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The Value of Advice: Is It Worth the Fee?

Stephen C. Winks

It is the rarest of investor who does not see the benefit and understand the wisdom of engaging professional investment and administrative counsel in making investment decisions. As individuals, we are either too close to our investments and surcome to our emotions, or are so busy and so distant that we fail to exercise our discretion. The knowledge, judgement and dispassionate attention brought by professional investment and administrative counsel to our financial affairs is well worth its cost, even if we are financially astute as investors. This is why physicians engage other physicians when it comes to their own health.

As investors. we are loyal to a fault to our financial advisors, yet because we can only hear and see what we understand or what we are interested in, we are rarely our own best counsel. We all are limited in our investment considerations, not only by our professional knowledge, our interests and life experiences, but by our egos, our sense of trust and/or control that obscures or even precludes sound reasoning. Thus, even though there is a clear need for investors to engage professional investment and administrative counsel, this almost insatiable desire for reliable counsel has proven to be difficult to attain.

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In the abstract, it is easy to presume there are a large number of advisors (1) who are capable of addressing and managing a broad range of investment and administrative values as required by regulatory mandate, (2) who are willing to acknowledge their fiduciary responsibility and (3) who are accountable for their recommendations. Yet the reality is that there are far more investors who want value to be added than there are advisors capable of adding value.

This is not because of lack of interest on the part of the financial advisor; it is because the culture, support infrastructure and technology of the financial services industry, embedded in well over two centuries of practice, is, by design, geared for commission sales and product distribution, not to adding value and the fulfillment of fiduciary responsibility. The historical reality that persists today is that most financial advisors do not get paid until they sell an investment product, and firms that support financial advisors, as a consequence, are structured along product lines. There is a mutual fund product manager, a managed account product manager, an annuity product manager, etc. who can help advisors sell the specific products they manage; but, there is no one who can help the advisor cut across all financial product areas to construct portfolios for clients that effectively address and manage the values of risk, return tax efficiency, liquidity, lost structure and time essential for clients to achieve their goals and objectives. The advisor is left to their own devices in addressing and managing a broad range of investment and administrative values required by regulatory mandate. There is no institutionalized AIMR complaint monitoring of all of a client's holdings (investments, insurance, trusts, qualified plan assets, credit balances, etc. - held at multiple custodians) which is necessary in order for it to be even possible for the advisor to add value. This is not by accident, but by design.

The organizations supporting financial advisors have good reason to fear the fiduciary liability associated with their advisors rendering investment advice. Thus, broker/dealers supporting financial advisors have structured client relationships so that neither they, nor the financial advisors they support, acknowledge, imply or offer investment advice. The formal role of the financial advisor is simply to make the investor aware of investment alternatives. Technically, the client relationship is structured so that the investor makes the investment decision. In essence, investors are responsible for their own investment decisions and are required to become their own investment counsel. This absolves the firm and their advisors of fiduciary responsibility and its associated liability, but by extension, it also makes it institutionally impossible for the advisor to add value. Thus, if no advice is acknowledged, implied or offered, there is, in

fact, little or no value that can be ascribed to financial advisors and their supporting firms who are engaged in commission sales. This is the reason why commission brokerage rates have declined 60% over the past decade and why advisors will have to be two and a half times more productive today just to maintain their earnings of a decade ago. Investors reason that if no value is being added in commission sales, why should they pay several hundred dollars to execute a trade with a full-service broker, when the same result can be achieved for $10 or less. In neither case is value being added, which why commission brokerage is becoming a commodity service.

Even though investors would like value to be added and advisors want to add value, unless the financial advisor (1) takes the personal initiative to gain access to the processes and technology necessary to add value, (2) creates a division of labor within their practice to facilitate high level counsel and (3) acknowledges fiduciary responsibility; it is simply not possible for financial advisors engaged in commission sales to address and manage a broad range of investment and administrative values as required by regulatory mandate.

There is a disconnect between selling financial products and adding value. Financial products in their own right add no value. It is what an advisor does with the financial product, or process, that adds value. In an industry which is structured along financial product lines with a product management organizational structure, the process through which value is added is highly disruptive. Product managers, around which advisor support organizations are built, are reluctant to subordinate their product area and their money, power and status within the organization to an objective process which, at best, is neutral on their product, or at worst, discourages their product's use. To fill this leadership vacuum, advisors must create their own processes and associated technology necessary to add value and fulfill their fiduciary responsibility. In "How Are Top Advisors Continuing to Grow Their Businesses At a Double Digit Clip in a Difficult Market" (*Senior Consultant,* April 2003, http://www.SrConsultant.com/Articles/2003-04-Top-Advisors-Grow.pdf), we explain how an advisor adds value using a investment process consisting of six financial services (asset/liability study, investment policy, strategic asset allocation, manager search and selection, performance monitor and tactical asset allocation), which is implicit in fulfilling their fiduciary responsibility (citing statute, case law and regulatory opinion letters) as well as establish the technology and division of labor within their practice that is necessary in order to add value. There is no doubt that all investors want value to be added, as it is clearly preferable to the other option. Assuming the advisor is capable of adding value, the question then becomes: Is the value added worth the fee required to engage the professional investment and administrative counsel of the advisor?

ASSUMING THE ADVISOR IS CAPABLE OF ADDING VALUE, THE QUESTION THEN BECOMES: IS THE VALUE ADDED WORTH THE FEE REQUIRED TO ENGAGE THE PROFESSIONAL INVESTMENT AND ADMINISTRATIVE COUNSEL OF THE ADVISOR?

Dalbar has done research that suggests that the average return achieved by investors acting on their own behalf, without the benefit of professional counsel, is nearly 5%, while the return realized by utilizing advisors is just 50 basis points (one half of one percent) better. This reaffirms the thesis that advisors engaged in commission sales add little or no value. Yet, for those advisors who have developed the processes, technology and division of labor necessary within their practice necessary to add value and fulfill their fiduciary responsibility, there is considerable value that can be added relative to the poor returns achieved by investors who have to rely on their own limited counsel. But there is no question that the cost of professional counsel does somewhat offset the value the advisor adds. So, how do you compensate a highly skilled advisor? Should these highly skilled advisors (senior investments management consultants) earn half of the returns realized in excess of that which the client can achieve on their own? No, because the absence of professional counsel creates far too low of a threshold for performance. This would exaggerate the added value attributed to the consultant. The client could always invest in an index fund or an ETF, and use that as a threshold for performance. As an alternative then, should these highly skilled senior consultants be compensated on a share of the return they achieve in excess of a custom index based benchmark developed for each investor? No, because it would minimize the value the consultant adds and does not take into consideration important aspects of counsel that are not return-related such as tax efficiency, risk, cost structure and liquidity. If the emphasis is solely on the return, in order to beat the benchmark, the advisor would be motivated to take more risk than implied by the benchmark, as the advisor is not being measured based on risk. Or, if the benchmark return becomes particularly challenging to achieve, the advisor would seek other forms of compensation from other sources such as mutual funds which offer on-going 12(b)1 compensation and are three times more expensive than managed accounts. Again, if no one is monitoring or disclosing the cost structure of investment vehicles, the investor would not be aware of the on-going compensation secured by the advisor from mutual fund companies. This is why, Congress and state legislatures have created public policy in the form of UPIA, ERISA, UMIFA and UMPERS, which establishes the parameters within which an advisor must work in order to fulfill their fiduciary responsibility and why most major financial services firms will not acknowledge fiduciary responsibility and its associated liability. Fiduciary responsibility requires full disclosure of all forms of compensation of all relationships and of all potential conflicts. Insurance agents would have to disclose that they earn hundreds of thousands of dollars by simply arranging for large employers to switch defined contribution plan providers without any material change in plan or participant services. Commissioned brokers would have to disclose

that popular mutual funds are three times more expensive than managed accounts. Asset management firms would have to voluntarily disclose that they are not performing well relative to their investment mandate and their appropriate peer group. This, of course, is very unlikely as money managers would have to ultimately fire themselves, if they were acting in their clients' best interest.

The role of the advisor should always be to act in the client's best interest, without conflicts of interest. The only way to achieve this is through full disclosure and the acknowledgement of fiduciary responsibility. As a consequence, the best means of compensation is to engage the professional investment and administrative counsel of an advisor for an on-going advisory fee that entails full disclosure. This requires the advisor to address and manage a broad range of investment and administrative values as required by regulatory mandate and set forth in investment policy. There is no economic incentive for an advisor to make an investment recommendation unless it is in the best interest of the investor. A fee-based advisor with the right division of labor within their practice, access to the enabling processes and technology, and the full disclosure of all material facts as required by regulatory mandate can provide a truly extraordinary level of counsel. Make no mistake; this requires extraordinary effort on the part of the advisor and an extraordinary expenditure of capital, intellect and resources.

THE ROLE OF THE ADVISOR SHOULD ALWAYS BE TO ACT IN THE CLIENT'S BEST INTEREST, WITHOUT CONFLICTS OF INTEREST. THE ONLY WAY TO ACHIEVE THIS IS THROUGH FULL DISCLOSURE AND THE ACKNOWLEDGEMENT OF FIDUCIARY RESPONSIBILITY

The seldom disclosed secret of senior investment management consultants is that they have limited time to engage, and continuous, comprehensive counsel, as required by regulatory mandate, is very labor-intensive. If an advisor is to offer continuous comprehensive counsel, there is a limit as to how many clients the advisor can humanly serve. Typically, the financial services industry's top advisors provide continuous, comprehensive counsel to 100 clients or less. Depending upon the division of labor within the advisor's practice, either more clients can be served or a higher level of custom service can be provided to a smaller number of clients. Yet, because continuous, comprehensive counsel is so demanding on time, talent and resources, regardless of whether a client has $10,000 or $10 billion, the advisor gravitates towards clients with larger assets, who have the greatest needs, who view fiduciary responsibility more seriously and who have a greater appreciation of high level counsel. So, it is not uncommon for advisors who are capable of offering high level counsel to have an account minimum of $250,000-$1 million or more. Some senior consultants only entertain new client relationships of $10 million or more, and in the institutional market, $100 million minimums are common. This assures a high level of counsel is both economically viable for the advisor/senior consultant to provide and that their counsel is responsive to the unique needs of each client, typically entailing highly customized client support.

So, what exactly is this high level counsel, how much does it cost, is worth it and how do you find it? Describing high level counsel and its six financial service investment process is a topic onto itself and is described in "How Are Top Advisors Continuing to Grow Their Businesses At a Double Digit Clip in a Difficult Market" (Senior Consultant, April 2003, http://www.SrConsultant.com/Articles/2003-04-Top-Advisors-Grow.pdf). There are 97 responsibilities that the advisor must fulfill through an implied six financial service investment process that constitutes continuous, comprehensive counsel. The cost of continuous comprehensive counsel averages around 1.9% or 190 basis points for individuals. Larger institutions and individual investors who have substantial assets, command a lower fee based on the size of assets which will be placed under the consultant's advisement. The 190 basis point fee for individual investors includes (1) best-in-class, objectively selected third-party asset management at 50 basis points, (2) best-in-class custody, clearing, trade execution at 5 to 20 basis points, (3) advisory support services either structured within the advisor's practice or outsourced to their supporting broker/dealer or to outside supporting firms at 60-70 basis points and (4) 60-70 basis points for the advisor's continuous comprehensive counsel to fulfill their regulatory responsibilities. The advisor has to spend 60-70 basis points for the advisory support technology and the technical support staff within their practice that makes high level counsel possible. Custody, clearing and trade execution cost are the actual wholesale cost incurred in holding, monitoring and trading (buying and selling) assets. Similarly, in asset management, the actual wholesale cost incurred in engaging money managers to manage a very specific investment mandate, defined and monitored by the advisor/senior consultant, is 50 basis points. The fee-based advisor does not receive any compensation from the money managers they engage on their client's behalf to avoid any potential conflicts of interest. The sole compensation the advisor receives is the 60-70 basis points they earn for their continuous, comprehensive counsel. The cost of high level counsel is 190 basis points, but the advisor only earns 60-70 basis points.

Every one would agree that at 190 basis points, continuous, comprehensive counsel is an extraordinarily compelling value proposition when you consider a mutual fund costs on average 150 basis points, not including trading and clearing cost which can easily run another 100 basis points. By prospectus, a mutual fund is run according to its stated purpose at the discretion of its manager. By definition, a mutual fund cannot be sensitive to individual investor needs and circumstances. It does not have tax lot accounting and does not allow direct ownership of its underlying securities. So, in mutual funds, a high level of customized portfolio detail cannot be managed for each investor. Thus, mutual funds cannot come close to addressing and managing a broad range of investment and administrative values as an accomplished senior consultant can. And most importantly, the consultant can do so far less expensively than a mutual fund. But, there in lies the problem. Though everyone wants high level counsel, it is only within the reach of investors who have at least $250,000 in investable assets. Importantly, even at $250,000 minimum, there are far more investors who want high level counsel than are advisors capable of providing it.

So, where do you go to find high level, unconflicted counsel? Because high level counsel is only made possible by the initiative of the individual advisor, there are no blanket statements to be made as to at what institutions you may find high level counsel. High level counsel has not yet been institutionalized. There are several hundred senior consultants at the five major brokerage firms (Merrill Lynch, Smith Barney, Wachovia, Morgan Stanley, UBS) who engage their counsel for an ongoing advisory fee and are capable of high level counsel. The most successful and accomplished of these have been recognized by their peers and have been honored by their election to the Society of Senior Consultants. In same vein, there are several thousand Registered Investment Advisors (RIAs) who have their own consulting advisory firms and who are either correspondents of the major brokerage firms or work administratively through Schwab, Fidelity or T.D. Waterhouse. These RIAs acknowledge fiduciary responsibility and are capable of offering high level counsel. Many of these advisors only engage their counsel for a fee and have no need for securities licensing. The most accomplished of these RIAs have also been elected by their peers to the Society of Senior Consultants. In the institutional markets, there are several hundred consultants that engage their counsel with institutions that have assets in excess of $100 million. The largest of these institutional consulting firms resemble software development firms more than consulting firms because of their strength is offering highly customized monitoring and evaluation services at a very low cost, relative to the assets they advise. The top management of these firms have also been recognized by the Society of Senior Consultants.

From, a practical standpoint, the financial services industry's most accomplished senior consultants are more likely to find investors than investors are to find senior consultants. In markets as large as Richmond, Virginia, there only one or two senior consultants. In large major metropolitan areas, there are often only ten or so. The trick in investors finding high level counsel is not to focus on the established senior consultants with $200 million to $2 billion under advisement. It is to focus on the fee-based advisor who is a CFA and/or CIMA, who has $50 million or more under advisement, and who has developed the division of labor and secured the technology within their practice necessary to add value. These advisors are capable of high level counsel, acknowledge their fiduciary responsibility and have room to grow. These are the advisors with whom you can grow and who would happily work with $250,000-$1 million minimum accounts that are becoming so prevalent.

So, is continuous, comprehensive worth the fee? You bet. Now we just need more advisors capable of providing continuous, comprehensive counsel. ■

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Notes

SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
WWW.SRCONSULTANT.COM