NORTHSTAR
FINANCIAL PLANNERS INC.

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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

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"If there's 10,000 people looking at the stocks and trying to pick winners, one in 10,000 is going to score, by chance alone, a great coup, and that's all that's going on. It's a game, it's a chance operation, and people think they are doing something purposeful … but they're really not."

—Merton Miller, Economist, Nobel Prize Laureate

THE CONFLICTED CADDIE

So I was out on the links one Sunday and decided to bring a caddie along. I guess I was thinking a little professional advice might lower my usual score, a number you usually only see associated with Category 5 hurricanes. We came up to the fourth tee, and it was about 150 yards to a water hazard and another 50 or so to the green. My caddie handed me a 5 iron.

"You think I can carry that water with this?" I asked.

"No problem. It's more than enough club," he responded.

I lined up and swung and sailed the ball—straight into the water. He tossed me another ball from my bag. I took a drop and played on.

Came to find out later, my caddie had a deal lined up with Titleist golf gear.[1] The more balls I used, the more he got paid. Looking back, maybe that advice on Hole 4 wasn't completely impartial.

OK, so absolutely none of that actually happened. I'm a scratch golfer: If someone asks me if I want to play, I scratch my head and ask "Why?" But I know a bunch of our readers are golf enthusiasts, and I trust you'd agree if you hired a caddie, you'd want to know about any side arrangements they might have and would reject anyone with such an obvious conflict of interest. You want a caddie to give you advice aligned with your goal: to lower your score.

Yet in the world of financial advice, most people hire advisors with conflicts of interest. And the cost to you isn't a few bucks for new golf balls. It could be thousands of dollars. On the other side of the ledger, the possible gain to the professional giving the conflicted advice isn't a buck or two—it's thousands, or tens or hundreds of thousands, of dollars. There's a lot of money that can be made off your money. That's why probably the most important question you can ask a financial advisor is **"How are you paid?"**

In my subjective opinion, the simplest (and best) compensation arrangement for an advisor is the "fee-only" model. You pay your advisor, and they give you financial advice. I like to think this is the best way to align your goals with your advisor's. That's the caddie who is paid by you and only you. There are no

side arrangements that might make you question the caddie's objectivity. And as a bonus, a fee-only advisor is required by law to follow **the fiduciary standard,** which puts your interests ahead of their own (or the interests of their employer).

But many advisors are not fee-only. They receive compensation from any number of sources other than you. Here are a few of the common compensation arrangements for advisors and a description of how the resulting conflicts of interest could hurt you as an investor:

1. **Compensation from a mutual fund company:** Some fund companies pay the advisor a commission when a fund is purchased for a client; others don't. A fee-only advisor can select any fund they want for a client, but if the selected fund pays a commission, the advisor can't accept it. That means the advisor has no vested interest in choosing one fund over another. Their only motivation will be what best meets the client's needs.

   (Side note: As a fee-only advisor, I can tell you the number of times I've selected a commission-paying fund for a client is exactly *zero*. That is the number of times I have found a commissionable fund that was better for my client than a non-commission-paying one.)

   The commissioned advisor, on the other hand, will be looking at only a subset of available funds, and yes, it's that subset from which I have *never* selected a fund for my clients. And why don't I select them? Because the fees those funds charge the client are much, much higher than the funds I end up getting—they *have* to be so the fund company can recover the commission expense they pay out to the advisor. Fund fees are paid by my clients, and I want those fees to be as low as possible because I want my clients to make money on their money, not the mutual fund company.

2. **Compensation from an insurance company:** There is *often* a need for life insurance in financial planning, but *not always*. An objective look at your finances and goals may reveal that you don't need life insurance, or maybe need only a small, inexpensive term policy.

   But if your advisor also sells life insurance, there's a good chance they are going to recommend life insurance products, and likely expensive ones like universal life or annuities. Why the more expensive products? Well, I don't know, but they do pay a much higher commission to the advisor than a term policy.

   Now I'm not saying the reason for the advice you get on which insurance product to buy is in any way linked to how much money the advisor will make but—well, OK, I'm pretty much saying that. At the very least, your advisor is acting more like the caddie with a side deal going. That alone should make you wonder: Is that advice in your interest or his? **Would an advisor without a side deal give the same advice?**

3. **Compensation for also serving as your broker:** Most investors bank with well-known wirehouses (full-service brokers) like Morgan Stanley, Merrill Lynch, or Wells Fargo. It's just what you do, or so you've been taught through billions of dollars of advertising. Small, independent Registered Investment Advisors like Northstar don't quite have that kind of marketing budget.

   As Super Bowl ads are a bit beyond our reach, we really have no way of effectively spreading the message to the masses that combining your broker and your advisor isn't the best idea. Why not? Again, it's the caddie analogy. Brokers make a lot of money off your money in two main ways: (1) trading and (2) overnight lending of the cash in your account. As an advisor who makes no extra money based on the number of trades I do or the amount of your portfolio I keep in cash, I'm free to make lots of trades or no trades, keep all your money in cash or none of it in cash, and my only motivation is what best serves your needs.

   So what do I do? I make very few trades, and I keep very little in cash. Trades generate fees and often trigger gains that might be taxable, and those costs are paid by the client. And money kept in cash returns almost nothing, actually losing value over time because of inflation. That's why I try to keep just enough cash on hand to meet your short-term cash flow needs, and keep the rest invested so it is working for you.

   The broker/advisor has a motivation to make more trades and keep more money in cash because their company makes more money when they do that.

Once again, the company is using your money to make money for themselves, not you, and they are doing so at your expense.

4. **Compensation for selling proprietary products:** Oftentimes, when we gain a new client and transfer their account away from their prior advisor/broker, we find the portfolio contains funds with the same name as the broker—i.e., Fidelity funds in a Fidelity account or JP Morgan funds in a JP Morgan account. The reason is simple: The company can now charge you a fee for advisory services, fees for making trades, *and* a fee for managing the funds that were bought for you. Triple dipping!

   That fund created and managed by the same company you are investing with is called a proprietary fund, and it allows the company to keep the fund management fee rather than allowing it to go to some other investment company. So ask yourself, given that situation, would you say the recommendation to buy the proprietary fund is impartial advice aligned with your best interest? Of course not. It's a huge conflict of interest. You'd have good reason to suspect your advisor *never really considered* other possible investments that would better suit your needs.

This is not an exhaustive list, just a few examples of the ways in which your advisor (and their employer) may be getting paid. Bottom line is this: There is an inherent conflict when advisors receive compensation from any source other than you. You are better served by an advisor who is only compensated by a fee charged to you, a fee that is based on:

- The total value of the portfolio (regardless of what it is invested in),
- The amount of advice you are receiving (an hourly rate), or
- A flat fee that doesn't change based on any variable at all.

It is completely fair, *and very necessary,* to ask your advisor, or prospective advisor, how they are compensated, and demand that they disclose *all sources of compensation,* so that you can be comfortable you are working with someone whose interests are aligned with yours.

—Steve Tepper

[1] No Titleist golf balls were harmed in the writing of this article. The purely fictitious story at the beginning of this article is not meant to impugn the reputation of Titleist Corporation, which I'm sure is a fine and honest company. As for Taylormade, no comment.

STEVE'S PEARLS OF WISDOM

Use a bunch of technical terms to describe your strategy and conclude with "outperform the market." You're likely to scrounge up a willing investor or two.

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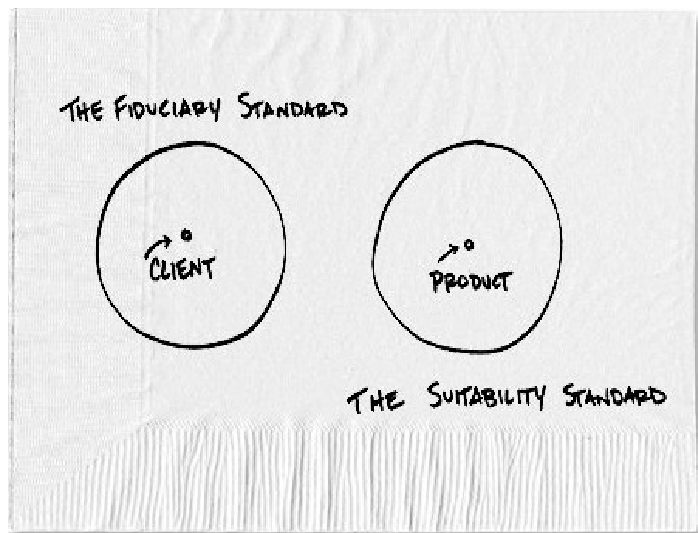
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

"I've crunched the numbers in your retirement account. It's time to figure out who will be wearing the mask and who will be driving the gateway car."

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