License
Examination Type	CFP® Certification Examination
Continuing Education/Experience Requirements	30 hours every two years
Accredited by	National Commission for Certifying Agencies (NCCA)

Also consider CPA Financial Planners—CPAs that also offer comprehensive financial planning. Many are licensed as investment advisor representatives of a Fee-Only (RIA) firm and fiduciary.

The CPA designation is one of the world's most trusted. CPA Financial Planners provide traditional CPA services, but with the added benefit of providing comprehensive financial planning—a natural extension of the CPA's scope of services. Your CPA already knows every aspect of your financial life. This, combined with the profession's attention to detail and work ethic, make the CPA Financial Planner well worth your consideration—especially one registered with a Fee-Only RIA and fiduciary and one that does not sell products or receive commissions. The next chapter identifies the least you should expect from a financial advisor.

“

It takes twenty years to build a reputation
and five minutes to ruin it.
If you think about that,
you'll do things differently.

Warren Buffet
CEO, Berkshire Hathaway

Chapter 2: The Least You Should Expect

What are the basic credentials, skills, and policies that you should expect from your financial advisor?

1. A clean disciplinary background. Ask the advisor which organization regulates his conduct: the Securities and Exchange Commission or the Financial Industry Regulatory Authority. Then, go to the appropriate website (www.sec.gov or www.finra.org), and see if the advisor has faced any disciplinary proceedings.
2. A full-time fiduciary obligation to always act in your best interests. A fiduciary is a person with a legal requirement to always act in your best interests.
3. Use of transparent investment vehicles that clearly identify the costs of ownership.
4. A reputation for honesty, integrity, accessibility, accountability, and confidentiality that is confirmed by several long-standing clients.
5. At least three years of work experience as a financial advisor in the specific area in which you seek advice, such as investment management or financial planning.
6. At least one professional designation, such as the Certified Financial Planner (CFP®) or the Certified Public Accountant/Personal Financial Specialist (CPA/PFS).
7. Broad knowledge of many areas and specialization in at least one area, such as financial planning or investment management.

8. Objectivity, as measured by a compensation formula that is aligned with your interests.
9. The ability to provide referrals to other competent professionals, such as CPAs and attorneys.
10. An investment philosophy with which you are comfortable. For instance, does the advisor attempt to beat the market or simply try to match the market's returns? Asset allocation that reflects tolerance and goals.
11. A written client Agreement that spells out what services will be provided, the cost of the services, the method of compensation, and whether the financial advisor has "discretion" (permission) to act without first checking with you.
12. Reasonable advisory fees and full disclosure in dollars—as opposed to percentages—of all commissions and other expenses for all products. The fees should be compared to the annual expenses of low-cost investment vehicles, such as no-load index funds.
13. A relationship with a well-known "custodian," which is a financial institution safekeeping your account. For example, Charles Schwab and Raymond James are financial custodian firms. Custodians offer brokerage services as well.
15. Annual reviews, at a minimum, as well as a strategy for harvesting tax losses and realizing capital gains to mitigate your tax liability.

It's a Relationship.

A relationship with a financial advisor is a personal relationship. Your comfort level with the advisor makes a difference. Your advisor should be a good listener who has a personality and demeanor that makes you comfortable. Remember that you are intending to work with this advisor for a long time.

The advisor should be responsive to your requests and need for service. You have a right to timely answers to your questions, and you have a right to ask your advisor for another explanation until you are confident you understand the situation. The advisor works for you.

An advisor can provide a wide range of services, depending on your needs and his skills; however, to ensure that your major concerns are being

addressed, here are some basic services that should be part of the package:

Check the named beneficiaries on your accounts. It is not uncommon for people to have more than one brokerage account, bank account, 401(k) or IRA. People change jobs, and they open accounts and forget about them. Divorced people may have an ex-spouse who is still named as beneficiary on an account. Early in your advisory relationship, your advisor needs to collect all of your accounts and make sure that the beneficiaries are identified correctly.

Protect your assets. The financial advisor should be knowledgeable enough about estate taxation to protect your assets from the costly probate process, even though he may not specialize in the area of estate planning. You don't need an attorney to have your accounts properly titled, such as establishing a payable-on-death account to protect savings held in banks or a transfer-on-death brokerage account. Your advisor should provide the necessary paperwork.

He should also be able to identify whether your insurance coverage is sufficient. The need for life, disability, long-term care—as well as additional property and casualty insurance or an umbrella policy—should be reviewed.

Identify your risk tolerance. Certainly, your goals and dreams for the future should be identified as well, but if your risk tolerance is not properly evaluated, your asset allocation—the mixture of stocks, bonds, and cash in your portfolio—may be too aggressive or too conservative. An asset allocation that is too aggressive may cause you to become more conservative and sell stocks after the market is already in a steep sell-off, only to see the market rally when you lighten up on stocks. Conversely, if your asset allocation is too conservative, you may be tempted to become more aggressive as you chase a market that has already experienced a strong rally, only to see the market wane shortly thereafter. In other words, improper asset allocation will tend to make you more emotional about your investments. Emotion is one of the investor's worst enemies.

Develop your Investment Policy Statement (IPS). Your financial advisor should require that you complete an investment policy questionnaire that will

help identify your risk tolerance. The IPS is a blueprint for how you and your advisor will direct your investments in the future. You should make sure that you understand and agree with everything in the IPS. Ultimately, the IPS serves as a basis for your asset allocation.

The IPS should address the following issues:

1. **Liquidity.** "Liquidity" is the amount of money you need available in cash or a cash-equivalent that you can have access to immediately for any need that might arise. It is a good idea to keep several months' worth of typical spending in an extremely liquid account, such as a checking account or money market.
2. **Taxes.** Your tax obligations and your federal and state tax rates should be identified.
3. **Investment restrictions.** These can include investments you are refusing to make (tobacco stocks, for example), or that you are restricted from making by an employer or some other legal entity.
4. **Primary goals.** What are your primary goals—retirement, income generation, savings, long-term capital gain, etc.?
5. **Time frame for your investments.**
6. **Secondary goals and secondary time frame.**
7. **Risk tolerance.** This leads to your investment approach based on your risk tolerance (conservative, moderate, or aggressive).
8. **The level of volatility that you are comfortable experiencing.** As an example: How would you feel if your investments fell in value by 20 percent?
9. **The projected volatility of your portfolio.** What level of volatility should you expect?
10. **Current and future income needs.**
11. **Estate planning considerations.**
12. **The use of leverage.** Whether you will use leverage in the portfolio, such as a margin account, or any investment vehicles that employ leverage.
13. **The frequency of rebalancing the portfolio.** How often will you reallocate among certain asset classes, such as stocks, bonds and cash?

14. **Performance evaluation.** Which benchmarks will be used to evaluate the portfolio's performance?
15. **Evaluation frequency.** How frequently will you evaluate performance?

The next chapter compares two very different standards of care among financial advisors.

“

Risk comes from not knowing what you are doing.

Warren Buffet
CEO, Berkshire Hathaway

SECTION 2
FIDUCIARY:
THE "GOLD STANDARD" OF CARE

What is a fiduciary or a fiduciary relationship?

A fiduciary is a person or organization that owes to another the duties of good faith, trust, confidence, and candor.

This special relationship of trust established by law is similar to the relationship one has with an attorney or doctor. When an advisor acts in a fiduciary capacity, that advisor is legally obligated to maintain an allegiance of confidentiality, trust, loyalty, disclosure, obedience and accounting to his or her clients. All NAPFA members must sign and abide by the NAPFA Fiduciary Oath.

Source: NAPFA

Chapters 3, 4, and 5 provide an historical perspective of the landscape prior to Regulation Best lnterest (Reg BI), which took effect in 2019. lt requires somewhat better disclosure on the part of broker-dealers. However, Reg BI fails to require brokers to meet the fiduciary standard, or anything close to it. Although chapters 3, 4, and 5 now serve the purpose of providing an historical perspective, the past and the present are not too far afield. Again, Barbara Roper, Director of lnvestor Protection for the nonprofit Consumer Federation of America stated the following regarding Reg BI: "lnstead of strengthening protections for investors, the new standards place them at greater risk—misled into expecting best interest advice that the rules do not require."

Although Reg BI may not provide better protection for investors, it will however succeed in giving brokerage firms a new catch phrase to use in their advertisements, as they will no doubt attempt to suggest that Reg BI is somehow on par with the fiduciary standard. Do not be fooled. lnsist your advisor sign a fiduciary oath like all NAPFA advisors are required to sign.

Chapter 3: What Standard of Care Applies?

Many, if not most investors believe that all financial services professionals are held to the same standard of client care. Unfortunately, it's not true. Some advisors (and the firms that employ them) have a legal obligation to place the client's interests first at all times. This is known as a **"fiduciary"** legal obligation, or fiduciary duty. Your attorney, as well as your doctors, are examples of "fiduciaries." A trustee would be another example. Other advisors don't—they are actually allowed to place their interests and the interests of their firms ahead of the interests of their clients.

Almost all financial advisors and firms today profess to place their clients' interests first, but only a fraction of them are legally obligated to do so. Fighting through the advertising and vague promises to identify those fiduciary advisors can be a daunting task. It's not as if the other firms take out ads that assert "We sometimes act in your best interests," or "We always place our stockholders' interests first, your interests place a distant second." Ads claiming to put clients first are not necessarily untrue. The question is, how often does the firm really put their clients' interests first? I submit that anything less than *always* is not often enough, because it only takes a momentary lapse of the fiduciary standard to be sold a product rife with conflicts of interest, and high operating expenses needed to cover hefty hidden recurring commissions. What is not widely known is that there are two very different standards of client care required by financial services professionals, depending upon what type of account you maintain:

The Fiduciary Standard, as defined in the Investment Advisers Act of 1940*, which imposes a legal requirement that the financial advisor always act in clients' best interests and fully disclose all sources of compensation, as well as any potential conflicts of interest.

The Suitability Standard, which requires only that recommendations are suitable—not necessarily the best or most cost-effective.

Imagine if there were two different standards of care among doctors. One standard is stringent, requiring that your doctor always act in your best interests. The other standard allows the doctor to benefit from hidden financial incentives that are not aligned with your interests. You would no doubt insist that your doctor be required to meet the higher standard when he is treating you. Shouldn't you do the same when you seek financial advice?

What's the practical impact of the suitability standard? Under the suitability standard, the investment recommendations you receive may be influenced by which financial products pay higher commissions, or by certain revenue-sharing arrangements between the issuers and the firms that sell their products. Also, the law doesn't require that you be given the specific details that may influence your advisor's recommendation. You're operating in the dark.

In 2011, Cerulli Associates released a survey of 7,800 households:

- Thirty-three (33) percent said that they didn't know how they paid for the investment advice that they received.
- Thirty-one (31) percent indicated that they thought their financial advisor or broker provided investment advice for free.
- Sixty-four (64) percent believed that their financial advisor was held to the fiduciary standard. Sixty-three (63) percent of clients of the largest broker-dealers also believed that their financial advisor was acting as a fiduciary.

Other studies reveal that a relatively small percentage of investors understand the term 'fiduciary' or how it may affect them. This situation can make it challenging for a registered investment advisor firm like ClientFirst Wealth Management, a fiduciary, to effectively communicate its value proposition.

In 2010, financial-reform legislation empowered the Securities & Exchange Commission (SEC) to change the law. It directed the SEC to study whether broker-dealers—who employ the majority of financial advisors in the nation—should be required to meet a **fiduciary standard** instead of the **suitability standard** under which they now operate. As of this writing in March 2012, the SEC has not made any changes, so the two standards still exist as they have since the Investment Advisers Act of 1940 was signed into law.

Understandably, Wall Street is opposed to meeting the higher standard of client care. Certain financial products, which have very lucrative fees and hidden sales charges, become much more difficult to recommend when the fiduciary standard is required. The fiduciary standard also raises the bar significantly with respect to potential legal liability.

Moreover, one should pay attention to whether the firm is publicly held. Who wins, when attempting to balance shareholder demands for greater profits and your need for objective, cost-effective advice? If you maintain a brokerage account with such a firm, an account that imposes no fiduciary obligation to act in your best interests, whose interests do you believe will come first, yours or the shareholders?

Barron's published an article that I wrote on this subject in August 2010 entitled "Regulating the Givers of Advice." In the article, I stated:

> *It stands to reason that all financial services professionals offering personalized investment advice should be required to meet the fiduciary standard described in the Investment Advisers Act of 1940. Anything less would continue to shortchange some investors, as recommendations would continue to be influenced by unidentified conflicts of interest.*
>
> *To accept any argument to the contrary is to believe that failing to always act in clients' best interests is an acceptable practice. All medical doctors are required to meet the same standard of care, as are all attorneys. Why not all professionals providing personalized investment advice?*
>
> *At a minimum, all Americans seeking investment advice should be afforded the peace of mind associated with transparent investment recommendations.*

Of course, if a broker or insurance professional isn't providing personalized investment advice—if they are simply engaged in the sale of products—there is no need to impose the fiduciary standard.

Obviously, rules alone are not enough to eliminate abuses. There are numerous examples of investment advisors cheating and stealing from their clients. Broker-dealers with a history of fair dealing and regulatory compliance should applaud the extension of the fiduciary standard. Conversely, those firms with less impressive records may find it more difficult to defend themselves in the future.

Surprisingly, the same financial advisor can treat your account differently, and can be held to a different standard of care depending on what type of account you maintain. This strange state of affairs benefits Wall Street, not its retail customers. At some point, the SEC or another regulatory body might clean up the problem, but until that happens, it's up to each investor to become educated about the alternatives.

It is important to note that the broadest definition of a fiduciary is found in the Investment Advisers Act of 1940. Other definitions may be watered-down and limited in scope. Don't settle for "fiduciary lite." Require that your advisor hold a Series 65 or Series 66 securities license, regardless of any professional designations he may hold. Have your advisor sign the fiduciary oath found in chapter 5.

In the next chapter, I explain how to make sure your account provides you with the greatest possible protection.

**Investment Advisers Act of 1940 is the proper spelling of this legislation.*

Chapter 4: The Type of Account You Maintain Matters

The type of investment account that you maintain will determine the extent to which you receive the protections offered by the fiduciary standard. Your account type also can affect the investment recommendations that you receive. Will your portfolio be comprised of cost-effective, tax-efficient investment vehicles? Or will it include financial products characterized by high annual expenses, surrender charges and unnecessary tax liability? Over time, these factors can make a huge difference in your account balance.

There are two basic account types: the **Brokerage** Account and the **Advisory** Account. What is the difference? Brokerage accounts must only meet the suitability standard, but advisory accounts must meet the fiduciary standard. To repeat from the previous chapter, the suitability standard provides far less protection for investors than does the fiduciary standard.

If you have a brokerage account, your financial advisor is typically compensated by commissions. Sometimes, these commissions are clearly identified, and sometimes they are not. Any advice you receive in your brokerage account is considered to be "incidental to the sale of securities." In other words, your financial advisor is legally considered to only be conducting a transaction at your request, rather than giving you investment advice. This regulatory loophole leaves the advisor's primary allegiance to his employer—not to his client. The brokerage firm has no fiduciary legal obligation to act in your best interests.

With an advisory account, the investor gets much greater transparency. The financial advisor and his firm have a fiduciary legal obligation to you. Typically, you will be charged an advisory fee each quarter (usually based on a percentage of the assets that the advisor is managing for you).

The Investment Advisers Act of 1940 requires that, for advisory accounts, your financial advisor must:

1. Always act in your best interests and in good faith.
2. Fully disclose any conflicts of interest.
3. Fully disclose any compensation from third-parties.

The key questions are: do you wish to receive financial recommendations from a financial advisor and firm that have no fiduciary obligation, and whose recommendations may be influenced by commissions? Or would you rather pay an advisory fee for ongoing financial advice from a person and firm legally obligated to always act in your best interests?

If you chose the latter, you need to open an advisory account. That is where your protection will be greater, and where your advisor is legally obligated to provide you with better disclosure about the costs of the investments you are selecting.

If you want a relationship based upon the disclosures and fiduciary duty of an advisory account, you have two choices. First, if you have a brokerage account, your account can be switched to an advisory account. This might make sense if you like your broker and feel that he understands your needs. The broker would need a Series 65 or Series 66 securities license so he can operate as an investment advisor and fiduciary. Otherwise, you will still be compensating your broker through commissions. Commissions are acceptable if you do not require ongoing personalized investment advice. Just be sure that the commission is clearly identified. If you are purchasing financial products, such as mutual funds and annuities, request an itemized report identifying the investment's annual operating expenses, as well as a comparison to a low-cost alternative, such as a Vanguard index fund or variable annuity. Be advised that this is an unusual request, but don't be deterred. The differences will be quite eye-opening.

Your other alternative is to find another advisor and open an advisory account to utilize an advisor who works under the fiduciary standard. Fortunately, many of these advisors are available. In Chapter 21, I provide a list of questions from material developed by the National Association of Personal Financial Advisors (www.napfa.org) that will help you identify a fiduciary advisor.

Appendix A features an article from *InvestmentNews*—a cautionary tale for those who are not working with a fiduciary.

In the next chapter, I provide more detail about the three primary types of advisor business models, and identify which ones automatically operate under a strict fiduciary obligation to their clients.

“

The big print giveth,
and the small print taketh away.

Tom Alan Waits
American singer, songwriter, musician

Chapter 5: Your Financial Advisor's Business Model Matters

Despite the many job titles and professional designations that exist in the financial advisory profession today, there are three basic business models for financial advisors: a retail broker employed by a brokerage firm, an independent broker, or an independent investment advisor. Although you will find exceptional financial advisors working under each of these business models, the following discussion identifies the strengths and weaknesses of each business model from the client's perspective. Let's compare them.

The Retail Broker

The retail broker is employed by a brokerage firm and is otherwise known as a **stockbroker** or **registered representative**. Retail brokers offer brokerage accounts. As noted in Chapter 4, brokerage accounts provide no fiduciary legal obligation to act in your best interest.

Retail brokers generate income by selling securities such as stocks, bonds, mutual funds, and annuities. The more they sell, the more they earn through commissions. Their employer restricts the securities that they are allowed to offer, and the firm might have "revenue-sharing arrangements" with issuers of various financial products, such as mutual funds and annuities. This means that the firm might have extra incentives to recommend that clients purchase specific financial products. Under this model, the employee's primary allegiance is to their employer, whose interests may often be at odds with yours.

It should be noted that retail brokers also may be licensed as investment advisors. In fact, it's a regulatory requirement if the broker offers advisory accounts. So the same person may be dually-licensed as both a broker *and* an investment advisor. When the broker is acting as an investment advisor and making a recommendation on an advisory account, he has the legal obligation to act in the client's best interest—but only under those circumstances.

If your advisor is dually-licensed as both a broker and as an investment advisor and you have both a brokerage account and an advisory account, he can change hats at-will. One minute, he may be a fiduciary, legally obligated to always act in your best interests, and the next minute, he can sell you a financial product for which he receives a large hidden commission, such as a variable annuity. Your only warning that this transformation occurred might be a short disclosure in your account paperwork to the effect that "Your interests and our interests may not always be the same."

Any advice provided by the retail broker is considered to be "incidental to the sale" of a security or other investment. Yet in reality, people rely on those recommendations quite significantly. And, again, those recommendations may be influenced by commissions or sales contests.

Why should you care how much commission your financial advisor receives? Ultimately, you pay this commission through higher operating expenses, which are charged to finance the commission. There is no free lunch.

In addition to hidden financial incentives, retail brokers might be pressured by management to sell their house brand of mutual funds and other products, including banking services such as checking accounts, credit cards, and mortgage loans. The less revenue the broker generates, the more vulnerable he may be to cave to management's pressure to fatten the bottom line by selling certain products.

Then there's the sales manager who supervises a group of retail brokers. The brokers who "play ball" are the ones more likely to receive the most lucrative accounts. There tends to be a distrust of management among retail brokers. This is one reason why so many of them have become independent brokers

or independent investment advisors. They can join a firm with an independent broker platform, join a registered investment advisor firm (RIA), or open their own RIA. Even a very small RIA can offer just about everything that a large brokerage firm can. The RIA can affiliate with a large firm to handle clearing and custodial needs, such as carrying client accounts. One exception would be the availability of initial public offerings (IPOs). *Question:* How much money have you made on IPOs from your brokerage firm? You get large allocations of the bad deals, and little to none of the good deals, right? Brokers pursuing these independent channels can control their expenses and keep more of the revenue they generate. This is why so many brokers have become independent.

The pressure to produce commission revenue may intensify if the broker has received a bonus for switching brokerage firms. If the value of the broker's assets-under-management has fallen, he will have to generate extra revenue from the assets and clients that remain, or possibly be forced to return part of a signing bonus. There is no requirement that these (and other) rather obvious potential conflicts of interests be disclosed.

If you maintain both a brokerage account and an advisory account with the same firm, you should insist that your financial advisor declare in writing the capacity in which he is acting—advisor or broker—whenever he makes a recommendation that you purchase any financial product or service.

The Independent Broker

The independent broker is somewhat similar to the retail broker. Independent brokers can offer advisory accounts as well as brokerage accounts, provided they are dually-licensed. Unless you maintain an advisory account, the independent broker does not have a fiduciary legal obligation to you.

The term "independent" merely refers to the fact that these individuals are typically self-employed contractors. They do not work directly for the brokerage firm whose name is on their office suite. They pay their own expenses, but they are registered with the brokerage firm and subject to the same product restrictions and some of the same potential conflicts of interest as retail brokers.

Independent brokers do not have sales managers pressuring them to meet sales quotas. Independent brokers are typically former corporate employees of a brokerage firm who may have become frustrated that their employer was taking a large share of the commission revenue that they generated. They may want to be free of office politics and sales managers who may know less than they do, telling them what products to sell and how to serve their clients. They decide to associate with a new brokerage firm, one that caters to independent brokers.

What they gain is the right to keep much more of the gross revenue. A retail broker (a corporate employee who receives a paycheck from the brokerage firm) might receive 40 percent of the revenue he generates. An independent retail broker (a self-employed individual with identical revenue production and who is registered with the same brokerage firm) might keep 80 percent of gross revenue production. In return, the independent broker covers all the expenses that the large firm formerly covered—keeping a great deal more of his gross revenue if he maintains low overhead.

Independents may have more latitude than retail brokers about the amount of commission or markups for some transactions, such as stock or bond transactions.

The Independent Investment Advisor

The independent investment advisor is truly independent in every sense of the word. These advisors maintain their own offices and are either self-employed as a Registered Investment Advisor (RIA) owning their own firms, or employed by an RIA firm. The advisors offer **fee-based advisory accounts**, not brokerage accounts.

Independent investment advisors are typically not dually-licensed as brokers. Independent investment advisors are full-time fiduciaries. Some strictly offer financial advice and financial planning, but others offer investment management as well. Do not confuse an independent investment advisor with a broker, retail or independent, who is dually-licensed.

There are two types of independent investment advisors: **fee-based investment advisors** and **Fee-Only investment advisors**.

Fee-Based Independent Investment Advisors

Independent fee-based investment advisors do not charge commissions for so-called "secondary market" securities transactions, such as buying or selling a share of stock on an exchange as opposed to buying a share of a "new issue" of a particular security. Fee-based advisors are typically compensated by "hard-dollar" fees—fees that are either remitted by the client, or charged to the client's account by the custodian holding the account. Fee-based advisors can accept commissions for selling certain products, such as insurance policies, or can accept placement fees for selling or placing new issues of certain securities. Under this arrangement, certain potential conflicts of interest exist that you need to be aware of. For example: assume that you have an advisory account with your fee-based independent investment advisor, for which you pay an annual advisory fee of 1.0 percent. Now assume that he sells you $100,000 of a new product his company is offering—a structured note, for instance. The product has an embedded commission or placement fee built in amounting to 3.0 percent. If he only offsets one year of advisory fees, a common practice, he stands to receive a windfall of 2.0 percent, or $2,000. He should offset the full amount of the placement fee dollar-for-dollar so that there is no potential conflict, and he should fully disclose the amount of the placement fee or commission.

Fee-based independent investment advisors are required to make full disclosure of all sources of compensation, as set forth in the Investment Advisers Act of 1940. Again, these advisors should offset any commissions or placement fees against the advisory fees they charge on a dollar-for-dollar basis. This will help remove the potential conflicts of interest presented by placement fees for new issues or commissions for the sale of insurance policies.

Independent Fee-Only Investment Advisors

Independent Fee-Only investment advisors are full-time fiduciaries. They are not selling anything, and are not dually-licensed as brokers.

The Fee-Only investment advisor, as the name implies, is compensated strictly by the fees paid by their clients. They may be paid by the hour, the project, or as a percentage of assets-under-management (AUM).

Independent Fee-Only investment advisors receive no commissions, placement fees or any other form of third-party compensation. The most common arrangement is that advisors receive one fee, paid quarterly, as a percentage of AUM. They have the legal obligation to always act in the client's best interest.

My RIA firm—ClientFirst Wealth Management—is Fee-Only. A large part of my practice involves the design and management of fixed-income portfolios. I am always free to pursue the most attractive offerings and to negotiate prices. My independence also provides access to high-quality research from many sources.

It is important to note that Fee-Only investment advisors are not totally free of potential conflicts of interest—nobody is. For example, what if a client's needs are best served by paying off a mortgage? This will mean fewer dollars under management and less revenue for the advisor.

If you wish to work with an independent Fee-Only investment advisor with a local presence, there are thousands of qualified individuals located across the U.S. Go to www.napfa.org (the website of the National Association of Personal Financial Advisors) to find advisors in your area. Membership in NAPFA is comprised solely of Fee-Only investment advisors. For independent Fee-Only investment advisors who are paid by the hour, check out the Garrett Planning Network at www.garrettplanningnetwork.com.

Another source of Fee-Only investment advisors is Vanguard (www.vanguard.com). Vanguard, famous for its low-cost index funds and exchange-traded funds, also offers financial planning and investment management from licensed specialists who are typically compensated by salary.

If you are unsure about your financial advisor's legal obligation to you and want to make sure that he has an uninterrupted, full-time fiduciary legal obligation to act in your best interests, have him sign the following commitment (obtained from NAPFA):

I am a fiduciary regulated by the Investment Advisers Act of 1940. I am legally obligated to act in good faith and in the best interests of my client. I will provide

written disclosure of any conflicts of interests that I or my employer may have, which may compromise my impartiality. Neither I, nor any party in which I have a financial interest, receive any compensation or remuneration contingent upon a client's purchase or sale of a security or other financial product. I do not receive fees or other compensation from another party based upon referring a client or a client's business.

If your advisor can't (or won't) sign it, consider an advisor who will.

The NAPFA website offers the following:

"Start with a general practitioner...a Financial Planner (whose) compensation should be from fees alone."—*Money magazine*

"Members of the National Association of Personal Financial Advisors (NAPFA) are ethically bound to operate on a fiduciary standard, meaning they have promised to do what's in your best interest."—*SmartMoney magazine*

"If you don't have a planner, ask your friends for recommendations. You want a 'Fee-Only' planner, meaning one who earns a living solely by charging fees for advice. Steer away from planners who sell financial products of any sort." —*CBS MarketWatch*

"It's worth your while to check out Fee-Only advisors so you don't have to worry about anyone selling you a product for their personal gain."—*Gerri Willis, Fox Business News (formerly of CNN)*

You can learn a great deal about a registered investment advisor firm (RIA) through the firm's required filings with regulators. Form ADV is available online at www.sec.gov. RIAs are also required to maintain a narrative brochure. Go to www.adviserinfo.sec.gov and look for the investment advisor search page.

In the next section, we begin to look at investing. We will start by exploring the impact of fees (investment fees and advisory fees) on the long-term growth of investments.

NAPFA Fiduciary Oath

The advisor shall exercise his/her best efforts to act in good faith and in the best interests of the client. The advisor shall provide written disclosure to the client prior to the engagement of the advisor, and thereafter throughout the term of the engagement, of any conflicts of interest, which will or reasonably may compromise the impartiality or independence of the advisor.

The advisor, or any party in which the advisor has a financial interest, does not receive any compensation or other remuneration that is contingent on any client's purchase or sale of a financial product. The advisor does not receive a fee or other compensation from another party based on the referral of a client or the client's business.

Following the NAPFA Fiduciary Oath means I shall:

- Always act in good faith and with candor
- Be proactive in disclosing any conflicts of interest that may impact a client
- Not accept any referral fees or compensation contingent upon the purchase or sale of a financial product

Source: NAPFA

SECTION 3
FEES MATTER:

Too often, what makes big bucks for Wall Street makes little sense for investors.

“

The miracle of compounding returns has been overwhelmed by the tyranny of compounding costs.

John C. Bogle
Founder, Vanguard Group of Investment Companies

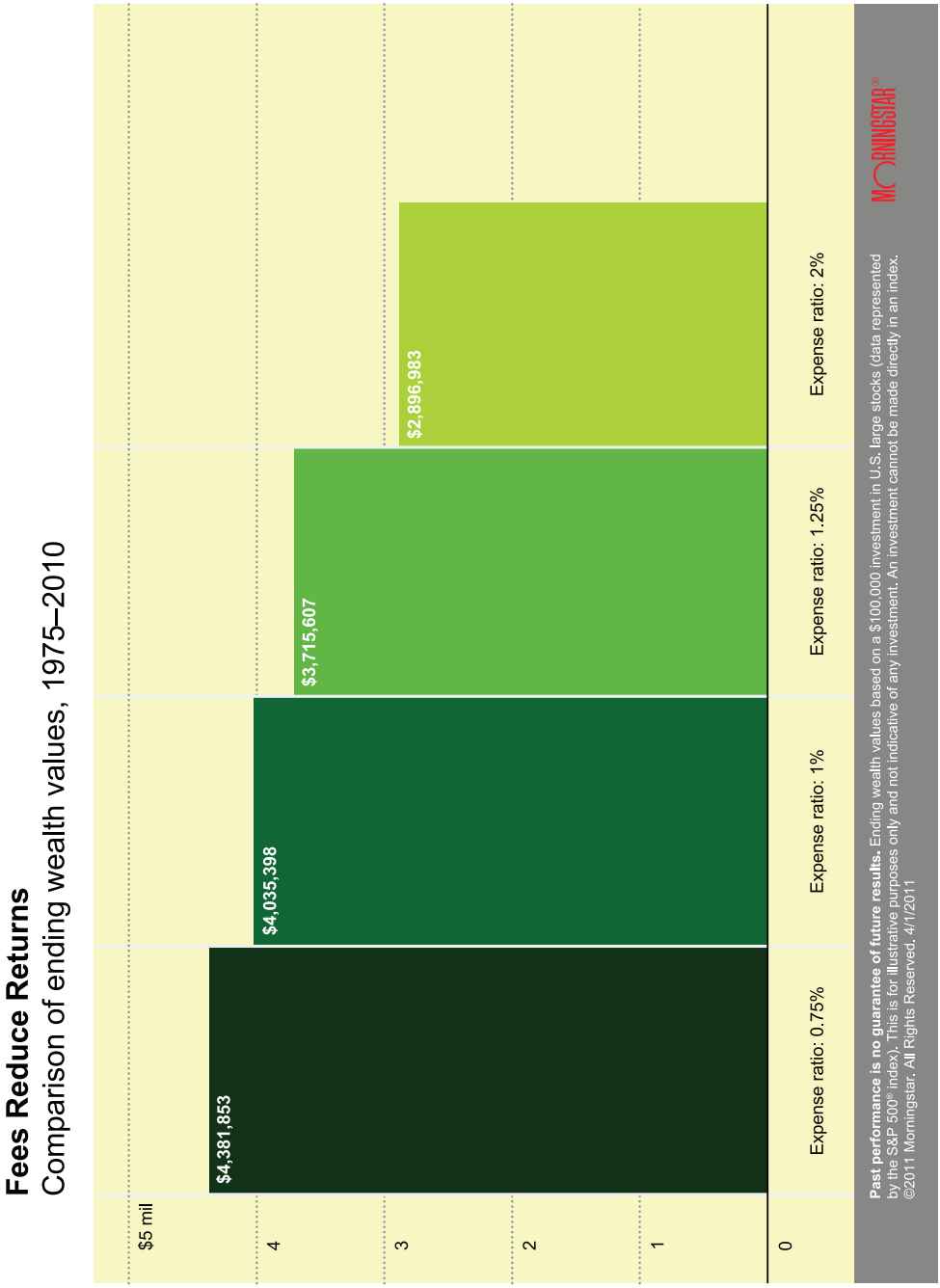
Chapter 6: Fees Matter

How long will it take for your money to double? The "Rule of 72" provides the answer: simply divide 72 by your compounded annual rate of return. For example, if your investment return is 10 percent, it will take 7.2 years to double your money: 72/10. With an 8.0 percent return, it takes 9 years to double your money: 72/8 = 9.

Let's examine the impact of fees on your returns. It is not uncommon for annual fees to exceed 2.0 percent for many financial products—variable annuities, mutual funds, and separately-managed accounts, for instance. Many products collect fees directly from the fund's assets, so shareholders never see an invoice (Wall Street's true genius) for charges such as management fees, administrative fees, and ongoing asset-based commissions known as 12(b)-1 fees. A 2.0 percent expense ratio (annual expenses/total assets) is a huge burden to overcome. Consider the illustration on the following page. A picture is worth a thousand words.

In *The Random Walk Guide to Investing* by Burton G. Malkiel, published by W.W. Norton & Sons, Inc., the author asks whether you would still do business with your financial advisor if he asserted that when you retire, his fee would amount to half your account value? This may sound absurd, but this is exactly what happens (over time) when your investment expenses are high.

Many of Wall Street's fees are collected silently, directly from fund assets. This is why you've never received an invoice for portfolio management or


Fees Reduce Returns
Comparison of ending wealth values, 1975–2010
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3
2
1
0
$4,381,853
$4,035,398
$3,715,607
$2,896,983
Expense ratio: 0.75%
Expense ratio: 1%
Expense ratio: 1.25%
Expense ratio: 2%
Past performance is no guarantee of future results. Ending wealth values based on a $100,000 investment in U.S. large stocks (data represented by the S&P 500® index). This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.
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ongoing asset-based commissions for mutual funds, variable annuities and other financial products.

Wall Street does not want you to focus on expenses. You might demand more cost-effective investments—or a new financial advisor. The products with the highest management fees and the highest hidden commissions are the ones with the highest annual expenses.

The Financial Industry Regulatory Authority (FINRA) provides a cost calculator for mutual funds. The calculator clearly identifies the cost of ownership for thousands of mutual funds. It allows you to enter the amount of your investment in the various funds so that you receive a cost estimate tailored to your particular investment, as opposed to a generic example of a $10,000 investment, for instance. You can see the actual dollar amount of sales charges, such as front-end sales charges as well as all ongoing hidden sales charges for your particular investments. Visit http://apps.finra.org/fundanalyzer/1/fa.aspx. NerdWallet is also a good resource to learn about investment fees.

In the next chapter, we will look at fees that advisors charge.

“

Everyone gets the experience,
some get the lesson.

T.S. Elliot

Poet, essayist, publisher, playwright

Chapter 7: Your Advisor's Fee How Much Should You Pay?

Paying advisory fees directly to an independent advisor (fee-based or Fee-Only) is not always less costly than alternatives offered through a brokerage account; however, it does mean that the financial advisor has a legal obligation to always act in your best interests—and that certainly adds value.

Advisory fees vary widely depending upon many variables, such as the type of work being performed and the value of assets-under-management. So, how much should you pay a financial advisor?

It depends upon whether the advisor truly is adding value. In my practice, I add value by providing customized portfolios of stocks and bonds featuring individual bonds as opposed to bond funds. This is a labor-intensive, yet cost-effective approach that provides benefits—such as giving my clients ownership in individual bonds with stated final maturities, rather than ownership of bond funds. (Also, bond funds are more costly to purchase because they come with management fees and imbedded ongoing commissions that well exceed my fees).

Individual bonds give clients greater control over their unique financial plans. For example, clients with a tax-free appetite benefit from customized portfolios of tax-free bonds, issued in the client's state of residence, which avoids both state and federal income tax. This just makes good sense, but it can be difficult to achieve this with packaged financial products such as bond funds, or even exchange-traded funds (ETFs).

As a general rule, advisory fees for comprehensive wealth management (financial planning, planning updates, ongoing advice, asset allocation, rebalancing and investment management of a balanced portfolio comprised of stocks and bonds) should not exceed 1.0 percent for balances of up to $1,000,000. Advisory fees should fall as the value of the assets-under-management rises. For instance, a $2,000,000 account might expect to pay no more than 0.85 percent for comprehensive wealth management. An account comprised solely of fixed-income securities (bonds) should pay even less.

If your financial advisor is compensated by commissions, things get more complicated. Commissions on products such as mutual funds and annuities are not negotiable; they are embedded sales charges. A typical ongoing sales charge would amount to 1.0 percent of your investment's value annually. Products with embedded sales charges have other expenses, such as management expenses, and these can cause annual operating expenses to be quite high. How high? For mutual funds, as much as ten times higher than the annual operating expenses of an index fund (2.0 percent versus 0.20 percent)—even higher for variable annuities.

This is why it can make sense to replace your brokerage account with an advisory account. You can pay your financial advisor an advisory fee that the two of you negotiate, and you can insist on language in your advisory agreement stipulating that any placement fees or other source of revenue be fully disclosed in writing and credited against the advisory fees dollar-for-dollar.

Insist that your advisor provide a detailed written account of all the annual fees you incur, expressed in dollars as well as percentages.

Each position in your account should be itemized on a spreadsheet with the corresponding annual expense. Any commissions, front-end loads, back-end loads or level loads, such as 12b-1 fees should be itemized as well so you can clearly see how much of the fees you are being charged—hidden and otherwise—are paid to your advisor.

This may prove to be quite eye-opening.

One major area of fees deserves special attention: 12(b)-1 fees that are embedded in many mutual funds, variable annuities and other products. They are discussed in the next chapter.

“

Rule #1: Never lose money.
Rule #2: Never forget rule #1.

Warren Buffet
CEO, Berkshire Hathaway

Chapter 8: Hidden Ongoing Commissions

When I was growing up, I spent summers working on the family farm, which grew cotton, soybeans and rice. There were many snakes in the rice fields. I learned quickly that the snake you can see is not the one that bites you. It is the same way with hidden commissions, also known as 12(b)-1 fees. If you own a mutual fund or variable annuity, you are most likely paying a 12(b)-1 fee, whether you realize it or not. A 12(b)-1 fee is an ongoing commission often amounting to 1.0 percent of the value of your investment annually.

Named after the 1980 legislation that created them, 12(b)-1 fees were intended as one-year relief for struggling mutual funds. Today, over 70 percent of mutual funds and many variable annuities charge these onerous fees, which cost investors well over $10 billion each year. They are collected by the mutual fund directly from fund assets, and paid to the brokerage firm that holds the fund. Also known as trailing commissions or "trails," these fees can be charged for many years for mutual funds, variable annuities, or other products that impose them.

Most mutual funds charge 12(b)-1 fees, including funds found in retirement plan investment menus, but the information is well-hidden. Unless you dig through the investment prospectus, you will not know how much you are losing to these fees each year. The fees are not identified on invoices. You can only find them by carefully looking at all the costs the mutual fund is applying to your investments.

Unlike advisory fees, which can be negotiated lower, 12(b)-1 fees are set by the mutual fund, and that is what you will pay if you own that fund.

Some mutual funds are referred to as "no-loads." The implication is that they do not have sales charges. But no-load often just means that the fund does not charge a front-end load. These funds most certainly impose sales loads in the form of 12(b)-1 fees. Often, the 12(b)-1 fees are higher for so-called no-load funds in order to make up for the lack of a commission on the front end. A true no-load fund should not charge a 12(b)-1 fee.

To get a true understanding of the ongoing commissions you are paying for your investments, request that your advisor provide a written statement itemizing all the 12(b)-1 fees that your account(s) have generated over the past 12 months.

Although 12(b)-1 fees have been the subject of scrutiny by the Securities and Exchange Commission (SEC), little has been done so far to improve the situation for investors. In 2011, additional disclosures about these fees were mandated, but it's unlikely that most investors will know where to find the information, nor understand its impact.

In 1998, I obtained a no-action letter from the National Association of Securities Dealers (NASD)—currently the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization (SRO) for the securities industry. Specifically, I asked whether rebating 12(b)-1 fees to individuals by a broker dealer would be allowed (at this point in time, 12(b)-1 fees had never been rebated to an individual investor). The NASD reply indicated that it would take "no action" to prohibit this activity. Later, I obtained a similar no-action letter from the SEC. My intent was to provide individual investors the opportunity to recover some of the 12(b)-1 fees they were paying, since 12(b)-1 fees are not negotiable. Shortly after this "no-action letter" became available to the public, E*Trade started rebating 12(b)-1 fees. I do not know whether this opportunity still exists, or if my letter influenced them in any way.

12(b)-1 fees can be rebated, but as a practical matter, your broker will not rebate them because they are such a lucrative source of recurring revenue.

12(b)-1 fees destroy wealth silently. Each year, investors pay over $10 billion in 12(b)-1 fees, whether they realize it or not.

When mutual funds, annuities, or other investments charge high fees or commissions, their promoters may claim that they are delivering superior investment performance in exchange for those fees. In the next section of the book, I will discuss research that counters those arguments.

In 2019, the SEC announced a $125 million settlement with 79 firms that failed to disclose to clients they received 12(b) fees for recommending certain funds. The SEC found the firms promoted the high-fee share classes when less-expensive share classes were available in the same fund.

In an SEC initiative launched in 2018, the firms were allowed to self-report and avoid fines.

“

Know what you own
and why you own it.

Peter Lynch
Manager of the Magellan Fund
at Fidelity Investments,
between 1977-1990

SECTION 4: KNOW THYSELF

“

Time is your friend.
Impulse is your enemy.

John C. Bogle
Founder, Vanguard Group
of Investment Companies

Chapter 9: Know Thyself

One of the most important things that any investor can do is identify their risk tolerance. You should understand how recent market activity may influence the way you feel toward the market, and consequently, your risk tolerance at any given time.

I have followed Jason Zweig for many years and have always found him to be a voice of reason. *Your Money and Your Brain* by Jason Zweig, Simon & Shuster, should be required reading for all investors. The following article appeared in the *Wall Street Journal* in February 2012. If you do not read Jason's book, at least read this article.

The Intelligent Investor: This Is Your Brain on a Hot Streak by Jason Zweig

Past returns are no guarantee of future success. Just like smokers ignoring the Surgeon General's warning on the side of cigarette packs, investors overlook the most obvious caution about the stock market at their peril.

Even after Friday's stumble over renewed fears about Europe, the Standard & Poor's 500-stock index has gained 7% so far this year, and the Russell 2000 small-stock index is up 11%.

Why is it so hard for investors to regard such short-term hot streaks with the cold eye they deserve?

Decision Research, a nonprofit think tank in Eugene, Ore., has conducted a nationwide online survey of investors seven times since 2008. These surveys have shown that investors' forecasts of future returns go up after the market has risen and down after it has fallen.

William Burns, an analyst at Decision Research, says investors' forecasts of the market's return over the coming year were heavily swayed by how stocks performed in the previous month.

They might not have had a choice. The investing mind comes with built-in machinery that sizes up the future based on a surprisingly short sample of the past. Neuroscientists say the human brain probably evolved this response in a simple environment in which the cues to basic payoffs like food and shelter changed slowly and rarely, making the latest signals most valuable —nothing like what today's investors face with electronic markets in a constant state of flux. Experiments led by neuroscientist Paul Glimcher of New York University found that cells deep in the brain calculate a sort of moving average of past events, giving the greatest weight to the most recent outcomes.

When the latest rewards turn out to be better than the long-term pattern, these neurons fire unusually quickly, spreading a burst of dopamine—the neurotransmitter that triggers the pursuit of reward—throughout the brain. Thus, after a decade of mostly dismal stock returns, even a month or two of outperformance might prompt you into an impulsive plunge back toward stocks. Some investors seem to have learned how to resist this tendency, and you should, too.

Charles Manski, an economist at Northwestern University, has analyzed how people form expectations of what the stock market will do next. Based on nationwide surveys of households conducted from 1999 through 2004, he has identified three main types of amateur forecasters.

Just over 40%—the largest group—believe recent performance is likely to persist. Another third of investors think recent returns are likely to reverse. Finally, roughly one-quarter of people think returns are random and essentially unpredictable.

But each of these attitudes carries a distinctive kind of risk.

Investors who believe returns are unpredictable should, in the long run, capture the general rise in stock values that patient investors have generally received in the past. But, in the short run, they won't sidestep a big drop in the market.

Investors who believe recent returns are ripe for a reversal can sell too soon in a bull market and buy before a bear market hits bottom. Those who think recent returns will persist are especially prone to error. If you think a hot market is likely to get hotter, you will have no qualms about buying high; if you believe a bad market is bound to get even worse, you will end up selling low.

Here are a couple of steps you can take to minimize your odds of ramping up your exposure to stocks as their prices rise.

First, think back to the last time you felt certain you knew where the market was headed. Were you sure, at the beginning of 2011, that interest rates had to start rising soon? Were you convinced, in March 2009, that stocks were bound to keep dropping? The mere act of pausing to ask yourself how reliable your intuitions are might be enough to make you recognize that you need better justifications before you take action.

Then force yourself to come up with several solid reasons why the U.S. stock market is undervalued enough to justify suddenly increasing your exposure to it. And no cheating: You can't use "because it's been going up lately" as one of your reasons. While you are at it, think of a few factors that might make stocks stop going up.

Write down your reasons, so you can look back later and review your logic. The best way to learn from your forecasts—right or wrong—is to track them over time.

None of this means you shouldn't own stocks. It simply means you shouldn't rush into buying more just because the market has had a flashy rise. Decisions made in haste usually turn out to be mistakes—and big decisions made in haste almost always turn out to be big mistakes.

Stock market volatility is a significant retirement concern. Volatility may cause some investors to allow emotion to affect their decision-making, resulting in losses that are difficult to make up, especially in retirement or nearing retirement. For example:

- *A 20 percent loss requires a 25 percent gain to recover*
- *A 30 percent loss requires a 43 percent gain to recover*
- *A 50 percent loss requires a 100 percent gain to recover*

Chapter 10: Active Management vs. Passive Management

If a financial advisor's value proposition is founded on their (or their firm's) ability to consistently pick winning stocks, mutual funds or investment managers, or to time the market swings, it is highly unlikely that they will agree with what you will learn in this chapter. However, facts are facts.

Active management: Attempting to **beat** the risk-based returns of the broad market or a particular asset class, either through individual security selection or market timing. Any mutual fund, annuity, or separate account manager attempting to beat the market subscribes to active management. The term "active" does not necessarily mean that the manager is executing frequent buys and sells, although this is often the case.

Passive management: Attempting to **match** the risk-based returns of the broad market or a particular asset class by broad ownership of many or all stocks in the broad market or asset class. An example of a security relying upon passive management would be a no-load S&P 500 index fund.

The term "risk-based" return speaks to how much risk was assumed in pursuit of the returns achieved. A common measure of risk in financial instruments is the **standard deviation**—a statistical measurement depicting the degree to which numbers in a series vary from the series average. Think of standard deviation as a measure of volatility. Although not a measure of risk per se, it is often referred to as such.

Assume that a mutual fund benchmarks to the S&P 500 index, which has a standard deviation of 10 and an annual return of 10 percent for the last 10 years. A fund with a 10 percent, 10-year return, and a standard deviation of 11, exposed shareholders to 10 percent more risk to achieve the same return as the index. Therefore, the fund experienced a lower risk-based return.

Focusing on volatility as the standard measure of risk when comparing the performance of various investments may seem a bit odd. Most people are more concerned with losing money than they are with how much the price of their investment fluctuates, especially if they are long-term investors; however, volatility is the standard metric, and "standard deviation" is the term you need to remember when identifying risk-based returns. By the way, just because a stock or asset class is considered to be more risky does not necessarily mean that it may ultimately provide a higher return.

If someone says that the ABC fund had a 10 percent return over the past five years, several questions should come to mind immediately:

- *Which index does the ABC fund use as a performance benchmark?*
- *What was the return for the benchmark index over the same period?*
- *What was the standard deviation of the ABC fund over the five-year period?*
- *What was the standard deviation of the index over the five-year period?*

You should be able to find this information on the mutual fund's website. Be sure the comparison is made after all fees and taxes are considered.

A great and long-running debate among money managers is whether active management is superior to passive management. Active managers have much higher expenses than passive managers, higher trading costs, higher overhead and higher taxes to contend with. It is nearly impossible for the majority of managers to overcome those costs—sort of like a racehorse overcoming the burden of a significantly overweight jockey.

For equities, I rely upon investment vehicles that employ passive management, such as no-load index funds, exchange-traded funds (ETFs), and true no-load mutual funds offered by Dimensional Fund Advisors (DFA). The

DFA funds are only available to individual investors through a Fee-Only investment advisor, and the DFA managers rely on a passive approach.

Certain few talented investment managers managing securities in a particular asset class may be able to beat the market for a while. If they possess an edge—superior knowledge or some other advantage, or are dealing with very inefficient securities as opposed to mainstream securities—maybe a few of them will consistently beat the market for a significant period of time.

For instance, the distressed-debt markets (that is, bank loans or bonds issued by companies or countries that are now in financial duress) require tremendous skill to navigate. It can be hard to get good information, and it's harder still to predict which of those distressed debt issuers will actually be able to make good on their obligations. The more readily that information is available about a security, the lower the odds of your gaining an edge over other investors. What everybody knows is not worth knowing. For example, think of how difficult it is to get any edge when investing in blue chips stocks.

We call markets like distressed debt "less efficient." These markets provide greater opportunity for a manager to outperform. But this does not mean that a specific manager will actually outperform, just that the conditions are more favorable.

The questions you should ask yourself are:

- Can you or your financial advisor select which manager will outperform in the future?
- Will you be able to get onboard before the period of out performance has run its course?
- What criteria will you use to select that investment manager?
- What if you are wrong? What is your exit strategy?
- What is the added expense of employing active managers?

In my opinion, for most investors, the high probability of potentially significant under performance is not worth the low probability of finding the proverbial needle in the haystack. Many allegedly active fund managers are simply "index-huggers." They buy substantially the same stocks as their

chosen benchmark index—the index by which they grade their performance. They slightly overweight or underweight a particular sector, such as healthcare stocks, but think about it—this approach is very close to simply buying an S&P 500 index fund, yet the investor is paying annual expenses of perhaps 2.0 percent for "active" management, rather than a fee of 0.20 percent for an index fund or exchange-traded fund.

It has been said that mutual funds (and annuities) are sold, not purchased. I submit that most investors would avoid actively-managed funds if they understood that their odds of success are so low.

The Random Walk Guide to Investing by Burton G. Malkiel, published by W.W. Norton & Sons, Inc., explains that whenever large numbers of individuals are participating in an activity, there will always be a small number of individuals with exceptional performance. He offers an example of 1,000 individuals in a coin-flipping contest tasked with flipping heads as many times in a row as possible. Since coin-flipping is a 50/50 proposition, one-half of the flippers are eliminated with each toss, i.e., after the first toss, only 500 are left to toss again. After the second toss, only 250 remain and so on until—on the seventh toss—only eight contestants will have flipped heads each time. These are the "experts"—the ones that will be heralded by the media as the best in their field.

Now instead of coin-flippers, let's imagine that we are discussing the field of active money managers. No large number of individuals—regardless of the endeavor—can escape the laws of probability, including investment managers. There will always be a few exceptional individuals. Unfortunately, nobody knows in advance who they will be. This is the trouble with stock-picking and manager selection...the odds are against you.

Should You Ever Try to Beat the Market?

If you want to be more aggressive, you could deploy a small portion of your investments in active management in an attempt to enhance performance. Maybe you will be able to pick the next outperforming mutual fund or investment manager. Or maybe you can successfully pick individual stocks that outperform, just be aware that becoming a passive investor in low-cost index funds or ETFs is a steadier path to success.

What about Bill Miller of Legg Mason? A November 19, 2011 *Wall Street Journal* article by Jason Zweig, *Value Lesson: The Long Climb and Steep Descent of a Stock Picker*, describes the rise and fall of Bill Miller. His hot streak of beating the S&P 500 for 15 consecutive years abruptly ended in 2006. The article also states that "According to Morningstar, only 26 actively-managed mutual funds have beaten the market index each year over any given 10-year period since 1990."

What about the FairHolme Fund's Bruce Berkowitz, named domestic stock manager of the decade in 2010 by Morningstar? According to *InvestmentNews*, he under performed approximately 99% of his peers in 2011.

What about Warren Buffett? Mr. Buffett is exceptional—a statistical outlier. Mr. Buffett is also an exceptional businessman, and it might be that his guidance to company management as well as his representation on company boards correlates to the phenomenal success of many of his stock picks.

Active managers are less diversified than their chosen benchmark index. This stands to reason. They could not beat the index without differing from the index, or outguessing the market's broad swings.

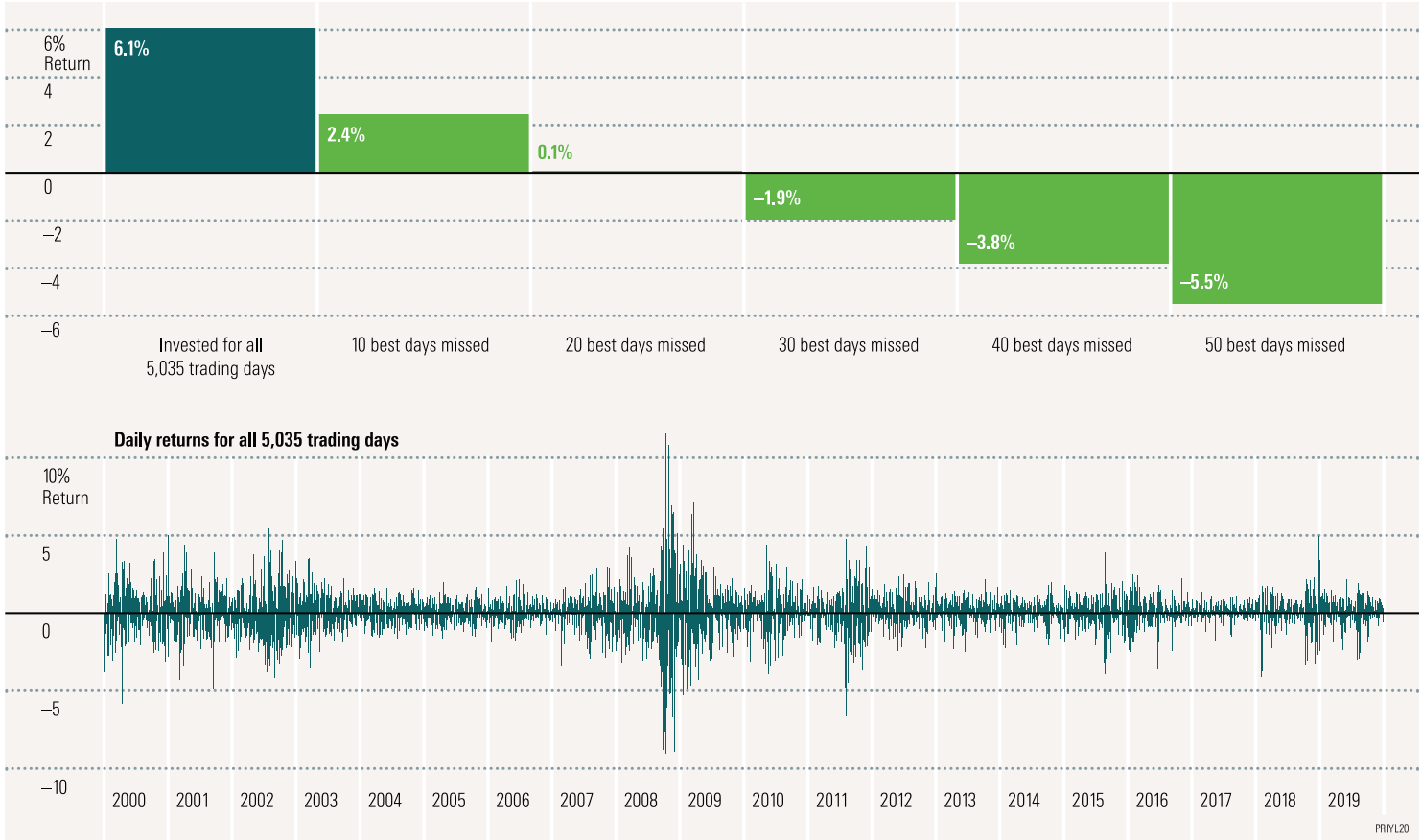
Also, when investors seek active managers, they tend to hurt their odds of success even further by chasing performance. Egged on by the financial media and eager salespersons, investors purchase yesterday's winners. They typically invest after the great performance is over in hope that it will continue, but it seldom does.

Market-timing is not a reliable investment strategy, either. The following illustration shows that if you stayed fully invested for the entire 5,043 days, your return would be 9.10 percent. However, if you missed the 10 best days by attempting to time the market, your return would fall to just 5.40 percent *(see illustration on the next page).*

Vanguard founder, Jack Bogle said it best: "Don't look for the needle in the haystack, just buy the haystack."

The Cost of Market-Timing

The Risk of Missing the Best Days in the Market, 2000–2019



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. •

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Again, mutual fund companies are required by law to include a statement in their marketing material to the effect that "past performance is not indicative of future performance." This fact does nothing to hinder the Wall Street marketing machine. As a marketing tactic, hyping past performance works, no matter what disclaimer is required.

So what should an investor do? Matching the market's performance is much easier than beating it. Utilizing investment vehicles such as cost-effective, tax-efficient index funds makes sense. Costs are one of the few things investors can control.

Conversely, many mutual funds fail to beat their own chosen benchmark index. The chance of any investor—professional or novice—consistently beating the market is very low. Which funds will outperform next year, or the year after? Nobody knows, not even the fund managers. So how is your financial advisor supposed to know? And if he does not know, what is his stock-picking or fund-picking or manager-picking advice really worth?

It's All About Cost Control

When it comes to investments, you *cannot* control:

- **Picking winning stocks consistently**
- **Picking winning managers consistently**
- **Timing the markets**

Actively-managed funds leave you stuck with factors you can't control. Less-costly index funds at least leave you in control of costs and not vulnerable to poor stock-picking.

Neither performance-chasing nor hope is much of an investment strategy. The illustration on the following page depicts the difference between the fund total return between 2001-2010, which amounted to 6.94 percent, and the average investor's return over the same period—minus 20.24 percent! Chasing after hot sectors or hot funds left investors holding the bag when these funds ran out of steam. Passive management through index funds (or "indexing") is the preferred strategy of the successful Thrift Savings Plan for federal employees, as well as the retirement plans of many states. See www.tsp.gov.

Hot-Hand Fallacy

Definition

- Perceiving trends where none exist and consequently taking action on this faulty observation

Implications

- Investors desire to invest in last year's winners
  - Favoring a "hot" money manager or asset class
- Skill is inferred from a random pattern of chance
- Can lead to erroneous assumptions and predictions

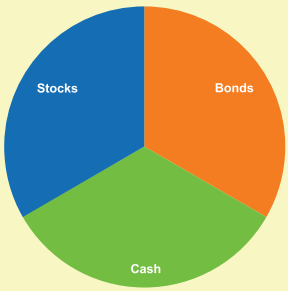
Using passive, low-cost investments is crucial, but there's more to the equation. You need to determine your asset allocation. That's the subject of the next chapter.

Chapter 11: The Importance of Proper Asset Allocation

The way in which you allocate your assets among asset classes, such as stocks, bonds, and cash will have the greatest impact on your investment results. Studies show that up to 88 percent of the variation in returns is explained by one's asset allocation, not by individual security selection, fund selection or market timing.

What is Asset Allocation?

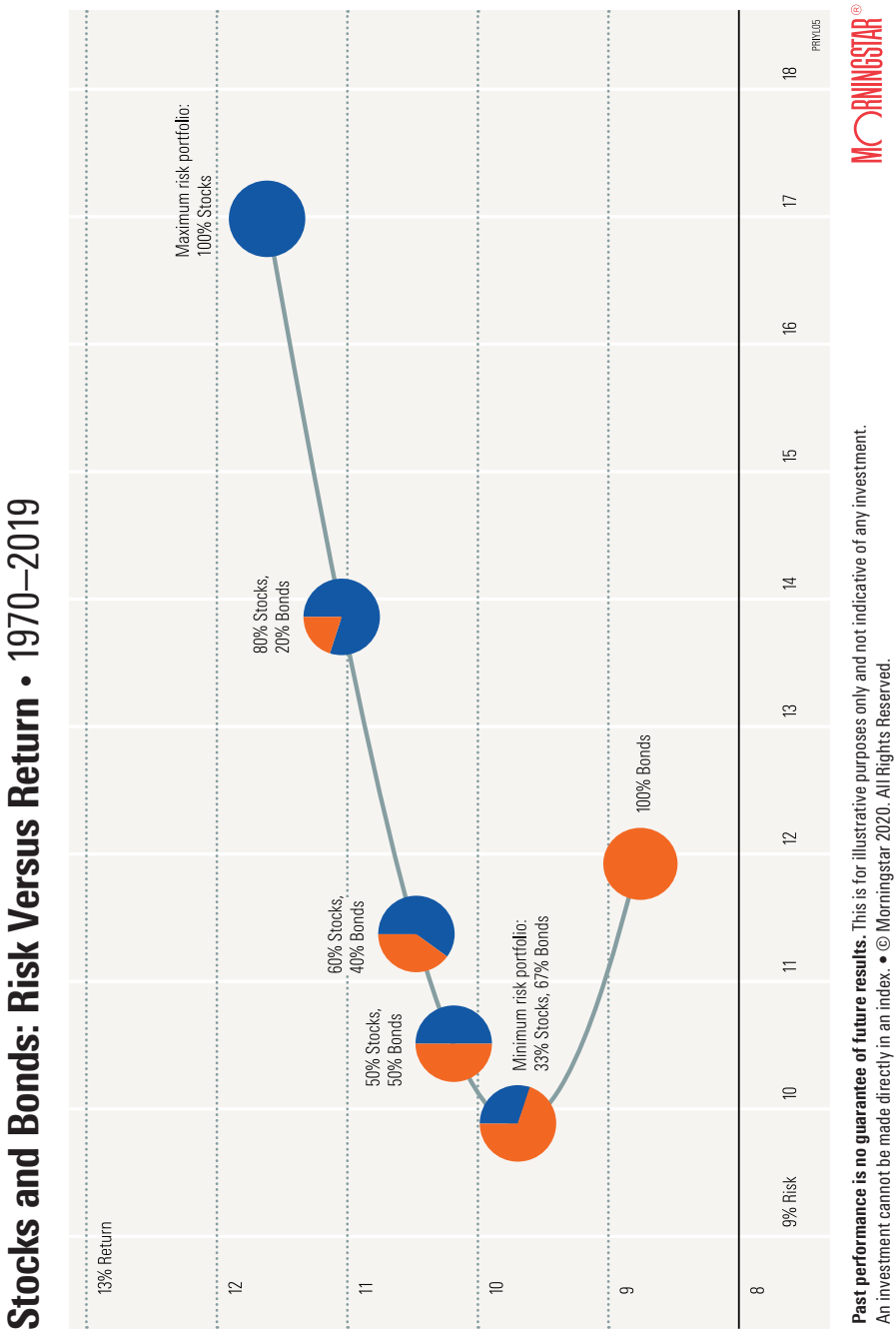
Asset allocation is the process of combining asset classes such as stocks, bonds, and cash in a portfolio in order to meet your goals.



A financial advisor, whether a retail broker or independent investment advisor, can add value by helping you make the important decision about how to allocate your investment assets. Essentially, asset allocation is the concept of proper diversification—not putting too many eggs in too few baskets, and of seeking the most efficient balance of the perceived risk and expected return.

Take stock of your mood when you determine your asset allocation. If the stock market has been rallying, you may be tempted to over-allocate to stocks. Also, be advised that fees are higher for managing stocks, as opposed to bonds. This creates an incentive for your advisor to recommend greater exposure to stocks.

Asset allocation is a deliberate strategy that is designed to minimize the correlation between asset classes, such as stocks and bonds. This should help reduce your portfolio's volatility, and help keep you invested during trying market conditions— the key to investment success over the long haul. Consider the following illustration depicting the impact to risk and return brought about by various allocation mixtures.



Proper asset allocation is critical to keep pace with inflation. The illustration on the following page offers some historical perspective of stocks, bonds and inflation—the relentless and invisible thief of purchasing power.

Ibbotson® SBBI®
Summary Statistics 1926–2019

	Compound annual return	Arithmetic annual return	Risk (standard deviation)	Return distribution
Large stocks	10.2%	12.1%	18.6%	
Small stocks*	11.9%	16.3%	28.1%	
Government bonds	5.5%	6.0%	8.5%	
Treasury bills	3.3%	3.4%	0.9%	
Inflation	2.9%	3.0%	0.02%	

–90 ← 0 → 90

A085

Past performance is no guarantee of future results. *The 1933 small-company stock total return was 142.9%. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. •

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Asset allocation is an analytical endeavor that your advisor should be trained to do. He should have advanced computer software to help consider several allocations, and should create projections of how those allocations might work in the future. That is your advisor's job. Most financial services firms offer asset allocation software on their respective websites.

Asset allocation starts with you. You have a responsibility to clearly communicate your objectives and your risk tolerance to your advisor, because they form the baseline for his analysis.

Determining your risk tolerance is critical. When you meet with your financial advisor, or when you complete the risk tolerance section of a questionnaire, take stock of your mood. Are you in a good mood? Has the market been rallying lately? These things can make a difference in how you identify your risk tolerance at any given time. For instance, when the market is in the midst of a significant sell-off, you will probably state that your risk tolerance is lower because you are watching what can happen when the market falls. Without an accurate read on your true risk tolerance, arriving at the best asset allocation targets may be difficult. The target allocations may be too aggressive, or not aggressive enough. Garbage in, garbage out.

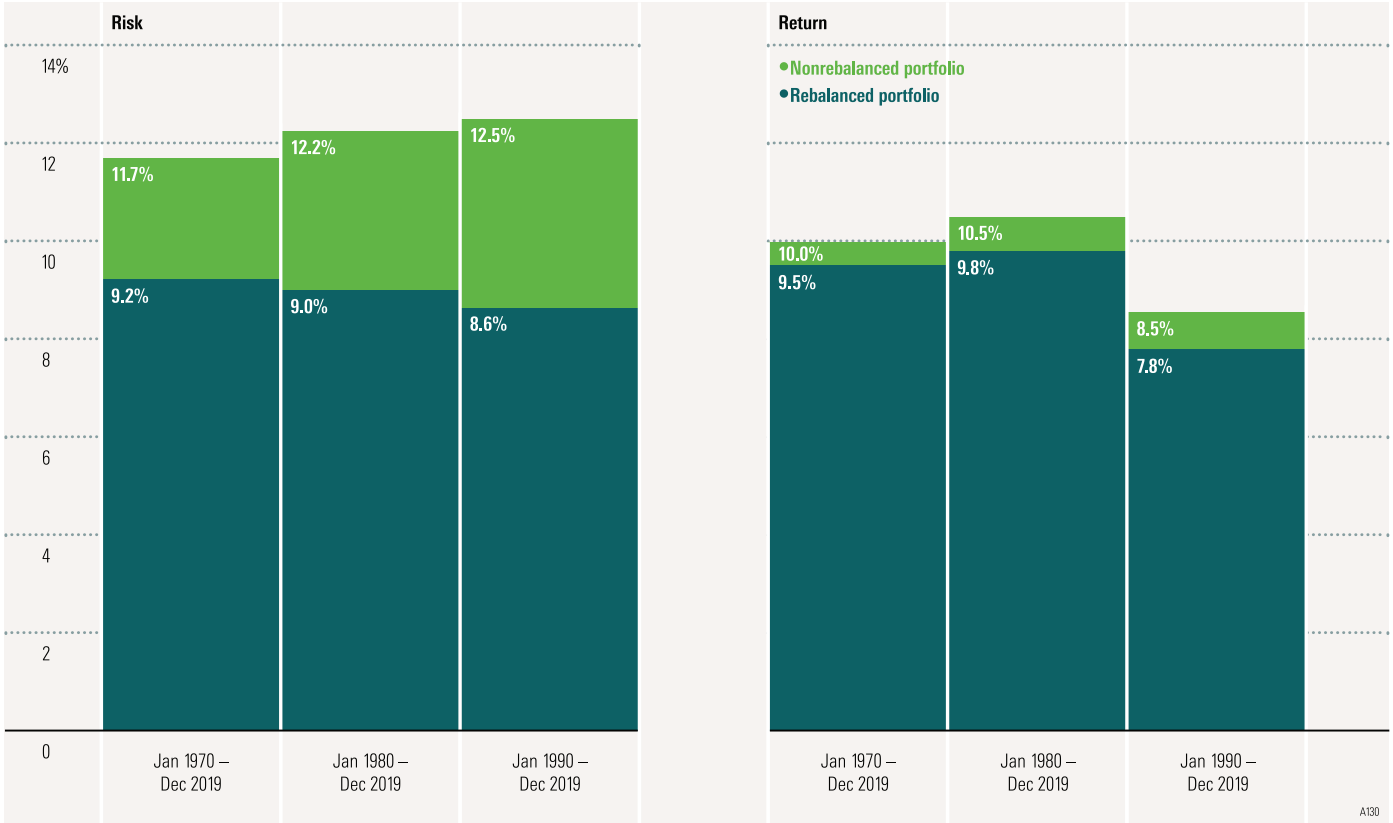
Your advisor should also take other factors about your financial situation into account when developing the asset allocation. These include your income, savings and spending patterns, financial goals, insurance coverage (life, disability, long-term care, and property). These factors will affect an advisor's assessment of both your emotional ability to tolerate investment losses and your actual financial ability to tolerate them.

Once the desired asset allocation is determined, your advisor should create a portfolio with that allocation and rebalance the assets to maintain your allocation target. Whether rebalancing is done quarterly, annually, or whenever one asset class is above or below the desired level by a certain percentage is not as important as the act of rebalancing. Target allocations should be reviewed periodically.

Actual rebalancing is fairly simple mathematics. Let's assume that your target portfolio allocation is 45 percent stocks, 45 percent bonds, and 10 percent cash. Now, let's assume that your stocks fall in value to 40 percent of your portfolio, while your bonds rise to 50 percent. It's time to rebalance. You (or your advisor) would sell 5 percent of the bonds and buy an additional 5 percent of stocks. You are redeploying assets to the asset class that has experienced price weakness. Consider the following illustration comparing portfolios that were rebalanced, versus those that were not.

Managing Risk With Portfolio Rebalancing

The Risk and Return of Rebalanced versus Nonrebalanced Portfolios



Past performance is no guarantee of future results. Risk and return are measured by monthly annualized standard deviation and compound annual return, respectively. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. •

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I liken rebalancing to a pilot keeping the wings of the airplane level.

Whenever rebalancing is needed, be sure that your financial advisor is being tax-wise about harvesting your capital gains. To the extent possible, capital gains should be offset by losses where appropriate to reduce capital gains tax liability.

It's also important to be balanced within each asset class. Stocks can be divided into several categories, such as value stocks, growth stocks, international stocks, small-company stocks (small-cap), medium-sized company stocks (mid-cap), and large-company stocks (large cap). "Cap" is short for market capitalization. A company's market capitalization can be determined by multiplying the number of shares outstanding by the current price of the stock.

Bonds can be divided into various categories as well, such as investment-grade corporate bonds, high-yield (junk) corporate bonds, U.S. government bonds, tax-free municipal bonds, etc.

Modern Portfolio Theory and True Diversification

Diversification among asset classes will determine the amount of overall portfolio volatility you experience. This is why it is so important to have a mixture of asset classes that do not tend to all trade in the same direction at the same time. In other words, you should seek a blend of asset classes that are not highly correlated to each other, or that are negatively correlated.

In 1952, Dr. Harry Markowitz developed a theory around this concept. In 1990, he won a Nobel Prize for developing what is known as Modern Portfolio Theory, reducing overall portfolio risk by blending certain asset classes.

Diversification is not perfect, but being less diversified is certainly not the answer. In a financial panic—like the one in 2008—investors place a premium on liquidity. This can pressure a great many asset classes at once, so that their correlation is high for a period of time. When the panic subsides, more normal correlations return.

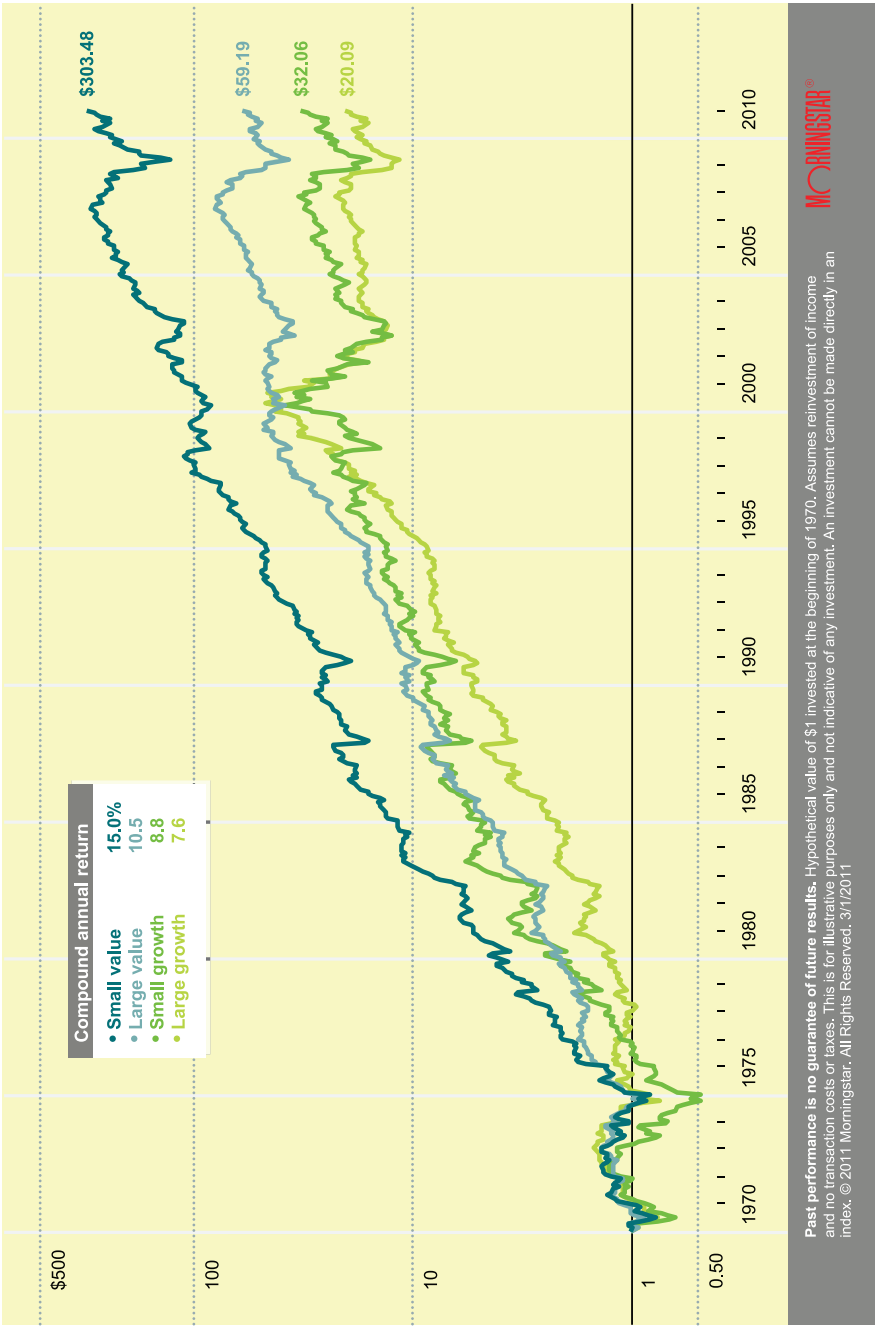
Owning several mutual funds does not necessarily mean that you are truly diversified. If the funds own many of the same securities, you have

not achieved proper diversification. Also, mutual funds suffer from what is known as style drift. In other words, a fund that is supposed to invest in growth stocks might drift by purchasing value stocks. If you already had value stocks in another fund, you might wake up one day to find out that you are too heavily invested in value, and you have lost exposure to growth-stocks.

Active managers tend to specialize in one type of stock or another, such as value or growth. Growth managers are looking for companies that are growing quickly, and hopefully, growing profits quickly. The stock prices of these companies are volatile, and their share prices can drop quickly if they show signs of losing momentum. Value managers tend to look for slower-moving companies, often companies that are not widely desired. Value managers hope that those companies can turn things around, raise earnings, and thus gain in value.

History suggests that value is superior to growth. However, we have seen periods when the growth style outperformed the value style, or vice-versa. In the following illustration, value stocks significantly outperformed growth, and small-cap stocks of the value style significantly outperformed their large-cap value counterparts; however, that's not the most important point. The most important thing is to be diversified, no matter what.

Growth and Value Investing
1970–2010



Past performance is no guarantee of future results. Hypothetical value of $1 invested at the beginning of 1970. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

Moreover, investors who select a mutual fund that purports to be in a particular category, such as small-cap stocks, might not get what they expect. A small-cap fund might own quite a few mid-cap stocks as company valuations grow over time. Such drift makes it difficult to pinpoint a client's exposure to a particular asset class at any given time. Keeping up with the changes in your asset allocation caused by drift is a little like herding house cats, especially since most mutual funds report positions with a one-month or one-quarter lag.

Investing in index funds can help solve this problem. At least you know what you own.

In the previous three chapters, I summarized the main arguments in favor of a passive investment strategy based on a carefully designed asset allocation: it will keep costs low and reduce the tendency to invest emotionally. In the next section of the book, I will discuss which investment products can support that strategy, and which should usually be avoided.

“

Diversification is the only free lunch in finances.

Harry Markowitz
Recipient of 1990 Nobel Memorial Prize in Economic Sciences

Modern Portfolio Pioneer

SECTION 5
INDEX FUNDS

“

Don't look for the needle in the haystack.
Just buy the haystack.

John C. Bogle
Founder, Vanguard Group
of Investment Companies

Chapter 12: Index Funds

An **index fund** is a bundle of stocks. The stocks that the fund holds are the same stocks, with the same weightings (percentages) as the stocks represented in a particular index, such as the S&P 500 index. You cannot own an index. You *can* own the same stocks as the index—an index fund.

The only time a stock in an index fund is bought or sold is when the publisher of the index makes a change in its lineup. For instance, if the S&P 500 expels ABC Company and replaces it with XYZ Company, then any index fund tracking the S&P 500 will do the same thing. This is mutual fund investing in its simplest form.

Index funds are said to be "**passively-managed**" because there is really not much to manage, which is why the costs are so low. As it turns out, more intense managing does not equate to more money for mutual fund shareholders, only more money for Wall Street.

Index funds do not buy or sell stocks often because changes to the underlying index do not often occur. This keeps capital gains tax liability low. The index fund avoids the expense associated with a lot of buying and selling—such as high-priced analysts, costly research, and the expense of conducting numerous transactions. The savings enable these funds to compete very effectively with mutual funds that are trying to beat the market.

Again, other mutual funds, known as "**actively-managed funds**" incur transaction costs and taxes as they compete against the market each day. They

try to outsmart the market—to little or no avail. Actively-managed funds have highly-paid managers and a great deal of additional overhead to cover. Annual expenses for index funds are often one-tenth as much as the annual expenses of actively-managed mutual funds, or less.

Exchange-Traded Funds

Index funds are also available as **exchange-traded funds** (ETFs). ETFs are index mutual funds that trade like individual stocks. An investor may pay a commission to purchase or sell the ETF, a commission that's fully disclosed on your trade confirmation, as if the ETF were an individual stock. Annual operating expenses for many ETFs are even lower than the annual expenses of many of their index fund cousins.

Certain index funds and ETFs are more efficient than others. For my clients, I stick with broad-based index funds, such as those representing the S&P 500 (for exposure to large companies) or the Russell 2000 (for exposure to small companies). I avoid narrowly-focused funds—funds that invest in a single market sector, such as healthcare or finance. Some ETFs are levered—that is, the fund's manager borrows money or purchases derivatives to increase the bet on a strategy. I do not recommend investing in levered funds because they are much riskier and more expensive to own.

ETFs are more transparent than actively-managed mutual funds. Mutual funds report holdings monthly or quarterly. Most issuers of ETFs, such as Barclays, report the current holdings of their various ETFs on a daily basis.

The primary differences between mutual funds and ETFs are as follows:

- ETFs are bought and sold throughout the day, like individual stocks. Mutual fund transactions are processed once per day.
- ETFs can be much less expensive to own than actively-managed mutual funds.
- ETFs are much more tax-efficient than mutual funds because they have much lower turnover (buying and selling) of the investments in the fund.

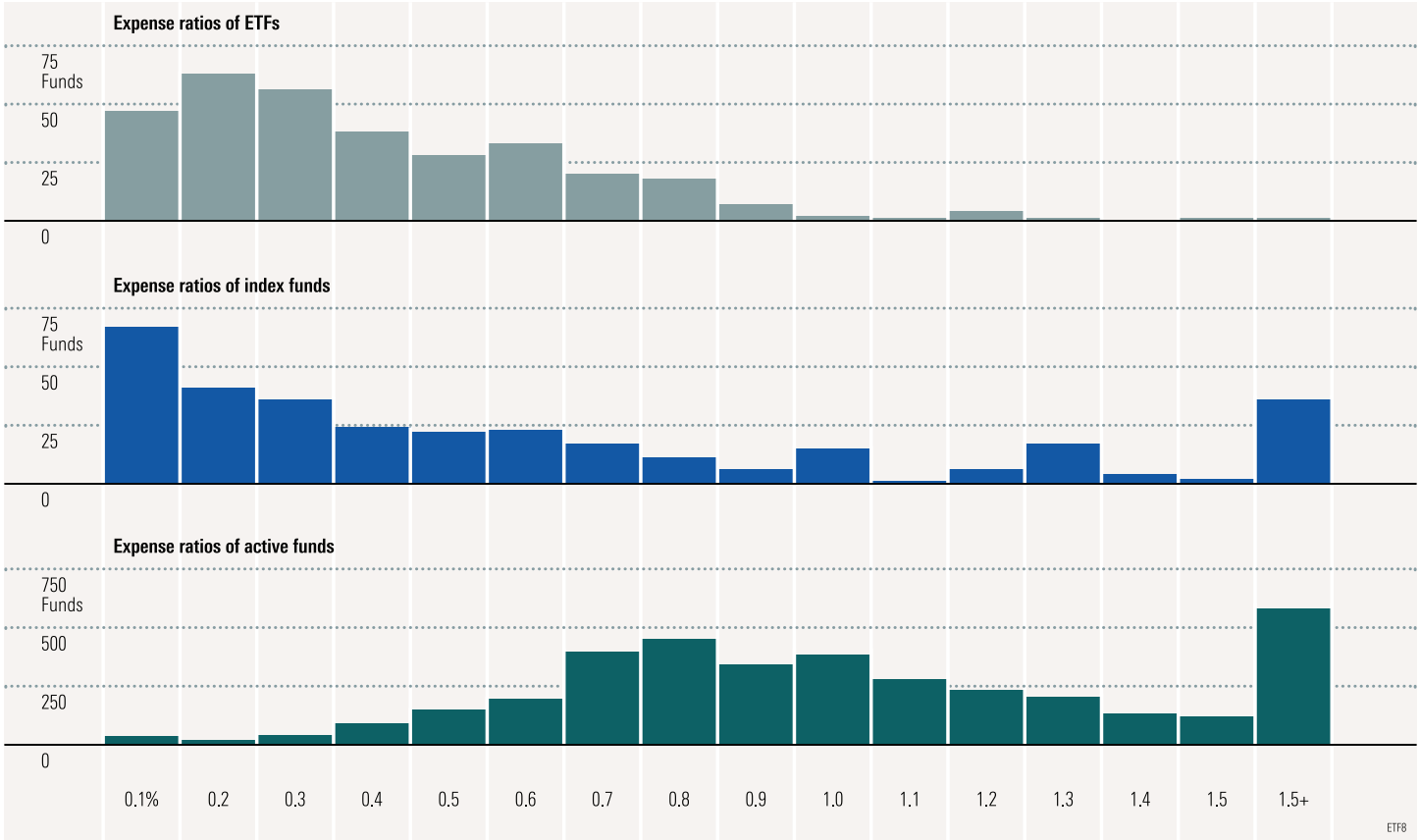
- The lower operating expenses and lower turnover of passive ETFs provide a significant advantage over mutual funds, unless commissions for ETF transactions are too high. Discount brokers will do trades for a few dollars.
- Investors pay a commission to buy or sell an ETF, and there will be a spread between the "bid" and "ask" price for an ETF. In other words, an ETF is traded just like a stock.
- Many different ETFs have been issued since the investment product was created in 1993. Most ETFs subscribe to passive management, though the industry has developed some actively-managed ETFs. Some ETFs have a very broad focus—such as the S&P 500 or the Wilshire 5000—while others are very narrowly focused on a single commodity, such as gold, copper or oil. The more narrow the focus, the greater the volatility in the investment.
- Some ETFs are leveraged.
- Just as a mutual fund can under perform a particular benchmark index, ETFs can as well. Even though a passive ETF seeks only to match or replicate the returns of a given index, it can fall short of that objective. The difference in the index's return and the ETF's return is called "tracking error."

In my practice, I have found that owning index funds and ETFs provide my clients with cost-effective, broad exposure to many asset classes.

I have also found that direct investments in bonds can help my clients achieve financial security at a very low cost. In the next chapter, I will discuss the use of bonds in a portfolio.

Expense Ratios of Large-Caps: ETFs, Index Funds, and Active Funds

As of December 2019



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment.

MORNINGSTAR®

Chapter 13: Bonds and Bond Funds

Most individual investors include bonds as part of their investment portfolios. Typically, bonds are the "safer" (or less risky) part of the portfolio. Essentially, bonds are loans to the government or a corporation, which are then paid back to the lender or bondholder over time. To simplify, a buyer of a bond has a contractual right to interest payments on a regular basis, and then the return of the principal. An exception would be a *zero coupon* bond (zeros), which has no coupon. Zeros are purchased at a discount to the par or face value. Upon maturity, the bonds are worth par or 100. The difference between 100 and the purchase price is your return. By purchasing bonds from highly-reliable issuers, a bondholder can have a very safe stream of income in the future.

Bondholders are protected. Usually, if a corporation goes bankrupt, bank debt is paid first, then secured bondholders, then unsecured bondholders. Only after those obligations are paid will excess funds be distributed to the holders of preferred and finally common stock.

One aspect of bonds that is not intuitive is the relationship between the "**yield**" of the bond (the return) and the "**price**" of the bond (what it costs to buy the bond). The yield and the price have an inverse relationship:

- When bond prices rise, bond yields fall.
- When bond prices fall, bond yields rise.

Just picture a see-saw with price on one end and yield on the other.

Other factors also influence the price of a bond. Generally, the longer the "**maturity**" of the bond, the more the bond's value is exposed to rising and

falling interest rates, and the general stability of the government or company that is repaying the bond. So, longer-term bonds pay higher rates of interest to compensate for those risks.

Financial advisors can use either individual bonds or bond funds for their clients. A portfolio of individual bonds provides certainty of the return of principal on specific dates, which offers major advantages:

- Individual bonds with stated final maturities can enhance financial planning opportunities. A "laddered" portfolio can be constructed with maturities coming due each year for a 10-year period, for instance. If interest rates fall, the longer-maturity bonds are providing a higher rate of interest and preserving income. If interest rates rise, the investor is not stuck with too many bonds at the old, low interest rates. Instead, when the short-duration bonds come due, you can reinvest the money to purchase higher-yielding bonds.
- Individual bonds eliminate many of the expenses associated with bond funds. Conversely, bond funds have the same disadvantages as equity mutual funds—high fees—and they do not guarantee the return of principal.
- Managers of bond funds may assume more interest rate risk or credit risk by purchasing bonds with longer maturities or lower credit quality to increase returns in an effort to compensate for their high fees.
- "Tax-free" bond funds may contain bonds that are subject to the alternative minimum tax (AMT), which is a federal income tax that affects millions of taxpayers each year. Bonds subject to AMT are taxable to certain purchasers. The higher yield makes the bond fund appear more attractive than it may be. Consider this example: If you are subject to the alternative minimum tax—as millions of Americans are—you would experience the following reduction in after-tax yield with regard to municipal bond funds with holdings that are subject to AMT.

Assumptions:
4.0 percent yield
26 percent alternative minimum tax rate
30 percent of the bonds in the portfolio are subject to AMT

Your effective rate of return would be approximately 3.69 percent, as opposed to the 4.0 percent yield advertised by the bond fund.

- The maturities of bonds held in a bond fund are constantly changing, but bond funds typically report their holdings monthly or quarterly. It can be difficult for shareholders to know the amount of interest rate risk or maturity risk that they face at any given time. An end-date or target date bond ETF, or a personalized portfolio of individual bonds, are more transparent and address this problem.

To be fair, bond funds do offer greater diversification than buying a few bonds directly. For smaller purchase amounts—$1,000–$10,000 for instance—index funds may make more sense, as many allow for investments of $1,000 or less. There is typically no transaction charge to purchase directly from the fund, as opposed to using a broker to purchase ETFs. Again, ETFs trade like individual stocks, so you may have to pay a commission for each transaction if purchased through a broker. ETFs that invest in bonds can be a cost-effective route to obtaining exposure to many fixed-income markets, such as Treasuries, corporate bonds, and high-yield bonds. Some bond ETFs are available with target end-dates as well, which addresses the uncertainty inherent in bond funds; however, if you need tax-free income that is free of both federal as well as state income tax, there are not many ETFs available. A portfolio of individual bonds issued in your state of residence may be the easiest way to avoid state income tax, as well as federal income tax. Many states levy state income tax on out-of-state municipal bond income.

Just like equity ETFs, fixed income ETFs experience tracking error—failing to generate the performance of the index they seek to mimic. Also, certain segments of the bond market lack liquidity. This can make it difficult to obtain exposure to some of the individual bond issues represented in the index and, consequently, to track the index.

Most ETFs use a market-cap weighting approach. This means that the issuers with the most debt outstanding receive higher weightings in the index than less-indebted issuers. You and your advisor should be comfortable with the individual underlying holdings in any ETF, as well as the weightings applied to each holding.

To help avoid tracking error in ETFs, a good rule of thumb is to avoid an ETF until it has a track record of at least three years.

Does Your Advisor Have Bond Market Experience?

A financial advisor who understands credit analysis and how to trade bonds, and who can readily determine a bond's value can add a great deal of value; however, most financial advisors have been trained to sell packaged financial products in which the actual investment is done by a third party. The advisor simply gathers money and hands it to someone else to manage. As noted several times previously, this approach adds a great deal of unnecessary expense. In the fixed-income arena, fees matter even more, because investing in bonds does not provide the potential growth that is provided by the equity markets.

Whether you purchase bonds directly from one or more brokers, and manage your own bond portfolio or elect to utilize a professional fixed-income manager, you are responsible for knowing what you own, and monitoring it for changes. At a minimum, bond investors should establish parameters with respect to:

- Credit risk
- Interest rate risk
- Position size
- Sector exposure
- Geographic exposure
- Liquidity

The following list is an example of allocation exposure to various areas of the municipal bond market:

1. No bond should have an "underlying rating" lower than A by S&P, Moody or Fitch. Some bonds are insured and consequently carry a higher rating than they would without the benefit of such credit enhancement. If a bond does not meet your credit criteria without the insurance, or does not have an underlying rating, be careful. Investors who relied on insured bonds got a rude awakening when many of the bond insurers experienced huge losses in 2008-2009, and no longer offer much comfort to bondholders. Non-rated bonds can offer great value, but require professional management.

2. No more than 50 percent of the portfolio should be "revenue bonds" (for instance, bonds whose debt service is derived from revenues such as water or sewer revenue bonds, as opposed to tax collections).

3. At least 50 percent of the bonds in the portfolio should be "general obligation" bonds—bonds whose debt service is dependent upon some form of tax collections versus revenue. These so-called general obligation bonds may be issued by a state, municipality or local school district.

4. No position should represent over 10 percent of the portfolio for general obligation bonds, and no more than 5.0 percent for revenue bonds.

5. Essential service revenue bonds should have a debt service coverage ratio of at least 1.20:1.00. In other words, there is sufficient cash flow dedicated to the bond issue to sustain the debt service and provide a cushion should revenues fall. Other bonds whose revenues are not as stable should have much higher debt service coverage. For example, a small town with only one major employer is vulnerable. So are its water and sewer bonds.

6. Liquidity. This will vary depending upon whether you are investing in corporate bonds or municipal bonds, many of which have relatively small issue sizes. Ten million dollars or less for some municipal issues, versus $500 million for certain corporate bond issues.

7. No improvement district bonds. An improvement district that must sell lots in order to generate enough user fees to cash flow its sewer bonds is dicey. Yields may appear generous, but they are high for a reason—greater risk.

This is just a sample of the beginnings of an IPS for municipal bonds. An IPS for corporate bonds or U.S. government agency bonds would differ somewhat.

Remember, do not rely solely on the rating agencies. The rating agencies have a less-than-stellar record in identifying problems before it is too late.

For municipal bonds, the following questions should be part of the credit analysis performed by your financial advisor. The advisor should not blindly rely on the rating agencies, bond insurance or their firm's trading desk:

1. *What changes have occurred in the issuer's financial statements?*
2. *How will economic adversity, such as a manufacturing plant closing, affect the creditworthiness of a bond?*
3. *What are the sources of repayment of the bond? Are there dedicated sources of revenue or general tax receipts?*
4. *Is the population in the issuer's area growing or shrinking, and how will this affect repayment?*
5. *What's the personal income per capita in the area?*
6. *What is the issuer's debt-service reserve? Is it fully funded? In cash and/or securities, or through an insurance policy?*
7. *What is the debt service coverage for a revenue bond, such as a water revenue bond or sewer revenue bond?*
8. *What are the call features?*
9. *What is the size of the bond issue?*

Individual bonds are much more transparent than bond funds; however, you as well as your financial advisor must be diligent about monitoring the issuers of the bonds you own. Certain transactions—such as interest rate swaps—have backfired on some municipalities, causing the value of their bonds to fall precipitously.

The following resources will help you track certain developments and activity. The web address for the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) is **www.emma.msrb.org**. On this site, you will find:

- Recent trade activity of individual municipal bonds (Just enter the bond's cusip or bond identification number).
- Recent official statements describing the issue.
- Continuing disclosure documents.

The SEC requires issuers to disclose certain material events (ME) to every nationally-recognized repository for municipal securities should they occur. These events include:

1. Rating changes.
2. Failure to pay timely interest and principal.
3. Modification of bondholders' rights.
4. Sale, substitution or release of any assets securing the debt service for the bonds.
5. Any event affecting the tax treatment of the bonds.
6. Any unscheduled drawdown of debt service reserves or credit enhancement.
7. Calls.
8. Defaults.
9. Debt defeasance.

Always check your trade confirmations and monthly statements closely. If you notice "ME" beside a particular bond(s), call your financial advisor to find out why. You should always do your own due diligence. Do not strictly rely on your financial advisor. The aforementioned EMMA website will provide this information. All you need is the bond's cusip number, which should be identified on your trade confirmations and statements. Another source for checking recent trade activity is www.investinginbonds.com. Look for the Trade Reporting and Compliance Engine (TRACE). Use this free resource to verify what others are paying for the same bond in which you and/or your financial advisor are interested.

The financial advisor's employer will control which bonds are offered, and at what price. If you limit yourself to only one firm's inventory, you severely restrict your opportunities. ClientFirst maintains relationships with many broker-dealers. Clients benefit from many firms' underwritings and inventory. Prices are negotiated on the client's behalf.

Call Features

Regardless of whether the bond is a municipal, corporate or government agency bond, you should always ascertain the "yield-to-worst" call. The bond may have more than one call feature. You should know what your lowest yield will be in the worst case scenario—the yield you will have if the most disadvantageous call feature is realized. This information should be identified on your trade confirmation (Purchase price/yield to maturity).

Most bonds—excluding U.S. treasury bonds—are callable by the issuer at certain dates and at certain prices prior to maturity. The call price may be higher or lower than the price you paid for the bonds. Consider this example:

Issuer:	Bugtussle Water Revenue Bonds
Coupon:	5.0 percent
Maturity:	12/1/2039
Callable:	At par 12/1/2024, to yield 2.39% to the call
Purchase price:	106.382
Purchase date:	112.246 / 11/22/2019

If this bond is called on 12/1/2024 at 100—the yield-to-worst call—your yield will amount to 2.39 percent. If the bond is not called on 12/1/2024, your yield will rise slightly the longer the bond remains uncalled. If the bond was never called (and simply matured), you would enjoy a yield-to-maturity of approximately 4.09 percent, because you got to hang on to the attractive 5.0 coupon all the way to maturity.

Do not be too impressed by the coupon or the "current yield" (coupon/purchase price). The yields that matter most are the yield-to-worst call and the yield-to-maturity. In the example above, the price was 112.246. Any price above par or 100 is referred to as a premium, and any price under par is known as a discount. This does not necessarily mean that one is a better value than the other as you might expect, it is just bond terminology.

Your financial advisor should not only be able to analyze the creditworthiness of a particular bond, but should also be able to recognize opportunities to avoid taxes. For instance, advising you to sell very short-term taxable bonds

with long-term capital gains. This way, you are taxed on the gain at the much lower long-term capital gains rates versus waiting for the bond to mature at face value and paying ordinary income tax) on the remaining coupon interest payments.

Moreover, do not assume that your financial advisor has done a great deal of research regarding a bond fund recommendation. Ask them to share with you the amount of research they did to arrive at the recommendation. Some bond funds hold nasty surprises. They may use certain derivative securities (securities that derive their value from other securities) to enhance yield — derivatives that have counter-party risk to whomever is on the other side of the trade. As many Wall Street firms learned the hard way during the 2008-2009 financial crisis, certain counter-party risk can be devastating.

Checking Prices of Individual Bonds

Broker dealers charge mark-ups, as opposed to commissions, where individual bonds are concerned. If a broker dealer pays 98.0 for a particular bond, the bond might be reoffered at 100 to retail customers, for instance. Mark-ups are not required to be disclosed. Broker dealers acting as **"principal"** actually own the bonds. They are not required to, and typically do not, disclose their mark-ups, even if they just owned the bonds for one minute. If the broker dealer is acting as **"agent,"** commissions—such as commissions charged for a purchase or sale of common stock—must be disclosed on the trade confirmation.

If you buy bonds from a broker, you should check the prices paid by others for the same or substantially similar bonds. Otherwise, you might overpay. I do not believe that broker dealers should have to disclose their mark-ups any more than your grocer should have to disclose his mark-ups on produce. Sometimes, broker dealers take losses when they own or inventory bonds. The amount of the mark-up is not as important as the price at which the bonds are offered. This doesn't mean you should not try to negotiate.

Again, two websites that provide valuable information about bonds are www.investinginbonds.com and www.bondview.com. At investinginbonds.com, you can verify the prices at which various bonds have recently traded.

You can use this resource to compare the price you are being asked to pay against recent trades in the same or similar bonds.

TIPS

One particular type of bond fund that can be difficult to research is a fund that invests in Treasury inflation-protected securities (TIPS). The problem here is yield inflation. Morningstar tracks over 170 of these funds, and even though they all invest in TIPS, their yields vary wildly. According to a May 2011 Wall Street Journal article entitled *How Inflation-Protected Funds Get to Inflate Their Yields* by Jason Zweig:

"Among the 173 TIPS mutual funds tracked by Morningstar, the reported 'SEC yields' as of March 31, (2011) ranged from minus -0.77% to 5.58%, with twelve funds yielding at least 5.0%. Four of the seven exchange-traded funds that specialize in TIPS displayed yields greater than 5.0%.

Yet no TIPS (the bonds that these funds purchase) yield more than 1.75%. How could anyone but an alchemist generate 5.0% or more out of 1.75% or less? The answer lies hidden in the term 'SEC yield.' In 1998, the Securities and Exchange Commission (SEC) forced funds to include only dividends and interest income in the yield that they must show investors.

In months that capture a small inflation change, SEC yields on TIPS funds will be low. In months when the rise in the Treasury's inflation value was 0.5%, SEC yield can brush 6.0%.

The return on TIPS, however, comes not just from interest income, but also from any adjustment in value as inflation rises. The SEC hasn't issued any guidance to fund companies on how to handle this peculiarity when they show standardized yields."

This situation allows mutual funds a great deal of flexibility in how they choose to identify their respective yields for TIPS funds.

This can be very confusing, whether you are a layperson or a financial advisor. The performance of TIPS funds may appear superior to the returns

of traditional bond funds; however, this can be an expensive illusion, as investors flock into what they mistakenly believe is a higher-yielding security. If a true apples-to-apples comparison to traditional bond funds was available—in other words, if the required yield calculations for TIPS funds were the same as the yield calculation requirements for traditional bond funds, this confusion would not exist.

Stress Tests

At bondview.com, you can "stress test" your bond portfolio to see how prices may fluctuate under various interest rate scenarios. For example, how will your bond portfolio be affected if interest rates increased or decreased by 1.0 percent (100 "basis points")? The stress test is a very valuable tool. Many bond investors have no idea just how far and how fast bonds can lose value when interest rates rise. "Duration" is a measure of interest rate risk. For instance, a 7-year duration implies that if rates rise one percentage point, the bond's price will drop by 7.0 percent.

Given a low interest rate environment, if rates rise by just 2.0 percent, you could expect a five-year maturity non-callable government bond to fall in value by approximately 8.0 percent. Conversely, a 10-year maturity bond could be expected to fall in value by approximately 14 percent and a 30-year maturity bond by approximately 23 percent. Obviously, the longer the maturity, the greater the interest rate risk. Although your principal would be returned at maturity, newly-issued bonds would be paying much higher interest rates. Thus your "opportunity cost" (the difference in the yields on the bonds you already own versus the higher yields you could obtain if you had cash on hand) would be high. Your financial advisor should be able to run stress tests on your portfolio on a regular basis.

Investing in a Time of Low Interest Rates

At the time I wrote this (late-2011), low interest rates had forced individual investors to stretch for higher yields to meet their income needs by purchasing long-term bonds. The problem is that if interest rates rise—or rather, *when* they rise—those investors will be stuck with bonds paying very little interest.

Their income will be locked-in at poor rates of return, and they will suffer opportunity costs. They have foregone the opportunity to invest at higher rates in the future, unless they want to sell their bonds at a loss. The same is true of investors locking in annuity rates.

As of this writing, U.S. interest rates are at 60-year lows. This is due to several factors—most prominently U.S. government policy to keep interest rates low, and investors' desire for safe havens for their money. Millions of baby boomers who were burned by the dot-com bubble, and again by the financial crisis of 2008, flocked to bonds. Unfortunately, this has created a bond bubble. Whenever the bubble bursts (and it will!), there will be a mad rush for the exits. Be sure that you and your financial advisor discuss what-if scenarios, such as:

- *What if interest rates spike substantially higher?*
- *What if interest rates rise gradually over time?*
- *What if credit problems materialize in the bond market, and there is a rush for the exits?*
- *How can I maximize income without taking on significant interest-rate risk or credit risk?*
- *What is the plan of action in each of these scenarios?*

As always, you should know what you own and how it may perform under various scenarios. With respect to the bond market, you need not stand at the exit trembling with fear, but you and your advisor had better know where the exit *is*.

Whether you choose to work with a professional fixed-income manager, or you are buying bonds from brokers on your own, you should have a basic understanding of the bond market.

Exit Strategy

Those who rely too heavily on bond-rating agencies may be surprised when the rating agencies make mistakes. This is what happened in 2008 to holders of many bond issues, including Lehman Brothers bonds, which maintained an investment-grade rating right to the end. Investors had ample opportunity to exit Lehman Brothers bond holdings. True, the sale might

Standard & Poor's, Fitch and Moody Credit Ratings

Standard & Poor's		Fitch		Moody	
AAA	Very strong	AAA	Very strong	Aaa	Very strong
AA+	Very strong	AA+	Very strong	Aa1	Very strong
AA	Very strong	AA	Very strong	Aa2	Very Strong
AA-	Very strong	AA-	Very strong	Aa3	Very strong
A+	Strong	A+	Strong	A1	Strong
A	Strong	A	Strong	A2	Strong
A-	Strong	A-	Strong	A3	Strong
BBB+	Good	BBB+	Good	Baa1	Good
BBB	Good	BBB	Good	Baa2	Good
BBB-	Good	BBB-	Good	Baa3	Good
BB+	Marginal	BB+	Marginal	Ba1	Marginal
BB	Marginal	BB	Marginal	Ba2	Marginal
BB-	Marginal	BB-	Marginal	Ba3	Marginal
B+	Weak	B+	Weak	B 1	Weak
B	Weak	B	Weak	B 2	Weak
B-	Weak	B-	Weak	B 3	Weak
CCC+	Very weak	CCC+	Very weak	Caa1	Very weak
CCC	Very weak	CCC	Very weak	Caa2	Very weak
CCC-	Very weak	CCC-	Very weak	Caa3	Very weak
CC	Extremely weak	CC	Extremely weak	Ca	Extremely weak

have been for 90, 80, 70 or even 50 cents on the dollar, but any of those bids were much better than nothing. The financial advisor who did not have his clients exit Lehman Brothers before it was too late, either lacked an exit strategy or was afraid to use it. An exit strategy is critical—especially for corporate bonds—as companies have fewer options in rough times than do governments, which can raise taxes or user fees to pay their bondholders.

The rating agencies got it wrong again with sub-prime mortgage bonds, as well as with the bonds of M.F. Global Holdings, Ltd., which were still rated BBB- by S&P a week before the company filed for bankruptcy in October 2011. Don't take ratings as gospel. They are only one indication of value.

Your advisor should provide a robust, detailed analysis of your bond portfolio, featuring:

- Weighted average coupon (WAC)
- Weighted average maturity (WAM)
- Modified duration (a measure of price volatility when interest rates change)
- Effective maturity (the date to which a bond is priced, considering embedded options such as call features)
- Number of positions
- Average price
- Face amount
- Market value
- Yield-to-worst call
- Yield-to-maturity
- Accrued interest
- Cash flow spreadsheet
- Geographic dispersion
- Credit quality dispersion

In the next several chapters, I will discuss some costly products developed and sold by Wall Street. Enter the gauntlet.

Chapter 14: Variable & Equity-Indexed Annuities

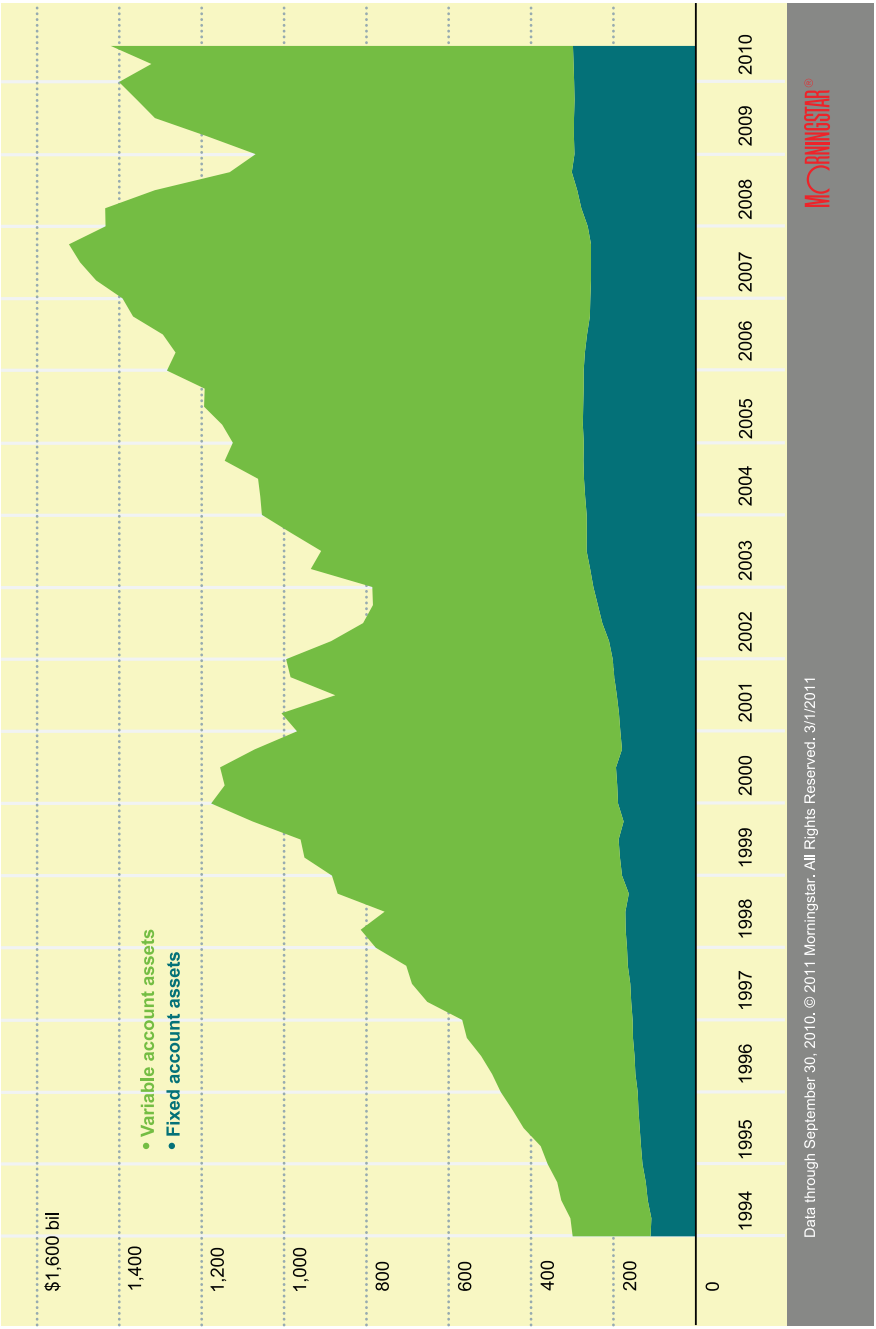
An annuity is the generic term for a financial product that will make a series of payments to an individual over time. These are known as fixed annuities. The level of payments, the amount of time, and the rate at which payments will increase (if at all) are part of the offer of the specific annuity. They are unique for each individual, but they are based on factors such as how much is invested in the annuity, the annuitant's health and age (that is, anticipated years of receiving the annuity). Annuities meeting this description are a source of steady income (cash flow) during a time when the stock market has been very volatile.

Previous chapters described some choices that investors can make about the types of investment accounts they can open, the types of financial advisors they can choose, and the basic financial products they can own. Wall Street has created a multitude of financial products. One of these financial products is the **variable annuity**. Just reading the prospectus is a herculean task and some "guaranties" may prove unenforceable if certain conditions arise, but you will only find this information with a keen eye. What the large print gives, the small print can take away. Years ago, when taxation rates for ordinary income and capital gains were much closer, the tax deferral feature of a variable annuity was worth more, which made them somewhat more attractive.

Variable annuities offer certain investment selections, the earnings on which are tax-deferred. The purchaser of the variable annuity is also sold insurance. The insurance component of the product provides some underlying guarantee through a death benefit–value guaranty. They can also be converted to fixed annuities.

Unfortunately, annuities can be expensive, especially variable annuities. Variable annuities are not known for providing value, but they are very popular. Why? Because they offer that guarantee of payment. "Guarantee" is a very powerful word. Two guarantees that are not emphasized are the onerous surrender charges and the exorbitant annual operating expenses. The illustration on the following page depicts the rise in popularity of the variable annuity.

Assets of Deferred Variable Annuities
1994–2010



A guarantee makes anything easier to sell. Variable annuities offer guaranties to protect individuals against certain events, but at a very high cost.

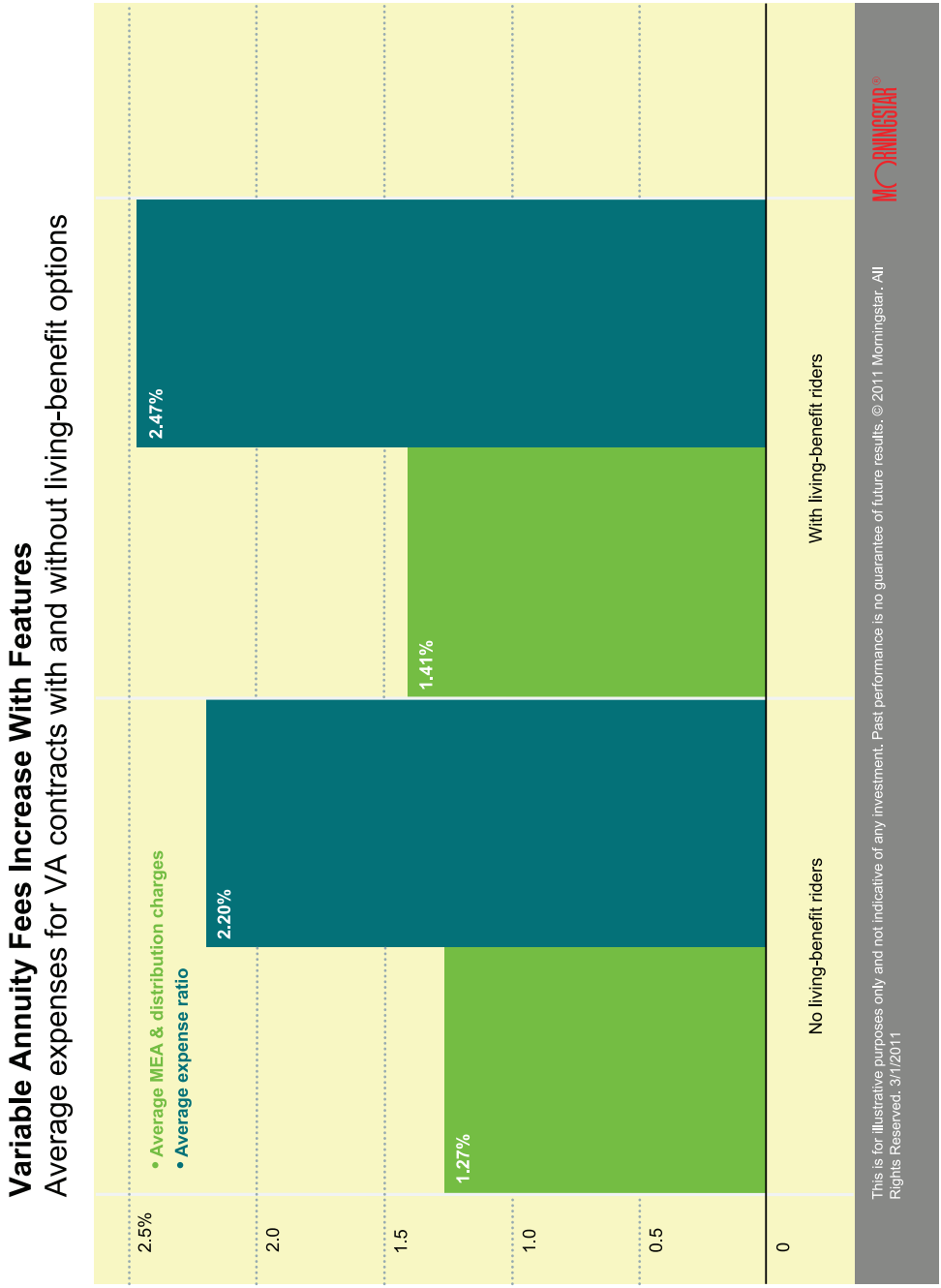
Variable annuities feature lucrative hidden commissions. A detective would struggle to uncover all the fees in many variable annuities. Ironically, the product is referred to as a "no-load," and the investor never receives an invoice for any operating expenses, which can amount to 3.0 percent annually. **Variable annuities will shake the money out of your pockets faster than an industrial-strength washing machine.**

Also, variable annuities entice buyers with a "signing bonus." A signing bonus—like a professional athlete! The bonus may amount to 5.0 percent or more of the contract or investment value, but don't be naïve. You pay many times more than the "signing bonus" during the life of the annuity contract through higher annual expenses, or through surrender charges.

Most variable annuities share some common features:

- They are insurance products and investments (securities).
- They feature a "death benefit," which restores an account balance to a certain level upon the death of the policy holder.
- They can be converted to a fixed annuity that provides steady income for a period of time.
- They offer tax deferral, much like an Individual Retirement Account (IRA).
- All investment gains in the annuity are tax-deferred. But unlike an IRA, the annuity owner is not required to begin taking "distributions" (withdrawals from the account) at age 70½.
- Earnings from an annuity are taxed as ordinary income—a rate that's typically much higher than the long-term capital gains rate on an investment account.
- Investment choices. The investor can select various investments representing stocks, bonds, and other asset classes, and can change the mix whenever they wish.
- Investors face a 10 percent tax penalty for withdrawing money prior to age 59½. Most variable annuities also offer a range of optional features that an investor can select. So-called 'riders' are purchased a la carte for various

additional payment guaranties. While these options sound attractive, they will raise the annual costs of ownership. See the illustration below.



Comparing Tax Rates

In 2020, the rate of federal taxation for long-term capital gains (securities you have owned for more than one year and one day) is 15 percent. By comparison, the highest federal ordinary income tax rate is 39.6 percent. An investor taking a distribution from a variable annuity will pay an income tax of as much as 39.6 percent on any earnings. If that money was instead held in an index fund for at least a year and a day, it would be taxed at the 15-percent federal capital gains rate when sold, unless annual income exceeds $488,000.

Years ago, when the long-term capital gains rates were much higher, the tax-deferral feature of variable annuities presented greater value. Today, much of that advantage is negated by the higher tax on annuity distributions. Again, the highest capital gains tax rate is 15 percent, versus the highest ordinary income tax rate of 39.6 percent.

High expenses. It is not uncommon for the annual expenses of a variable annuity to exceed 3.0 percent. In an investing environment of single-digit market gains and low yields for bonds, these are staggering fees.

High asset management fees. The fees paid to the various investment managers.

Mortality expenses, which are related to the death benefit feature. Variable annuities provide death benefits, which will return the investor's account or contract balance to a certain value in the event of the death of the annuitant. We are living longer, and life insurance rates have fallen dramatically, but you would never know it by looking at the cost of the death benefit in many variable annuities. If you are reasonably healthy, a simple term-life policy may be much cheaper, assuming that you need more life insurance in the first place.

Very steep surrender charges with very long surrender periods. These are the costs to get out of a variable annuity contract. Surrender charges can be as high as 8.0 percent, and the surrender period can be eight years or longer.

Equity-Indexed Annuities

Instead of offering the annuity-holder a menu of investment options, equity-indexed annuities (EIAs) tie the investor's performance to an index. They are also known as fixed-indexed annuities.

EIAs offer some upside of investing in the stock market, while providing downside protection against losses; however, EIAs are different than variable annuities in some important respects:

- EIAs are strictly insurance products. They are not securities. Therefore, they are not regulated by securities regulators. EIAs are regulated by the insurance departments of individual states.
- EIAs are fixed annuities.
- Surrender charges are high.
- While the investments do track an index, the investor does not participate fully in the upside experienced by the index.
- EIAs do not have ongoing fees. The issuers and retail brokers make their money at the point of sale. Surrender charges ensure that the issuer will recoup the hefty commissions it paid when the product was sold, in case you exit early.

Variable annuities and equity-indexed annuities are just two types of annuities. They should not be confused with other types of annuities, such as "immediate-pay" annuities, whereby you give an insurance company a sum of money, and it pays you a certain amount each year for the remainder of your life. When you die, the insurance company may not return any money to your heirs—even if you die in year one. There are versions of immediate-pay annuities that will pay some portion of your original investment to your heirs when you die; however, any such feature is bound to reduce the income that you receive. So will taking out a policy like this when interest rates are at 60-year lows, so think twice before you hand over your money.

A bond portfolio—properly structured—can provide steady income without any haircut from an insurance company. Unlike insurance products, the portfolio of individual bonds offers transparency, and you will still have your principal.

Variable Annuity: The Vanguard Option

If you are interested in owning a variable annuity, Vanguard Group—the big no-load mutual fund company—offers a relatively attractive product. Vanguard variable annuities have the following features:

- **No surrender charges.**
- **Annual expenses of approximately 0.25 percent.**
- **An investment menu of index funds, rather than costly, active Wall Street money managers.**
- **No gimmicks (such as signing bonuses).**

It should be noted that Vanguard annuities do not feature death benefits. Again, for the investor who is seeking life insurance to provide a death benefit for heirs, the answer is to go out and buy it directly, rather than through the indirect method of a costly variable annuity. Visit the following websites for quotes on term life insurance offered by many companies: www.eterm.com or www.selectquote.com.

For More Information

Annuities are regulated by state insurance commissioners and by the SEC. The National Association of Insurance Commissioners (NAIC) is comprised of state insurance commissioners. If you have questions or complaints about variable annuities, www.naic.org offers links to the home page of every insurance commissioner in the United States.

The SEC provides helpful information about variable annuities at www.sec.gov.

One final word about annuities. Whenever a financial advisor suggests swapping or exchanging one annuity for another—known as a 1035 exchange—you should be skeptical. This sort of activity provides the financial advisor with an opportunity to generate significant additional commissions, it is unlikely to do much for you. The "new and better" annuity is unlikely to feature significantly lower annual expenses, and it will certainly impose its own draconian surrender charges. The exception would be swapping into a Vanguard variable annuity—one without sales charges or surrender charges, and whose annual operating expenses are quite low. This may make sense if you need to protect earnings from taxation, while escaping high operating costs.

Any time a financial advisor recommends exchanging or swapping annuities (or mutual funds, for that matter), you should request a written explanation of why the proposed swap is beneficial to you. The explanation should include specific figures, such as a comparison of annual expenses, as well as full disclosure of all the advisor's financial incentives generated by the transaction. As always, read the fine print.

So what's a viable alternative to variable annuities? How about a sensible asset allocation featuring individual bonds and cost-effective index funds or ETFs to implement the allocation?

In the next chapter, let's look at another highly-marketed product: actively-managed mutual funds.

“

Price is what you pay.
Value is what you get.

Warren Buffet

CEO, Berkshire Hathaway

Chapter 15: Actively-Managed Mutual Funds

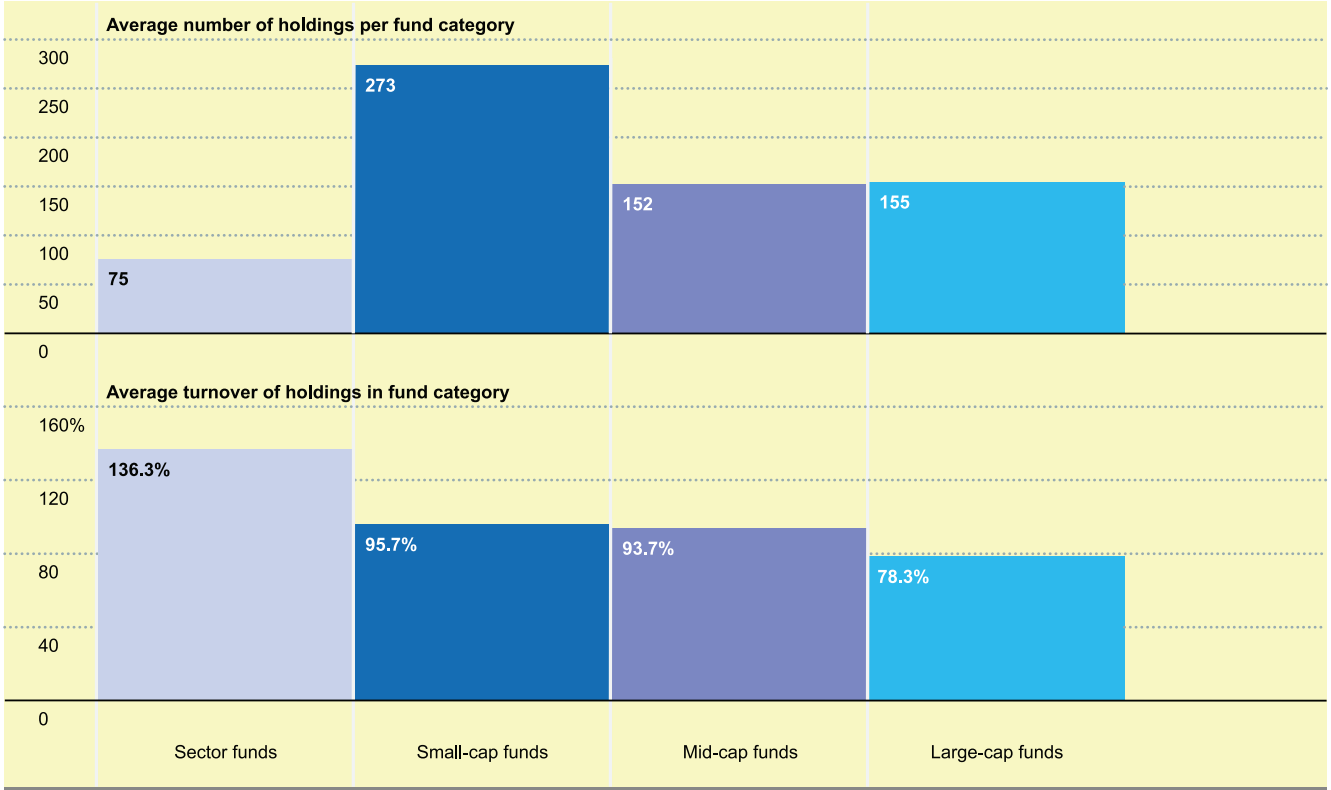
As we learned in Chapter 6, investment fees can make a huge difference in your long-term success. Management fees, sales charges and administrative fees are strong headwinds for all shareholders to overcome.

Actively-managed mutual funds may have annual expenses of 2.0 percent or more. This does not include friction costs—any commissions as well as price slippage—incurred when large buyers or sellers move a stock up or down when buying or selling stock.

However, if you read a fund's prospectus, you are more unlikely to see the true annual expenses because such friction costs are not included. Also, you will not see an estimate of the short-term capital gains liability that you face from the "**turnover**," or frequent buying and selling of securities in the fund's portfolio. The following illustration depicts the annual turnover experienced in various categories of mutual funds.

Holdings and Turnover

Sector, small-, mid-, and large-cap funds as of December 2010



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 3/1/2011

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Tack on the hefty management fees and sales charges, and the burden is just too great—sort of like running a marathon with a monkey on your back.

In August 2010, Morningstar Inc. released a study entitled, "How Expense Ratios and Star-Ratings Predict Success." The study indicated that low fees are the best predictor of success for mutual funds—better than Morningstar's own star-rating system! The five-star rating system measures past returns, adjusting for risk as well as sales loads.

Specifically, the study found that from January 2005 through March 2010, low-cost funds experienced better returns than high-cost funds—regardless of asset class or data point. For example, in the domestic equity category, the category of funds with the lowest fees generated an annualized return of 3.35 percent, as compared with 2.02 percent returns for the funds in the most-expensive quintile, or category, over the five-year period.

Russell Kinnel, author of the study and Morningstar's director of mutual fund research, concluded that expense ratios or annual expenses expressed as a percentage of assets, should be a primary test for selecting any mutual fund.

Fees are one reason why using actively-managed funds is a long-odds proposition. Consider this fact: approximately 80 percent of mutual funds fail to beat the market.

When you reflect on the odds against professional money managers outperforming the market and think about your odds of correctly selecting which ones will consistently beat the market in the future, you realize that you are looking for a needle in a haystack. Meanwhile, you will lose control over one of the few things that you *can* control—costs.

Paying a financial advisor to divine which funds will outperform does not make much sense, either. The fund managers themselves do not know which ones will outperform. Mutual funds are required by law to warn that past performance is not indicative of future performance.

Also, whenever mutual funds pay distributions to shareholders, there is a chance you may wind up paying taxes on gains that were accumulated before

you purchased the fund. In other words, you are paying taxes on someone else's gains.

There are other reasons to avoid actively-managed funds. Mutual funds that under perform the market in the first half of the year may assume significantly greater risk in the back half of the year in an attempt to catch up. In other words, professional money managers also become emotional investors—just like their shareholders. As stated earlier, emotions are one of the investor's worst enemies.

Moreover, the track record for mutual funds as a whole is less than meets the eye due to what is known as "survivorship bias." Survivorship bias is present in mutual fund performance statistics because when a failing fund is absorbed by a successful fund, the failing fund's poor performance simply vanishes because it is no longer part of the mutual fund universe. It's as if the fund never existed (but, of course, the losses were very real to the fund's investors).

By absorbing the funds, the industry overall can claim better performance. Some investment researchers estimate that survivorship bias accounts for as much as 2.0 percentage points of the industry's claimed performance.

How pervasive is survivorship bias? Morningstar revealed that only 74 of the 146 one-star equity funds in the international category survived the five-year period of one of its studies.

Understanding Mutual Fund Share Classes

Mutual funds are sold in three share classes, which differ as to their respective annual operating expenses. The investments are the same for each class within a specific fund:

1. **"A" class shares or "front-end loads." With these investments, a portion of your investment, say 5.0 percent, is commission when you purchase the fund. Therefore, a $10,000 purchase would be worth only $9,500.**
2. **"C" class shares, or "level- load funds," impose no immediate hair cut to your investment, but annual expenses are high and there is a surrender charge. Commissions to brokers for "C" class shares might amount to 1.0 percent annually. Surrender charges for these investments are calibrated to ensure that you hold the investment long enough for the issuer to cover the commissions paid at the point of sale. "C" class shares are the most popular form of shares today. They are easier because ongoing sales charges, or 12(b)-1 fees, are hidden. Typically, C shares convert to "A" shares after 8-10 years, depending upon the fund company or broker-dealer.**
4. **"Advisor" class shares, which are used by investment advisors in fee-based accounts. This class of shares does not pay commissions. Consequently, the annual operating expenses are lower than the share classes of the same fund that do. As the name implies, investment advisors buy these shares on behalf of their clients; clients can't buy them directly.**

Even if mutual fund performance is accurately reported, and costs and survivorship bias are accounted for, the average investor has another factor to consider—his own behavior. Mutual funds traditionally report their performance using what are known as "time-weighted" methods, which include all dividends and capital gains distributions over a specific period of time, but time-weighted reporting fails to identify the returns experienced by the average mutual fund investor, which are much lower. Why? Investors chase funds with good performance, and sell after performance sours. If investors do not

stay the course over the period of time in which the time-weighted fund performance is measured, their returns will not be the same as the fund's returns.

According to Vanguard founder John C. Bogle, author of *The Little Book of Common Sense Investing:*

"When we compare traditionally calculated fund returns with the returns actually earned by their investors over the past quarter century, it turns out that the average fund investor earned, not the 10 percent reported by the average fund, but 7.3 percent—an annual return fully 2.7 percentage points less than that of the fund. (In fairness, the index fund investor, too, was enticed by the rising market, and earned a return of 10.8 percent, 1.5 percentage points short of the fund return itself.) Yes, during the past 25 years, while the stock market index fund was earning an annual return of 12.3 percent and the average equity fund was earning an annual return of 10 percent, the average fund investor was earning only 7.3 percent a year.

Compounded over the full period, the 2.5 percent penalty incurred by the average fund because of costs was huge, but the dual penalties of faulty timing and adverse selection were even larger. $10,000 invested in an index fund grew to $170,800; in the average equity fund, to $98,200—just 57 percent of what there was there for the taking. But the compound return earned by the average fund investor tumbled to $48,200, a stunning 28 percent of the return on the simple index fund."

And once again, the value of all those dollars tumbles because we must take inflation into account. The index fund real return drops to 9.0 percent per year, but the real return of the average fund investor plummets to just 4.0 percent. On a compounded basis, $76,200 of real value for the index fund versus just $16,700 for the fund investor—only 22 percent of the potential accumulation was there for the taking. Truth told, it's hard to imagine such a staggering gap, but facts are facts."

Although index fund investors also suffer from faulty timing, their suffering is not compounded by hefty operating expenses and adverse selection, or picking a fund that performs poorly.

Target-Date Funds

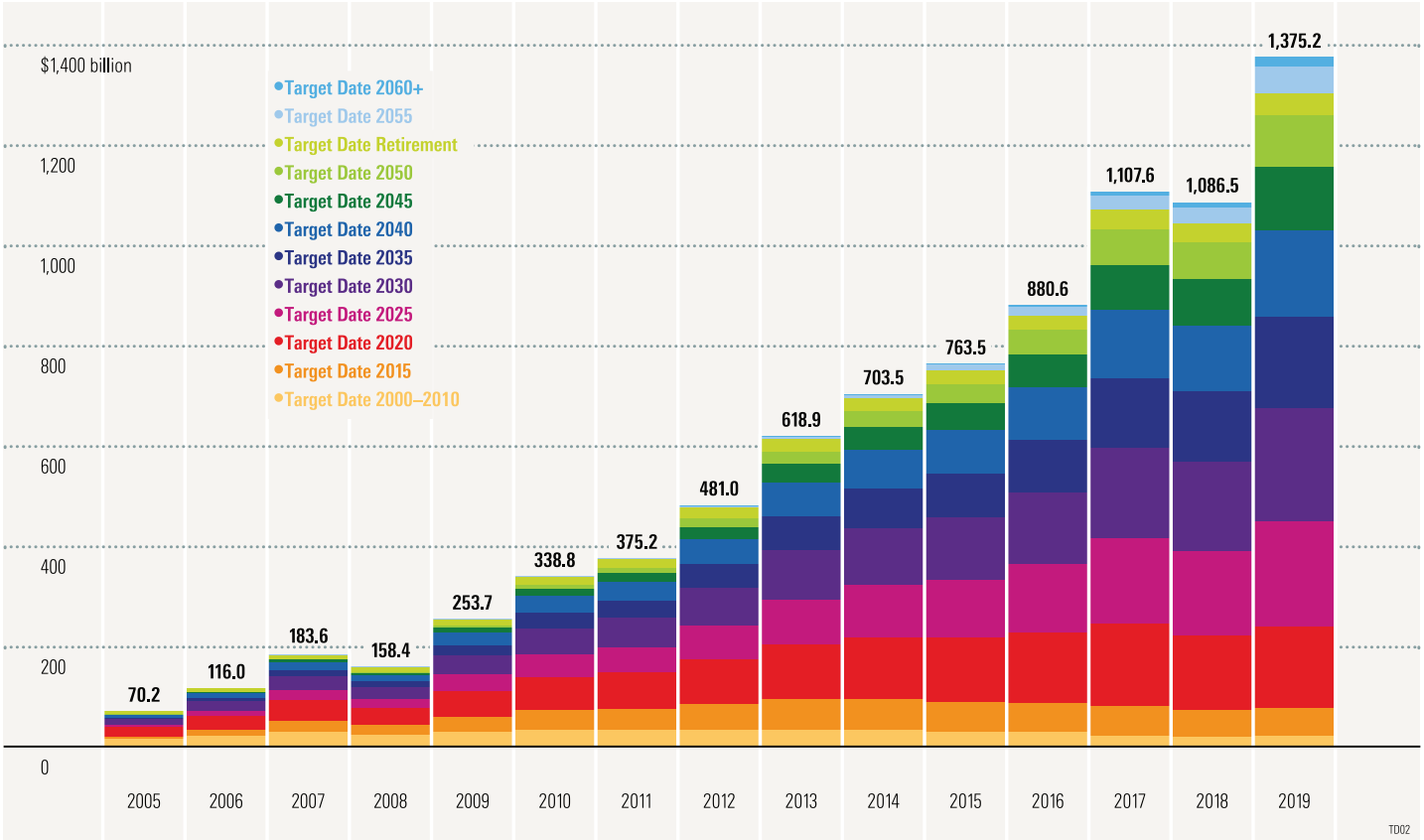
Target-date mutual funds are popular. These are funds that change an investor's allocation automatically over time, to alter financial risk as a person nears retirement or another defined goal (a child's college education, for example).

All target-date funds are not created equally. Some have done a poor job of making the necessary adjustments to the asset allocation. For example, during the 2008-09 market crash, it became apparent that some target-date funds had failed to reduce investors' exposure to the market in accordance with their stated aims, based on the investor's age and risk tolerance. This is all it takes to turn a retiree into a would-be retiree.

Many retirement plans have target-date funds on the menu. The asset allocation of the target-date fund should be in harmony with your desired asset allocation for all of your assets as a whole. To put it another way, you should know what you own. You should understand the weightings of the various asset classes, such as stocks, bonds and cash. For example, if you look to retire in thirty years, you should consider a 2050 target-date fund.

Target-Date Fund Assets Continue to Rise

Total Net Assets by Category, 2005–2019



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It is very important to know the target-date fund's "glidepath"—the method by which the fund will roll down equity allocations, as well as the fund's policy regarding tactical allocations. Compare the target-date funds of various mutual fund companies for these metrics as well as expenses and historical performance. Vanguard offers low-cost target-date funds.

Target-date funds feature three basic glide paths—linear, steep, and stepped. Consider the exhibit on the following page.

Glide Path Discussion
Linear, Steep, and Stepped Paths

- Linear: equities are rolled down in a gradual, linear fashion, producing a consistent slope.
- Steep: equities are kept near or above the averages in the longer-dated funds but dramatically reduced in the decade before retirement.
- Stepped: equities are kept at their original target level over each 10-year period.
- Target-date funds adopt three general approaches to tactical allocation, or deviations from the strategic glide path.
  - No tactical allocation is allowed.
  - Modest deviations are allowed.
  - Active tactical allocation is allowed

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Chapter 16: Separately-Managed Accounts

Separate accounts—also known as separately-managed accounts or "separates"—are segregated individual accounts with one or more investment managers. Unlike mutual funds, your investment is not co-mingled. Many investment managers participate in the separate account programs offered through major brokerage firms and other institutions.

It is expensive to access investment managers through a brokerage firm. A brokerage firm directs your money to one or more investment managers who manage a separate account for you. The investment manager charges an ongoing management fee, perhaps 0.75 percent. Then the brokerage firm charges what is known as a "wrap fee," which is an ongoing fee that is wrapped around the investment manager's fee (the folks who you are already paying to actually manage your money). The brokerage firm collects both fees each quarter, pays the investment manager, and keeps the rest.

One major problem with separately-managed accounts (SMAs) is the brokerage firm's wrap fee, which can easily amount to twice as much as the investment manager's fee. Unlike mutual funds, the ongoing fee for SMAs is not hidden. All you have to do is look at your statement to identify the total you are being charged—however, the total fee is typically not itemized—so it is difficult to identify what portion of the fee is paid to the manager, and what portion of the fee is paid to the brokerage firm.

One reason wrap fees are so high is that the brokerage firm may not compensate a financial advisor for selling SMAs, unless he negotiates a wrap fee above a certain level, such as 0.50 percent annually.

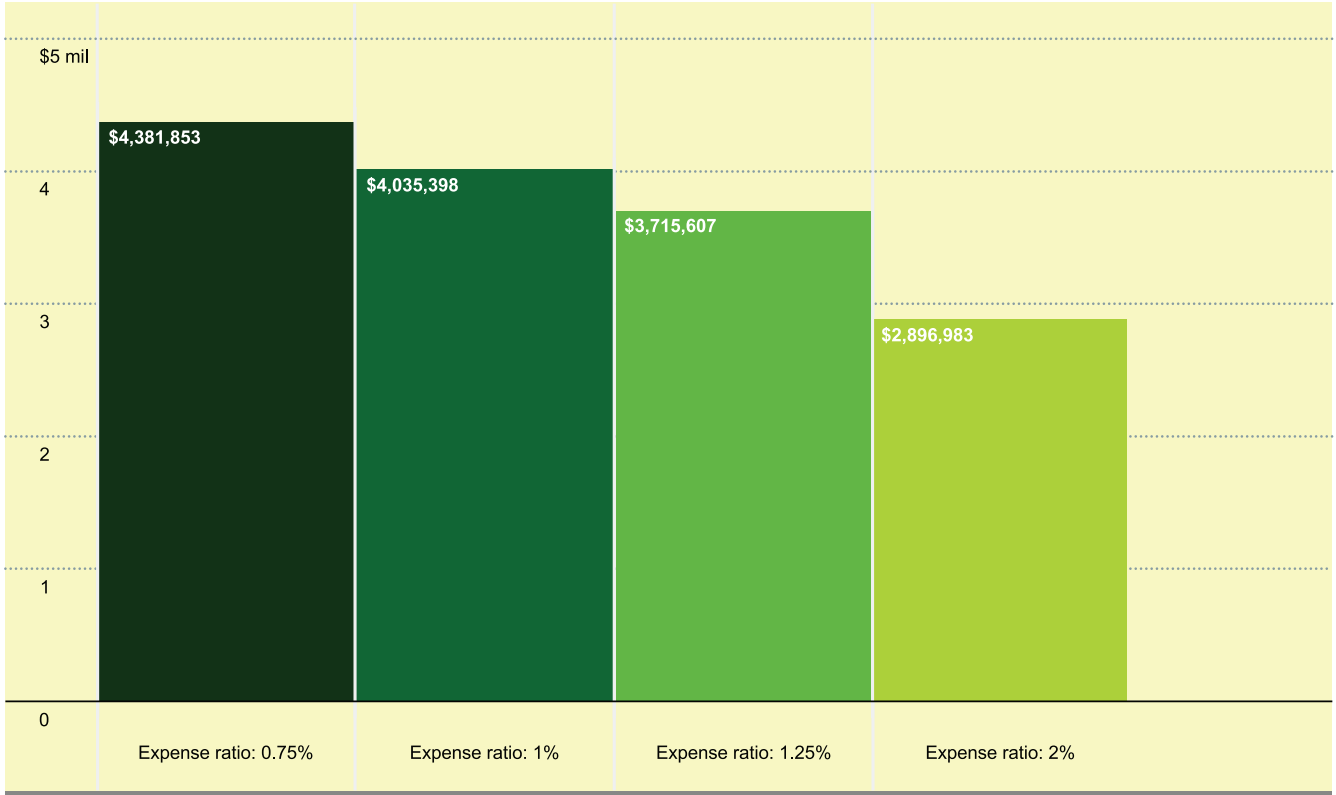
With SMAs, the financial advisor may receive a larger payout if he negotiates a higher fee. This compensation arrangement is clearly not aligned with your interests.

Keep in mind that this is just the wrap fee. When you include the investment manager's fees and administrative fees, the net impact can be 3.0 percent in annual expenses.

If you learn nothing else from this book, you should learn how devastating investment expenses are. Three percent is outrageous, and so is 2.0 percent. The illustration on the next page depicts the wealth one would have accumulated from 1975-2010, given a $100,000 investment in U.S. large cap stocks, applying various annual operating expense ratios. This is the same illustration that appears in Chapter 6. It is equally applicable where SMAs are concerned.

Fees Reduce Returns

Comparison of ending wealth values, 1975–2010



Past performance is no guarantee of future results. Ending wealth values based on a $100,000 investment in U.S. large stocks (data represented by the S&P 500® index). This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

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SMAs provide an opportunity to control capital gains distributions and manage tax obligations. Mutual fund distributions can't easily be managed in the most tax-efficient way. A more sensible way to manage both the tax liability and operating expenses is to simply purchase an index fund or ETF. Remember, the vast majority of investment managers fail to beat the indexes.

The next chapter provides a brief discussion of alternative investments.

Chapter 17: Alternative Investments "Alternatives"

What are alternative investments? Alternatives are those investments other than traditional investments, such as stocks and bonds. Examples include private equity funds and hedge funds. Both funds are typically structured as partnerships, and have a high barrier to entry due to the large minimum investments. A common structure may feature an asset-based management fee amounting to 1.5 to 2.0 percent per year as well as a bonus amounting to 20 percent of the profits.

Private equity funds usually have a longer-term focus, often purchasing companies to unlock value later through some liquidity event—such as a sale or public offering—or they may be focused on taking a publicly-traded company private.

Hedge funds often focus on trading strategies—trading stocks, bonds, currencies, and commodities. Hedge funds do not necessarily hedge their risk—often just the opposite. Many employ heavy use of leverage, and may amount to little more than a leveraged bet on a particular sector of the capital markets. Private equity funds use leverage as well.

Many hedge funds lack transparency. It can be difficult to pinpoint the true returns of hedge funds as a whole because so many of them go out of business, and their track record simply vanishes.

"Alternatives" may have a low correlation to traditional investments and are often used as a means of seeking greater portfolio diversification. Today, there are many investment vehicles in the alternative space, including some mutual funds, exchange-traded funds (ETFs) and exchange-traded notes (ETNs) which seek to mimic certain hedge fund strategies, such as long/short, arbitrage and others. Some provide exposure to a single commodity, such as oil, gold, silver, aluminum or copper. Some trade as open-end mutual funds and some, such as ETFs trade like individual stocks. Minimum investment amounts are lower as are the annual operating expenses compared to more traditional private equity or hedge fund partnerships.

In 2011, many investors were lured to alternative investments, hoping that they would find relief from hideously low bond yields and lackluster equity returns. Unfortunately, performance in the alternative space was disappointing as well—especially after fees are considered.

Exchange-traded notes are discussed in the next chapter.

Chapter 18: ODDS AND ENDS

Two investment vehicles which have not been discusssed thus far:

1) Exchange-traded notes
2) Non-traded Real Estate Investment Trusts (Non-traded REITs)

Exchange-traded Notes

Exchange-traded notes (ETNs) can be easily confused with exchange-traded funds (ETFs). ETNs appear to be very similar to ETFs. They are traded on an exchange just like an ETF; however, an ETN is simply a contract between the issuer and the purchaser. The return of the investment may be designed to track the stock or bond market as a whole, certain segments of the stock or bond markets, certain commodities or currencies. The purchaser typically accepts credit risk or counter-party risk from the issuer—a bank or brokerage firm, for instance.

The problem is that some ETNs do a very poor job of tracking their intended targets. The *Wall Street Journal* article found in Appendix B describes just how badly, and how quickly things can go South.

Non-traded REITs

A Real Estate Investment Trust (REIT) is a company which owns or finances income-producing real estate or mortgages. Many REITs operate the properties that they own. REITs are required to distribute at least 90 percent of taxable income to shareholders.

REITs may be publicly-traded on an exchange like any other stock, or they may be publicly-registered but not traded on an exchange. Publicly-traded REITs are fine to consider.

The dividend income for REITs is higher than the dividend income of other stocks. Yields can be even higher for non-traded REITs versus publicly-traded REITs. Non-traded REITs have less transparency and less liquidity than publicly-traded REITs.

When an investment lacks transparency, you should be very careful. Commissions, as well as operating fees can be excessive and it may be difficult to evaluate the value of the REIT's assets. Certain non-traded REITs have suffered huge declines in value as described in the *InvestmentNews* article featured in
Appendix C.

REITs, ETNs are often used in certain retirement accounts—the subject of the next chapter.

Chapter 19: Retirement Accounts

Most of the information in this book regarding diversification, fees, and working with a fiduciary can be applied to retirement accounts, such as 401(k)s, 403(b)s and IRAs. The following brief discussion identifies a few other things to keep in mind.

For many, retirement accounts represent a very large portion of their investment portfolio. Deferred taxation, as well as generous company- matching opportunities through which to acquire company stock, make vehicles such as 401(k)s very attractive.

There are, however, many rules governing retirement accounts that you and your financial advisor should be aware of. For instance, the rules regarding required minimum distributions (RMDs):

What if your spouse passes away and you inherit their 401(k)?

1. You could elect to take the cash—the least attractive option because the entire amount is taxed immediately as ordinary income. Moreover, if you are under 59½, the distribution will be subject to a 10% penalty for premature withdrawal.

2. If the surviving spouse continues working, the rule requiring that RMDs begin at 70½ does not apply.

3. The age of both the deceased spouse as well as the surviving spouse will determine additional options that are available. For example, if the deceased spouse was under age 70½, and the surviving spouse is under age 59½, the surviving spouse is not required to take the RMDs until such time that the deceased spouse would have been required to take them. Also, when the surviving spouse reaches age 59½, the funds can be rolled over into his or her IRA.

4. Knowing your options is critical to good decision-making. You may even find it advantageous to disclaim the inherited account, opting to establish a bypass trust to receive the assets.

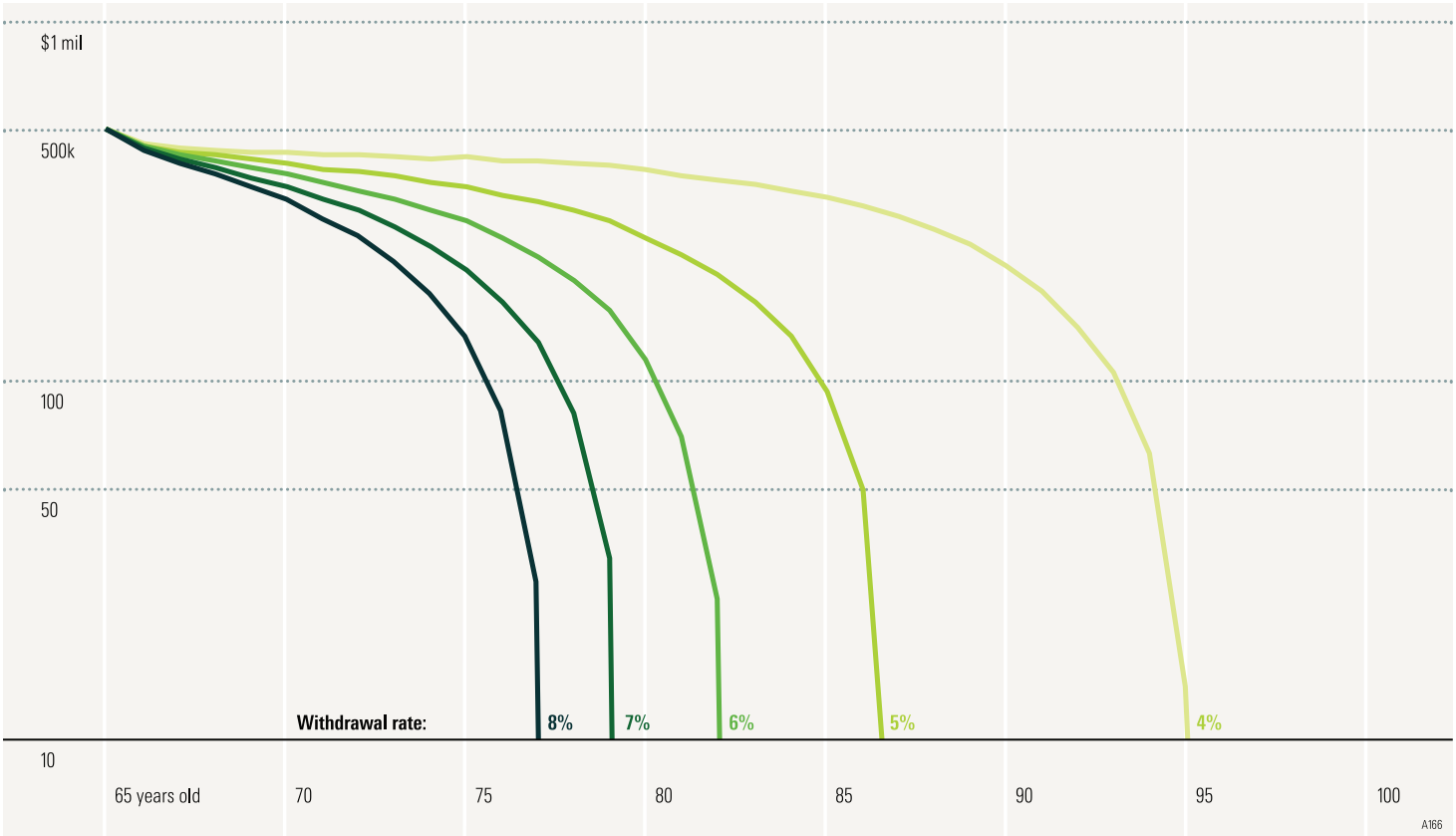
IRAs are sometimes used to purchase certain investment products such as variable annuities (VAs). In my opinion, the only reason to sell someone a VA in their IRA is to earn a hefty commission, often 5% or more. The VA already provides tax deferral, why put it in a tax-deferred account such as an IRA? Undoubtedly, you are already paying for the tax deferral feature when you purchase a variable annuity. Moreover, one of the few attractive features of a variable annuity is that—unlike IRAs—you are not required to take distributions at age 70½. VAs typically do not require distributions until much later—age 85 or 90, for instance. This allows your money to continue to earn tax-deferred income much longer. Purchasing a VA in your IRA destroys this benefit.

As always, periodically check your named beneficiaries for accuracy and identify all fees imposed upon plan participants. Obviously, the rate of withdrawal is critical. Generally, four percent is an acceptable level, but it depends on the circumstances. Depleting your balance too soon can be devastating. Consider the exhibit on the next page.

In the final section of the book, I offer specific steps that you as an investor can take immediately to gain better control over your financial future—whether you are selecting a financial advisor for the first time, working with your current financial advisor, or seeking a new advisor.

High Withdrawal Rates Will Quickly Deplete Your Assets

Simulated Portfolio Values (90% confidence level)



IMPORTANT: Projections generated by Morningstar regarding the likelihood of various investment outcomes using the Ibbotson Wealth Forecasting Engine are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Results may vary over time and with each simulation.
This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

MORNINGSTAR®

SECTION 6
WHAT TO DO NOW

Chapter 20: Important Questions

If you are concerned about how your financial matters are being handled, or you just want assurance that you are on the right track, you should seek a second opinion of your portfolio and an analysis of the arrangement you have with your financial advisor. You should consult a Fee-Only investment advisor—a full-time fiduciary who is not compensated by commissions.

Resources for finding a Fee-Only advisor are The National Association of Personal Financial Advisors (www.napfa.org), Vanguard Group (www.vanguard.com), The Garrett Planning Network (www.garrettplannning network.com), and ClientFirst Wealth Management (www.clientfirstwealth-management.com).

What if you already own a variable annuity?

You may be better off to surrender your policy and pay the surrender charge. Compare the surrender charge to the annual expenses to obtain a break even point. For example, if the surrender charge is 7.0 percent and annual expenses are 3.5 percent, you would break even in a little over two years, provided that you reinvest in an ETF with 0.20 percent annual expenses. If you also pay an advisory fee of 0.50 percent, your break even point would be approximately 2.5 years. Surrender charges may be tax-deductible, which could significantly shorten the break even period. There is a 10 percent penalty for surrendering the annuity before age 59½.

Earnings are taxed as ordinary income. If your variable annuity has significant earnings, instead of reinvesting directly in an index fund(s), consider a tax-free exchange for another more efficient annuity. This is known as a 1035 Exchange. Vanguard offers low-cost variable annuities featuring annual expenses of approximately 0.25 percent. The menu of the Vanguard annuity will consist of many low-cost, passive investment options that aim to match the performance of a certain index. As previously indicated, red flags should appear whenever a financial advisor recommends a 1035 exchange for another variable annuity which generates additional commissions. Vanguard annuities do not pay commissions, so there is no financial incentive to recommend a 1035 exchange for a Vanguard annuity.

What if you already own equity or stock mutual funds?

Identify the annual expenses you are paying and compare them to the expenses of holding a no-load index fund or ETF. If your fund has had some unrealized gains, you may want to hold on to it, or exchange it for a more cost-effective class of shares (such as advisor-class shares, if available). An exchange of share classes is typically not a taxable event. Take the same approach as you would when evaluating whether to hold a variable annuity. Identify your break even point after all surrender charges and annual operating expenses.

If you sell your mutual fund, you can purchase a no-load index fund or ETF in an advisory account. If you pay your financial advisor a 0.50 percent annual advisory fee (versus paying 2.0 percent in annual expenses for the mutual fund), your savings will be quite significant over time.

If you are unfortunate enough to have been sold B class or back-end load shares of a mutual fund, you will face multi-year surrender charges, just like an annuity.

What if I already own bond mutual funds?

Ideally, you can find an advisor who can design and manage a portfolio of individual bonds. This will allow you to replace your costly bond funds.

If you have owned the fund long enough to eliminate all surrender charges, you have a couple of alternatives. The first alternative is to see whether the

mutual fund company offers advisor-class shares of the same bond fund. These shares will be less costly to own, because they do not impose embedded sales charges. The only reason to consider this option is if you happen to have a significant capital gain and have no way to shelter the gain from taxation, such as a loss carry-forward. Otherwise, sell the fund and reinvest in a no-load index fund, fixed-income ETF, or individual bonds. There are many low-cost alternatives using passive management that track U.S. Treasuries, investment-grade corporate bonds, high-yield corporate bonds, and municipal bonds. If you own municipal bond funds, determine the amount of your bond income that is subject to the federal alternative minimum tax (AMT). Municipal bonds with coupon interest that is subject to the AMT are found in many municipal bond funds. They offer higher yields than similar bonds not subject to the AMT, but of course that extra income is "lost" to the investor at tax time. If you have an AMT problem and own a municipal bond fund with AMT bonds in its portfolio, you can sell the fund.

It can be difficult to find no-load index funds, or an ETF for municipal bonds comprised solely of bonds issued in your state of residence. If you are a resident of a state that imposes a state income tax, you can avoid that tax on the coupon interest if the bond is issued by an issuer located within the state. Certainly, if you own a high concentration of bonds in any state, it is even more critical that you know exactly what you own. Paying some state income tax can be a small price to pay for diversification. On the other hand, with state income taxes of 6.0 percent and higher, bonds that allow you to avoid this tax are well worth a look.

What if you already own Separately-Managed Accounts (SMAs) through a brokerage firm?

As with variable annuities and mutual funds, first conduct a break even analysis—comparing the annual expenses of the SMAs to those of no-load index funds and ETFs benchmarking the same index. SMAs can have very high annual expenses (up to 3.0 percent). Unlike annuities and certain share classes of mutual funds, SMAs have no surrender charges.

When exiting SMAs, your main concern is tax liability. For example, you may have four equity managers: large-cap, mid-cap, small-cap, and international. Identify your tax liability in each category. To the extent that you have gains, you can instruct the managers to offset them by taking losses where available. You can also request that any positions with net unrealized gains be delivered to your brokerage or advisory account "in-kind" so your gains are protected from taxation. However, you or your financial advisor will have to manage these positions in the future, which can be a time-consuming and complex task. Unrealized capital losses can be carried forward indefinitely, to offset future gains, or to be used against ordinary income up to $3,000 each year. You can redeploy the proceeds into cost-effective index funds or ETFs. If the SMA is comprised of bonds, you can take the entire account in-kind. Just be sure that you are working with an advisor that has experience managing a bond portfolio.

What if my account balance is less than $100,000?

If you have less than $100,000 to invest, you should consider using Vanguard or some other low-cost provider of comprehensive wealth management. If you work with a financial advisor compensated by commissions, you may be sold an annuity or a mutual fund with sales loads (load fund), high annual expenses, and surrender charges. If you establish an advisory account, the advisory fees may be too high to be efficient for a small account.

Where should I hold my account?

The victims of Bernie Madoff wish that they had paid more attention to who had custody of their assets. Be sure that your account and your assets are held at a well-known custodian. Never allow a money manager, wealth manager, or financial planner to have custody of your assets.

What if I like my present financial advisor, but prefer an advisory account?

Insist that your financial advisor obtain the necessary license (Series 65 or Series 66) to provide advisory services through an advisory account and act as a fiduciary. Many financial advisors are already licensed.

What if I already have a fee-based (as opposed to a Fee-Only) advisory account, but my advisor is partially compensated by commissions, and I do not want recommendations influenced by commissions?

You will need to search for an independent Fee-Only investment advisor. To find one in your area, go to www.napfa.org or www.garrettplanningnetwork.com, www.vanguard.com and clientfirstwm.com.

How do I know if the advisory fees that I am paying are fair?

Generally, any fee over 1.0 percent should be avoided. Advisory fees that include a comprehensive financial plan and periodic updates will typically be higher than those that do not.

How can I reduce advisory fees?

If you feel that advisory fees are too high, request a reduction. There is no law against negotiating. Request a proposal from competitors to use as a comparison. You may realize significant savings with another financial advisor.

If I terminate the client agreement, what fees am I entitled to recover?

Many fee-based advisory agreements charge fees quarterly, in advance. Others charge in arrears, after the work is done. If you have paid in advance, you are generally entitled to receive a pro rata refund for the remaining days in the quarter.

What if I am a trust beneficiary and wish to change trust companies?

It depends upon the language in the trust document. Some documents give the trust department or trust company a virtual lock on managing the assets. Trust departments, known more for their unremarkable money management than anything else, can relax knowing that they have no competition. It may be possible to move the assets to another trust company, and to have the financial advisor of your choice manage the investments. Studies reveal that one of the most common complaints from trust beneficiaries is discovering that trust assets are deployed in poorly-performing investments—often the bank's proprietary investment products that have high fees.

What if I already own a whole-life insurance policy?

If you already own a whole-life insurance policy, such as a traditional whole-life policy, a universal-life policy, or a variable-life policy, you should consider buying term-life and cashing out of your existing policy. You may be able to save a significant amount of money.

There may be extenuating circumstances under which you may not be able to achieve significant savings, and under which you have little choice but to hold onto your existing policy. If, for instance, you are not in good health, a new policy could be prohibitively expensive or unavailable altogether.

Where can I purchase cost-effective life insurance?

For online quotes from multiple insurance carriers, try www.selectquote.com or www.eterm.com.

What if I already own a target-date fund?

You need to read the prospectus carefully to be sure that asset allocation is not too aggressive. You can always contact the fund company, your financial advisor, or your 401(k) plan sponsor to get the answers you need.

What if I like working with my financial advisor, but I just learned that he has been disciplined or fined by a regulator?

In one word, *leave!* Find another financial advisor. You should periodically check your financial advisor's record at the appropriate regulator by visiting either www.sec.gov or www.finra.org.

What if I convert a variable annuity balance to a fixed annuity?

In this instance, the fixed annuity is a sum certain paid periodically for a period certain, such as 10 years or life, depending upon your needs. Once you "annuitize" your variable annuity balance, you will have credit exposure to the insurance company, just like any other fixed annuity. You should check to see what yields are available in the bond market before annuitizing. Chances are, if it is a good deal for the insurance company, it may not be such a good deal for you.

What if my 529 college savings plan is registered in my former state of residence?

Consider a rollover to another provider—one that offers a 529 in your new state of residence. This should enable you to avoid state income taxation. Be sure to compare investment alternatives and fees.

How do I re-title bank accounts or brokerage accounts so that they escape probate?

Just request Payable-on-Death paperwork from your brokerage firm, and Transferrable-on-Death paperwork from your bank or other depository institution.

What if I own a variable annuity in my IRA?

Fire your financial advisor! A large part of the value associated with a variable annuity is the tax-deferral feature, and you pay dearly for this feature, but your IRA is already tax-deferred.

What if my only life insurance coverage is group term-life, offered through my employer?

This situation is not uncommon. Depending upon the terms of the coverage, you may be able to maintain the coverage after you retire, but at much higher premiums. So, even if you do have employer-based coverage, you might consider buying an individual term-life policy as a supplement. Although the premiums may be higher, you will have portability if you change jobs and will avoid the need to shop for life insurance at retirement, when your life will be more costly to insure. By the time you retire, you may have health issues, making coverage unaffordable or unavailable.

What if an insurance agent is suggesting that I purchase one insurance product to help pay the premiums for another?

For instance, what if you need long-term care insurance and the agent suggests buying an annuity to generate income to pay the premiums on the long-term care policy? Request a written cost-benefit analysis and as always, make sure you are working with a fiduciary.

The next chapter provides a list of questions to ask your financial advisor.

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It's not how much money you make,
but how much money you keep,
how hard it works for you,
and how many generations you keep it for.

Robert Kiyosaki

Chapter 21: Questions To Ask Your Financial Advisor

The following is content from NAPFA's "Pursuit of a Financial Advisor Field Guide." Used with permission from NAPFA.

THE PURSUIT BEGINS

Finding qualified, independent financial advice should not be difficult, but it is for many hard-working Americans. With so many people claiming to be financial planners, financial advisors, financial counselors or wealth managers, how do you know when you've found someone who can really help you?

The National Association of Personal Financial Advisors (NAPFA), the country's leading professional association of Fee-Only financial planners, is pleased to provide you with this field guide to assist you in your pursuit for a qualified, independent financial advisor.

The **Pursuit of a Financial Advisor Field Guide** is set up to help you with every aspect of your quest, including:

- Preparation for the Pursuit
- Equipping Yourself—Knowing What to Ask!
- Selecting Where to Look

- Evaluating Potential Advisors
- Engagement
- Evaluating Your Advisor
- Additional Tools and Resources

Before you head out on your pursuit for a financial advisor, it is important for you to understand some basics about the financial services industry so that there are no surprises. After all, wouldn't it be troubling to hone in on a potential advisor, only to have he/she be a wolf in sheep's clothing? *For example:* Let's say you selected a financial advisor to develop a comprehensive financial plan for you and your family, but after you engaged the advisor, he/she focused solely on your investments and disregarded other aspects of your financial life. Even worse, you could be pushed into several investment or insurance products that are inappropriate for you. Based on this scenario, would you have engaged the advisor to begin with? Probably not. Unfortunately, if you don't prepare appropriately, you may find yourself in this exact situation.

Here's how you can properly prepare for the pursuit. First, you need to educate yourself about these aspects of working with a financial advisor:

- Credentials
- Compensation models
- Disciplinary issues
- Elements of financial planning
- Fiduciary vs. Suitability standards

Don't let there be any surprises.

CREDENTIALS

There are more than 100 professional designations in the financial planning industry, but only a few of them truly indicate a professional's ability to do real broad-based financial planning. All of those fancy letters after a planner's name may be significant, or they may just be a way of making the advisor sound more competent than he or she really is. NAPFA suggests looking for

financial advisors who have one or more of the following:

- Certified Financial Planner® (CFP®)
- Personal Financial Specialist (CPA/PFS) – granted to CPAs who meet necessary requirements
- Chartered Financial Consultant (ChFC)

NAPFA accepts both the CFP® and CPA/PFS credentials as meeting its requirement for a broad-based education in financial planning. Learn more at www.NAPFA.org/Consumer/FAQ.

How compensation is received may affect the advice YOU receive.

COMPENSATION MODELS

Be sure you understand the various ways in which a financial professional can be compensated. How compensation is received may affect the advice you receive, if that planner faces hidden conflicts of interest. The three most common models of compensation are:

Fee-Only Compensation. This model minimizes conflicts of interest. It is the required form of compensation for members of NAPFA. A Fee-Only financial advisor charges the client directly for his or her advice and/or ongoing management. No other financial reward is provided by any institution—which means that the advisor does not receive commissions on the actions they take on the client's behalf. Compensation is based on an hourly rate, a percent of assets managed, a flat fee, or a retainer.

Fee-Based Compensation (fee and commission). This form is often confused with Fee-Only, but it's not the same. Fee-based advisors charge clients a fee for the advice delivered, but they also sometimes receive payments for products they sell or recommend. In some cases, commissions are credited towards the fee, giving the appearance of a lower-priced option, but any outside compensation lessens the advisor's ability to keep the client's best interests first and foremost.

Commissions. NAPFA has always maintained that an advisor who is compensated through commissions is primarily a salesperson. A client working with a commissioned salesperson must always ask himself: 'Is this advice truly in my best interest, or is it the most profitable product for the advisor?'

Unfortunately, often the answer is the latter. In fact, a commissioned advisor usually is required to put the best interests of his employer ahead of the best interests of his client.

DISCIPLINARY ISSUES

You don't want to work with a dishonest advisor, regardless of the advisor's form of compensation. Although there are no foolproof ways of ensuring that the advisor is honest, there are numerous ways of tracking down information that will significantly increase your confidence in the integrity of the advisor you select.

A Registered Investment Advisor (RIA) is required to have a Form ADV—a document that is prepared according to regulations developed by the Securities and Exchange Commission (SEC) that must be made available to every prospective client. The Form ADV outlines an advisor's business, including compensation, experience, service offerings, and any disciplinary history. These documents are often available on an advisor's website. If not, you need to request a copy during the evaluation of the advisor's firm. To learn what to look for in the Form ADV, visit the SEC website.

The SEC and oversight organizations set up by the financial services industry also keep records about disciplinary actions against advisors. Before hiring an advisor, check out the SEC Investment Adviser Public Disclosure (IARD) website.

If your prospective advisor is not an RIA, he/she is most likely a registered representative of a broker/dealer. In this case you can check the FINRA *BrokerCheck* website or the NASAA *Check Out Your Broker* website for his/her disciplinary history.

It is a good idea to check both locations. Your prospective advisor may be a new RIA with a Broker/Dealer history.

Being diligent will help you be safe.

ELEMENTS OF FINANCIAL PLANNING

You will need to be careful on your quest. Just because someone calls himself/herself a financial planner does not mean that he/she is a financial planner.

Sometimes, the term "financial planner" is used by people to build false trust among consumers in an effort to sell financial products. A person who has passed the Series 7 examination, or who has a law degree is not necessarily a financial planner. True financial planning requires understanding all facets of personal finance—and developing the ability to use that knowledge through practical, hands-on experience with real clients.

As you approach potential advisors, keep in mind that a true financial planner should be able to help you address—among other things:

- Estate Planning
- Investments
- Education Funding
- Insurance and Risk Management
- Retirement Planning
- Senior Issues (including health insurance and long-term care)

FIDUCIARY VS. SUITABILITY STANDARDS

Although regulations now hold brokers to a somewhat higher standard, always insist on a fiduciary. Federal and state law requires that Registered Investment Advisors (RIA) be held to a Fiduciary Standard. **This requires an advisor to act solely in the best interest of the client at all times.** RIAs must disclose any conflict, or potential conflict, to the client prior to and throughout a business engagement and must adopt a Code of Ethics and fully disclose how they are compensated.

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.

Because broker-dealers are not necessarily acting in your best interest, the SEC requires them to add the following disclosure to your client agreement. Read this disclosure, and decide if this is the type of relationship you want to dictate your financial security:

"Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time."

If this disclaimer appears in agreements you are signing, you are not working with a Fiduciary advisor. If you wish to work with the broker, you should ask additional questions about how he or she is compensated, and where his or her loyalties lie. Then decide if the relationship is in your best interest. Be sure to read the fine print!

EQUIPPING YOURSELF—KNOWING WHAT TO ASK!

Once you are ready to narrow the field, here is a series of questions that will help you determine whether or not your targeted advisor will be a good match for your needs, and will work in your best interests. The following questions are accompanied by the NAPFA-recommended response you should receive to each question:

Is your firm a Registered Investment Advisor (RIA), a broker-dealer, or both?

NAPFA believes that any financial advisor offering comprehensive financial planning services should be registered as an investment advisor with either the Securities and Exchange Commission (SEC) or with the state regulatory agency within the advisor's state. Information pertaining to both SEC Registered Investment Advisors (and the vast majority of state registered investment advisors) is set forth on Part I of the advisor's Form ADV (see www.sec.gov). Unlike other investment professionals, only Registered Investment Advisors owe a fiduciary duty under law to their clients. Employees of broker-dealers do not owe the same duty of client care.

What is your educational background?

Although not currently required by regulatory authorities, NAPFA believes that a financial advisor should have an advanced education in financial planning topics such as investments, taxes, insurance, or estate planning, in addition to a college degree. Also, NAPFA believes that your planner should be required to participate in continuing professional education to keep his/her knowledge base current.

What are your financial planning designations, credentials and affiliations?

There are more than 100 certifications or designations financial advisors can obtain, but they cover a wide range in terms of education, experience and ethics requirements. Make sure your advisor's credentials indicate a broad-based education in financial planning topics and a requirement to put the interests of the client first.

How long have you been offering financial planning services?

To become a NAPFA-Registered Financial Advisor, a professional must have a certification (CFP® or CPA/ PFS) and must have at least three years of experience in financial planning. (Provisional members have certifications but have not yet achieved three years of experience.) Taking an advisor's experience into account can be important, especially when you are seeking comprehensive financial planning for a complicated financial situation.

Will you provide me with references from other professionals?

The financial advisor should be willing to share the name of another financial professional with whom he/she has worked. From this other financial professional, you might be able to learn more about your prospective advisor's abilities and strategies for recommending prudent courses of action. Privacy laws severely limit an advisor's ability to share client information.

Have you ever been cited by a professional or regulatory governing body for disciplinary reasons?

Be wary of a financial advisor who has been disciplined by a professional or regulatory body. In many cases, financial advisors who are disciplined are being held accountable for imprudent advice or abuse. You should, however, give an advisor the opportunity to explain his/her side of the disciplinary incident.

How many clients do you work with?

Personal attention is important when engaging a financial advisor. The number of clients an advisor works with will help you better understand how much attention he/she will be able to devote to you and your situation. If the number of clients seems excessive, ask how advising that many clients will affect your relationship. Keep in mind that larger firms often use a "team" approach in which numerous professionals on the staff will provide services.

Will you or an associate work with me?

When engaging a financial advisor, you will want to know whether you will be working with that person directly or another qualified professional who is part of a team. If the advisor indicates that an associate will primarily work with you, ask to meet that person prior to commencing the relationship.

Will you sign a Fiduciary Oath?

Accountability is important in financial planning. While there are many people in the financial services industry who profess to have the client's best interests at heart, they still may make recommendations that present a conflict of interest. NAPFA requires all of its members to sign a Fiduciary Oath; this helps to ensure that each client's best interests, not the advisor's, are always a priority. Learn about the NAPFA Fiduciary Oath by visiting www.napfa.org/about/FiduciaryOath.asp. Insist your advisor sign a Fiduciary Oath—the NAPFA Fiduciary Oath is excellent.

Do you have a business continuity plan?

A concern for many clients is they will retain the services of a financial advisor who might retire, pass away, or transition completely out of financial

services. If any of these events were to occur, what would happen to you? You should ask your prospective financial advisor if he/she has a plan in place to address any potential situations whereby he/she might no longer be able to provide services.

How is your firm compensated, and how is your compensation calculated?
NAPFA members firmly believe that financial advisors should be compensated solely by the client (a Fee-Only basis). Although NAPFA recognizes that financial planners can provide services on a commission basis, it is NAPFA's core position that a Fee-Only engagement removes the potential conflicts of interest that are inherent in a commission relationship.

Do you have an agreement describing your compensation and services that will be provided in advance of the engagement?
Prior to formalizing a relationship, a financial advisor should always provide full and clear disclosure about how he/she will be compensated. Ask for this information prior to signing a contract, and make sure you understand any conflicts of interest presented by the compensation arrangement.

Do you have a minimum fee?
Financial advisors may charge a minimum fee for services they render. If you have limited financial planning needs and/or a small portfolio, paying a minimum fee may not be in your best interests. If that is your situation, search for an advisor who will provide you with professional advice on a flat-fee, project, or hourly basis.

If you earn commissions, where do they come from?
While NAPFA encourages you to consider using a Fee-Only Financial Advisor, you may instead select an advisor who accepts commissions. Financial advisors who are compensated based on commissions should be able to explain how they are compensated, and identify what percentage of their compensation is derived from the sale of various commission-based investment products and/or securities trading.

Are you currently engaged in any other business, either as a sole proprietor, partner, officer, employee, trustee, agent or otherwise?
By knowing what other business ventures a financial advisor is involved in, you will better understand if there are any conflicts of interest with regard to the advice that you might receive. This is especially important if the advisor is involved with an investment-related entity. Ask for a detailed account of how that relationship will impact the advice he/she will provide you.

Does any member of your firm act as a general partner, participate in, or receive compensation from investments you may recommend to me?
Ask your prospective financial advisor if he/she is limited to presenting certain types of investments or investment products to you. If so, inquire why he/she is limited, and how this might affect the success of attaining your goals and/or the amount of fees to be paid.

Do you receive on-going income from any of the mutual funds that you recommend in the form of "12(b)1" fees, "trailing" commissions, or other continuing payouts?
Mutual fund and investment product sponsors often pay extra fees to advisors as a way to encourage the advisors to recommend their products to their clients. Also, investing in funds and financial products with these fees usually is more expensive than investing in products without the fees, because the sponsors raise the costs to recoup the fees. These fees are legal, but they can raise conflicts of interest on the part of advisors who accept them. A financial advisor who receives 12(b)1 fees or "trailers" is not a Fee-Only financial advisor.

Are there financial incentives for you to recommend certain financial products?
Commission-based advisors may receive higher commissions on certain products they sell than on others. They may also receive incentives like special awards, bonuses or trips based on sales volumes. This may influence their decision to recommend investment products that are not in your best interest. Ask your prospective financial advisor how his/her recommendation might affect

the success of attaining your goals, and/or the amount of fees you will pay (immediately, and over a period of years). Fee-Only advisors do not have this conflict of interest; they are able to recommend investments based solely upon your specific needs.

What personal financial issues will your services address for me?
Many financial professionals loosely use the term "comprehensive" to describe their range of financial planning services. At its best, comprehensive financial planning covers a wide range of both short- and long-term financial issues and addresses your personal goals, objectives, and significant life cycle events, but many advisors who say they are comprehensive do not really offer more than investment advice. Find out, in detail, what services your advisor is offering, because the broader the range, the more likely you will be getting truly comprehensive financial planning.

Do you provide a comprehensive written analysis of my financial situation and recommendations?
The financial advisor that you engage should be able to provide you with a written analysis of your current financial situation, as well as appropriate corresponding recommendations to help you accomplish your objectives. This written analysis can be both the culmination of your first comprehensive financial plan, as well as the starting point for a long-term client/advisor relationship that adjusts the plan at regular intervals.

Do you offer assistance to implement the plan?
The development of a comprehensive financial plan is the initial step to properly assess your finances and define your long-term goals. A plan, however, has little value until it is implemented. As opposed to 'going it alone', consider having your financial advisor implement the plan. Fee-Only advisors can often reduce your investment costs by investing in assets with reduced annual expenses and no related sales commissions.

Do you offer continuous, ongoing advice regarding my financial affairs, including advice on non-investment related financial issues?
Many consumers find regular or periodic reviews and ongoing

communication necessary to remain on track toward achieving their financial objectives. If this level of involvement is important to you, make sure the financial advisor you hire provides ongoing support.

Other than receiving my permission to have your custodian debit my investment account for your fee, do you take custody of, or will you have access to, my assets?

Allowing an advisor to debit your investment account for his/her fee is standard practice in the financial services industry; however, that should be the only direct access for withdrawals that the advisor should have. You should avoid permitting an advisor to have physical "custody of your investment assets" or the ability to make withdrawals or transfers from your account(s) without express specific prior written consent prior to each such withdrawal or transfer. Generally, Fee-Only advisors will not expose their clients to these "custody" type situations. When you use a Fee-Only advisor, an unaffiliated brokerage firm will usually maintain physical custody of your investment assets.

If you were to provide me ongoing investment advisory services, do you require "discretionary" trading authority over my investment accounts?

If you grant an advisor "discretionary" trading authority over your investment account, the advisor can place orders to either buy or sell securities without consulting with you ahead of time. If you have not granted your advisor "discretionary" trading authority, the advisor must obtain your approval prior to making any transactions in your account. If you are going to grant discretionary authority to your advisor, it is advisable to have a written document setting forth the terms and conditions of the discretionary engagement (usually set forth in an Investment Management Agreement). Make sure this is in place prior to making the first investment. Additionally, you should receive a signed, written document setting forth the investment parameters for the accounts to be managed (i.e. investment objectives, percentage allocations, restrictions, etc.), often referred to as an Investment Policy Statement. Of course, you should always continue to monitor the activity within your investment account to make sure that transactions are within the parameters of an agreed-upon investment policy.

Do you have many clients like me?

You are more likely to have an excellent experience with your advisor if he/she works with people of your asset level and concerns. Working with the "rock star" advisor sounds good, but unless you are a "rock star", you're not likely to get the best service.

SELECTING WHERE TO LOOK

It is time to find out where you need to look for an advisor. We recommend that you check several places to find a potential advisor, including:

Friends and Family

Those people who know you, your personality, and situation may be best suited to recommend an advisor for you. Ask your friends and family whom they go to, but keep in mind that your friend or family member who is making the recommendation is their own person, and their situation, comfort level, and risk tolerance may be significantly different than yours. Ultimately, you will have to be comfortable with your advisor.

Professional Referral

If you already work with an attorney or Certified Public Accountant (CPA), you could ask for a referral to an advisor they know and trust. These professionals know you and your current financial situation. In fact, more and more CPAs are offering financial planning and investment management. This arrangement can make a great deal of sense, provided they are registered only with a RIA, making them fiduciaries—versus being dually-licensed with a RIA as well as a broker-dealer, and merely selling products.

Professional Resources

There are several search engines available to consumers who are searching for a financial advisor. Again, be careful. Some of these search tools are nothing more than marketing sites that allow any advisor to purchase a link for a fee. We recommend looking into the following search tools because the advisors on these sites have earned their participation by meeting the standards set by independent organizations:

- NAPFA's Find An Advisor – Search for Fee-Only financial advisors who are held to a strict Fiduciary Standard
- CFP® Board of Standards Search – Search for CFP® professionals of all compensation models
- Garrett Planning Network – Search for Fee-Only financial advisors who only charge an hourly fee for services (most of whom are NAPFA members)
- Alliance of Cambridge Advisors – Search for Fee-Only financial advisors (all of whom are NAPFA members)

EVALUATING POTENTIAL ADVISORS

One of the best pieces of advice anyone can give you is "don't settle" for an unsatisfactory advisor. Don't settle for the first financial advisor you find. Keep your options open and find one who not only answers the questions the "right" way, but also one who makes you feel comfortable. Ensure your personalities mesh. Be certain that their interests solely lie in helping you achieve your financial objectives.

When you have narrowed down your search to a few potential advisors, ask for an introductory meeting where you can familiarize yourself with their respective practices. At the meetings, initiate the conversation by explaining why you are searching for an advisor and by sharing your personal goals! Be sure to cover:

- Why you are there
- How you found the advisor
- Your previous experience working with an advisor
- Your goals (personal, family, business, etc)

Once you have shared your information, ask the advisor a series of questions to gain more clarity on him/her and their firm. We recommend that you print a copy of the *NAPFA Financial Advisor Diagnostic* and bring it with you to the meeting. Ask the advisor to go through the Diagnostic with you, and note the answers to the questions.

Once you have completed all of the meetings, you can then compare the completed Diagnostics and check the responses against the provided answer key. Based on how the advisor answered the questions, combined with your

personal comfort level with each advisor, you are ready to select an advisor who you feel will be best for you.

ENGAGEMENT

Now that you have found an advisor you want to engage for your personal planning needs, you need to finalize the relationship. It is not as simple as saying, "Okay...I want you." You need to be sure there is an understanding in place about compensation, the services to be provided, and much more. Here are the documents that MUST be provided to you and signed by both you and the advisor:

Investment Management Agreement. A written document setting forth the terms and conditions of the discretionary engagement (if discretionary authority is being granted to the advisor).

Investment Policy Statement. Usually, an Investment Policy Statement is a written document setting forth the investment parameters for the accounts to be managed if the advisor is managing your investments, instead of just making recommendations (i.e. investment objectives, percentage allocations, restrictions, etc). Some advisors do not use these documents, or prepare the document as part of the planning process. Most advisors should be able to provide you with a statement of the investment philosophy of the firm including the types of investments used and whether or not they use outside managers.

Form ADV. Advisors registering with the SEC as a Registered Investment Advisor (RIA) must file a Form ADV if they manage more than $100 million in assets (and they must with their state if they manage less than that amount). The Form ADV outlines the advisor's compensation, background, service offerings, disciplinary history, and more. Learn more about the Form ADV on the SEC's website.

Fiduciary Oath. As stated, all NAPFA members must provide new clients with a signed copy of a Fiduciary Oath that binds them to the client's best interests. Not all advisors are willingly going to sign it, so be sure to ask if the advisor you are considering engaging will sign it for you. See NAPFA's *Fiduciary Oath* as an example.

Remember, do NOT pull the trigger until the advisor has been able to supply you with the above documents (if relevant) and you have reviewed them and had your questions answered.

EVALUATING YOUR ADVISOR

It's imperative that you continue to monitor your advisor throughout the relationship. You are hiring the advisor to fulfill your goals and objectives – either they are meeting your needs and living up to the high standards you are setting, or they aren't.

Every consumer is different, so what makes a relationship with a financial advisor "successful" for you may be different than the next person. So, when evaluating the performance of the advisor, review:

1. The investments and planning services outlined by the advisor at the time of engagement. Have the investments met what was outlined in the Investment Policy Statement? Have the recommended services been provided? Has the advisor's "activity" been documented and proven to support your stated goals?
2. The compensation you are paying the advisor. Have you paid the advisor anything other than what was specified in the Investment Management Agreement?
3. The timeliness of response to any questions or concerns. Has the advisor, or the advisor's firm, responded to your requests in a timely manner?
4. The effectiveness in working with other members of the advisor's team. Has the experience of working with others on the advisor's staff met your expectations?
5. Overall communication with the advisor. Has the advisor been accessible when needed? Are you hearing from the advisor frequently, not just when your quarterly bill is due? Do you get the feeling the advisor has a genuine interest in you, your family, and your situation?
6. The performance of investments relative to stated benchmarks. If the advisor stated a benchmark or goal for investment returns, have the investments met it?

Review each of these at least annually and compare the results of this

review from previous reviews. If you are seeing a change for the worse, contact the advisor immediately and schedule a meeting so you can share your concerns.

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Accountability breeds responsibility.

Stephen R. Covey
American Author

Chapter 22: CONCLUSION

Thank you for taking the time to read this book. It is designed to help you develop a relationship with an investment advisor that puts you on an equal footing.

If you don't know what to expect from your advisor, then you will be unable to direct him to fulfill your needs. You must come prepared with an understanding of what your advisor can do for you, as well as what he is legally obligated to do for you. Don't be afraid to ask questions—or to ask them again if you don't understand the answer.

RECOMMENDED READING

Bonds Now! Making Money in the New Fixed Income Landscape
by Marilyn Cohen and Chris Malburg, John Wiley & Sons, Inc., New York

Fooled by Randomness by Nassim Nicholas Taleb
Random House, New York

Investing–Starting from Scratch by Janet Holt
Eakin Press, Waco, Texas

The Little Book of Common Sense Investing by John C. Bogle
John Wiley & Sons, Inc., New York

The Most Important Thing by Howard Marks
Columbia Business School Publishing

The New Coffeehouse Investor by Bill Schultheis
Portfolio, a member of Penguin Group (USA), Inc.

The Only Investment Guide You'll Ever Need by Andrew Tobias
Harcourt, Inc., Orlando

The Random Walk Guide to Investing by Burton G. Malkiel
W.W. Norton & Company, New York

Your Money and Your Brain by Jason Zweig
Simon & Schuster, New York

APPENDIX A

Goldman flap underscores fiduciary issue

by Darla Mercado • *InvestmentNews,* Vol. 16, No. 12

When midlevel Goldman Sachs executive Greg Smith blasted his firm publicly last week for what he deems is rapacious behavior toward corporate and institutional clients, many retail advisers whose résumés include wirehouse stints nodded in recognition.

His New York Times Op-Ed piece struck an emotional chord with many of them who recalled relentless sales pressure.

"During the last 30 days that I worked at a brokerage firm, I received 25 e-mails from my branch manager on why every one of my clients needed to have [some] new proprietary mutual fund," said Bob Rall, a Fee-Only adviser at Rall Capital Management and a veteran of Prudential Securities Inc.

"Everything was about the YTB on the product—the yield to the broker—not the yield to the client," he said.

WAKE-UP CALL

Russell G. Thornton, a vice president at Wealthcare Capital Management Inc. and a Merrill Lynch alumnus, agrees.

"Within the commission and sales environment of the wirehouse world, the general operating principle is: 'How can I sell the most stuff to my clients?' " he said.

Although Mr. Smith's frame of reference reflects the institutional market, some advisers hope that his Op-Ed will be a wake-up call for clients, getting them to demand better quality of service they receive from advisers.

"One thing this … will certainly do is make the idea of a client-first duty of care harder to ignore," said Michael Branham, an adviser at Cornerstone Wealth Advisors Inc. and 2012 president-elect of the Financial Planning Association.

"Regardless of your legal obligation, it makes business sense to put the client's interests first," he said. "Whether it's [The Goldman Sachs Group Inc.] or a small independent broker-dealer, that's what clients are really asking for."

Some of the media coverage declared that advisers true loyalties to themselves and their firms, not their clients.

"A blazing resignation at Goldman Sachs shows us once again that financial advisers too often put their own interests first," blared a sub-headline in an article posted last week on Time magazine's website.

Some advisers think that they are far enough from Wall Street so that the Op-Ed won't spur clients to question their commitment.

But others said that all the attention the Op-Ed generated only made a stronger case for highlighting the distinction between advice from a fiduciary and product information from a sales representative. If anything, it gives the public a hint of the battle brewing in Washington over from whom a fiduciary standard of care should be required.

CLIENT LOYALTY

"I think clients want to know that whoever is working with them has their interests at heart, and that there's more loyalty to the client than to the firm," said Susan John, chairwoman of the National Association of Personal Financial Advisors.

"In the world of Greg Smith, the affected clients are institutional and presumed sophisticated—they should know and understand the rules of the game," said William L. McCollum, a portfolio manager and chief compliance officer at Eagle Financial Management Services LLC.

"To the retail client, the revelation of conflicts of interest may come as a surprise: They have been misled to believe that their interests come first, when in most cases, there exists no fiduciary relationship," he said.

"These firms and their representatives should not pretend to be something they are not," Mr. McCollum said.

But other advisers think that the basic tenet of doing what is best for the client transcends business models. In other words, Fee-Only service arrangements are the only way to do right by the customer, because bad apples can turn up among those advisers, as well.

"The whole fiduciary thing has been blown out of proportion, and ultimately it boils down to trusting someone," said Mr. Thornton, who describes his Fee-Only business model as "not better, but different" from his previous commission-based work.

"There were people I didn't like and didn't trust at Merrill, but I also know Fee-Only people who I don't trust or understand. Bernie Madoff should have been a fiduciary, and he was the worst." Mr. Thornton said.

"If you do what's best for the client, you still make money—but that's long-term, as opposed to short-term," said Rick Peterbok, chief executive of Interactive Financial Advisors, a dually-registered firm. "If you do more to help the client, the rest will be OK."

APPENDIX B

Chaos Over a Plunging Note

Complex Security Drops 60% in Value in Just Three Days; SEC Is on the Case

by Tom Lauricella, Jean Eaglesham and Chris Dieterich

Regulators are examining a complex exchange-traded note after volatile trading in the securities over the past week caused a 60% drop in value in just three days.

The Securities and Exchange Commission is looking into the VelocityShares 2x Long VIX Short Term Exchange note, sponsored by **Credit Suisse Group** AG, according to people familiar with the matter. The review, which could include trading and disclosures, is preliminary, the people said.

The scrutiny comes amid rising investor alarm and confusion over trading in exchange-traded notes. The Credit Suisse note, which trades as TVIX and is designed to track stock-market volatility, plunged 29% on Thursday last week and then another 29% the next day, even though market volatility was little changed. Another exchange-traded note, a **Barclays Capital** product designed to track natural gas, plunged this week for reasons that investors say remain unclear.

Spokeswomen for Credit Suisse and Barclays declined to comment.

Market observers say the confusion underscores the deceptively risky nature of exchange-traded notes. While hedge funds are usually the most active traders of the securities, the notes have become more popular with smaller investors, in part because they are low cost and easy to trade.

But what looks like a plain-vanilla instrument can be treacherous, said Samuel Lee, an analyst at Morningstar Inc. who follows exchange-traded investments. “It's an issue of financial innovation opening up these esoteric markets and allowing individual investors pile into them faster than the regulators can keep up,” Mr. Lee said.

Another type of security, exchange-traded funds, have exploded in popularity for similar reasons.

On the surface, exchange-traded notes, widely known as ETNs, appear similar to exchange-traded funds, which trade like stocks on an exchange. But the inner workings of ETNs are more complicated. An ETN doesn't actually hold any underlying investment as an exchange-traded fund, or ETF, would. Instead, an ETN

is contractual agreement by the issuer to pay shareholders returns equal to the investments it is designed to track.

Adding to complexity of this situation, the Credit Suisse ETN is linked to the Chicago Board Options Exchange Volatility Index, or VIX. That index, which is based on options prices, can experience wild swings. The Credit Suisse ETN is designed to magnify that volatility; investors make or lose twice as much as the daily move in the VIX.

Similar "leveraged" products have been the subject of scrutiny before. During late 2008 and again last summer, they were blamed by some for fueling late-day swings in stock prices.

Industry participants say the troubles in the Credit Suisse offering started as it approached $700 billion in assets and became too big for the market it was trying to track. Then, as the bank scrambled to manage the problem, it set off a chain of events that led to the price collapse.

The Credit Suisse ETN more than quadrupled in size this year. Meanwhile, the leveraged aspect of the fund required it to rebalance its portfolio at the close of trading each day based on moves in the VIX. Because traders knew that, they could profit by buying or selling before the fund, pushing prices higher and costing the bank more. Also, traders speculate Credit Suisse may have had internal limits on how much it could buy.

On Feb. 21, Credit Suisse suspended issuance of the ETN's shares "due to internal limits on the size of ETNs." The announcement carried a warning that the move "may cause an imbalance of supply and demand" in the ETN's shares.

But some investors continued to buy the now-limited shares of the fund, driving up the share price even as the VIX itself was falling. As a result, there was a steadily widening gap between the share price and its net asset value based on the level of the VIX.

On March 21, shares of the ETN closed at $14.43, 89% higher than its $7.62 net asset value, according FactSet Research.

Hedge funds and other sophisticated traders saw an opportunity and began aggressively betting the shares would decline. After the halt, the number of the ETN's shares borrowed by short sellers nearly quadrupled overnight, from nearly 600,000 on Feb. 21 to about 2.2 million a day later, according to Data Explorers. By March 22, the number of shares borrowed had jumped to 4.1 million.

But individual investors such as Eric Brehm, owner of a medical-supply distribution business in Sunnyvale, Texas, were in the dark. On Feb. 22, he had bought 2,200 of the shares for $17.30 each. it "was a way to hedge if the market took a big drop and offset my losses in other securities," the 59-year-old Mr. Brehm said.

Seemingly out of nowhere on March 22, the share price for the ETN went into a free fall, losing 29% on its way down to $10.20. That evening, Credit Suisse announced it would issue new shares of the ETN on a limited basis, raising eyebrows among traders who wondered if word of the move leaked out. Over the next two days it would fall further, closing at $5.88 on March 26.

—Ben Levisohn contributed to this article.

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A blindfolded monkey throwing darts
at a newspaper's financial pages
could select a portfolio that would do
as well as one carefully selected by experts.

Burton Malkeil
American economist and writer

APPENDIX C

Nontraded REITs need more regulation

Editorial, *InvestmentNews*

Given the barrage of negative publicity surrounding nontraded real estate investment trusts, broker-dealers and REIT sponsors have a vested interest in working closely with regulators to improve investors' understanding of the value and performance of nontraded REITs.

If they don't, they're likely to find themselves saddled with regulations that are cumbersome, costly and, most importantly, even more confusing than those that exist today.

Broker-dealers and REIT sponsors need to step up their efforts to develop industry-accepted standards for formulating asset valuations and to hold brokers more accountable for making sure nontraded REITs are suitable for the clients to whom they are recommending them.

RISKY FOR SENIORS

Regulators are right to set their sights on the nontraded-REIT industry. As sales of nontraded REITs have grown—no doubt thanks to the volatility of the stock markets and the low-interest-rate environment—so, too, has the number of investors, many of them seniors, who have found themselves blindsided by plunging share values or inadequate disclosure related to the illiquidity of their investments.

In an article appearing last week in InvestmentNews, news editor Bruce Kelly profiled the plight investor Susan Fox, who watched the value of nontraded-REIT shares in her IRA plummet. One of those REITs—Cornerstone Core Properties REIT Inc.—recently disclosed that its share value had dropped 72% to $2.25, from $8. In the story, Ms. Fox, 63, alleged that her broker invested too much of her retirement savings in nontraded REITs and that she was not made aware of the inherent illiquidity of those shares.

Ms. Fox is hardly alone. Last May, the Financial Industry Regulatory Authority Inc. accused David Lerner Associates Inc. of selling shares of its real estate funds to elderly and unsophisticated clients.

Clearly, more regulation is warranted. On March 7, Finra issued a revised proposal to amend NASD Rule 2340 to address the "per-share estimated values" at which unlisted direct-participation programs, including nontraded REITs, are reported on customer account statements.

Under the revised proposal, broker-dealers no longer would be required to provide investors with a per-share estimated value, unless and until the issuer provided an appraised value of the shares in a periodic report filed under the Securities and Exchange Act of 1934. During a nontraded REIT initial-offering period, broker-dealers would have the option of representing the security as "not priced" or presenting investors with a net offering price minus the broker's upfront commissions.

The public-comment period for that proposed rule change ends April 11. If enacted, the rule change would improve investor protection in two ways. First, it would shine light on the high upfront broker commissions for selling REITs. Those commissions, which often range from 10% to 15%, inevitably would fall—decreasing the incentive for brokers to sell unsuitable nontraded REITs.

Additionally, the rule change would help eliminate investor confusion about the value of REIT shares during their IPO period—and, in some instances, well beyond that.

In and of themselves, nontraded REITs are neither "good" nor "bad"; they're simply investment vehicles that are suited to some investors, but not to most.

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ABOUT THE AUTHOR

In 2007, Ed Mahaffy founded ClientFirst Wealth Management, LLC—an independent Fee-Only registered investment advisorand fiduciary—after more than 23 years in the securities industry. He holds the Certified Financial Planner and Chartered Financial Consultant designations, and is a member of the National Association of Personal Financial Advisors. Ed earned his MBA from the University of Arkansas, and his BSBA from The Citadel.

He has written many articles for various publications, including *Barron's*. He lives in Little Rock, Arkansas with his wife, children and dogs.

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