Evaluating and Choosing Financial Advisors

There are 3 critical mistakes to avoid when choosing a financial advisor.

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Over the last few years, many investors, including physicians, have re-examined not only their investment assumptions, but also their relationships with their advisors. Volatility in the market often leaves investors uncomfortable with the idea of staying the course with their plan, if they even have a plan.

In our experience, investors tend to make three common mistakes when evaluating current and potential advisors:

1. getting too caught up in past performance
2. failing to understand the scope of the client-advisor relationship and fees
3. ignoring what really matters—net return.

The Dangers of Relying Solely on Past Performance

A common mistake many physician investors make when evaluating or selecting their investment advisors is to overrate the importance of an advisor's recent returns. There are several reasons why this approach is flawed.

Time Frames May Be Too Short

When looking at an investment's track record, many clients will ask about gross returns (see later in this article for why this is a mistake) over the last 1, 3, and 5 years. However, that is simply not enough data to make conclusions about skill versus randomness or luck. In fact, 10 years of return-on-investment data may not be enough. An in-depth examination of this issue is beyond the scope of this article. To learn more about why such measurements must be looked at over decades, and why most investment performance claims may be based in luck, we recommend you read *Fooled by Randomness* by Nassim Taleb.

How Results Are Defined and Reported Varies

Comparisons of results from firm to firm are likely not apples to apples; in other words, the variables studied are inconsistently defined. Even the common question, "How did your portfolio do last year?" can lead to misleading answers in cases where portfolios have been designed for individual clients. Many investors have customized portfolios based on their risk tolerance, age, time horizon, tax bracket, financial objectives, and other factors. It is entirely possible that 1 client could realize return on investments of 3% in the same year that another client achieves a 20% return on investment. Both investors could be equally satisfied or dissatisfied, and neither of these results give you any helpful information about your particular situation. Comparisons are only worthwhile when the portfolios compared are designed with very similar goals, circumstances, and objectives.

Past Performance Does Not Guarantee Future Results

Anyone who has ever watched an investment firm's commercial on television, listened to an advertisement on the radio, or read one in a newspaper or magazine knows the phrase "Past performance is no guarantee of future results." Although this can be easily discarded as legalese by consumers, it is fundamental for investors to understand.

Making changes in portfolios or choosing your advisor to chase high short-term financial gains can be detrimental. It is not possible to know which asset class will have the highest or lowest returns simply by looking at recent historical data.

Failing to Objectively Evaluate and Reassess Your Client-Advisor Relationship

It is easy to gravitate toward advisors who are friends and family or a friend of a friend. It is also easy to become complacent in an advisor relationship and stay with someone longer than you should. Thus, it is important to routinely consider what is and is not working in your relationship with your financial advisor.

Two-Way Communication Is a Fundamental Element of Client Service

When polled, most clients of any professional advisor—from attorney, to CPA, to financial advisor—name "timely and effective two-way communication" as an essential element of a fruitful working relationship. Still, many investment advisors seem to focus more on returns. Even for those advisors who value customer service, certain business models within the investment business make such communication difficult.

As an example, consider the mutual-fund industry that many investors use for a substantial portion of their portfolios. Typically, the communication an investor receives from these funds are prospectuses, monthly and annual statements, and sometimes a newsletter. Generally, there is no individualized consultation regarding the portfolio mix or the tax impact of buying or selling within the fund. This is because the fund industry is built on a low-cost low-service model in which two-way communication between those investing in a fund and those managing it is cost prohibitive and rarely permitted.

When choosing an investment advisor to manage your portfolio, even if this choice involves finding assistance in the management of mutual funds or exchange-traded funds within a portfolio, it is important to consider a communication plan. This doesn't simply mean that your advisor calls you when there is a hot new buy, as some stockbrokers are known to do, but rather, there will be a predefined communication process throughout the year that is independent of trade suggestions. This type of communication is a fundamental part of customer service that is essential to any professional relationship.

A Transparent and Client-Aligned Business Model

Over the last few years, some troublesome conflicts of interest have come to light in the investment industry. As a result, we feel that all investors should work with financial firms that use a transparent business model that aligns the firm's interests with the client's interests. There are key elements to look for in such an arrangement.

Independent Custodian. Ideally, an investment firm does not act as custodian for (ie, hold) its clients' investments in the firm. Rather, the firm should have arrangements with several of the largest independent custodians (eg, Charles Schwab, TD Ameritrade) to hold their investments for safekeeping, while the investment firm manages the accounts. The inherent checks and balances of this type of arrangement prevent the insular secrecy that allowed Madoff, Stanford, and other criminals to operate.

Client-Aligned Fee Model. Many investors today are realizing that a clear fee-based model works best for them. Under such an arrangement, advisors charge a transparent, clearly defined fee on assets they manage. Contrast this with the traditional convoluted transaction-charge model that most brokers utilize in which a client pays based on trades in the account, regardless of whether the trade added value or not. In a fee-based model, not only do clients understand exactly what the fee is, but they also understand that the firm's interest is the same as theirs: seeing the portfolio increase in value. The annual management fee the investment firm earns is a percentage of the assets you have in your account with them. The more money you have, the more money the firm earns. It is important for investors to ask themselves whether they are more comfortable paying advisors set fees or commissions based on the number and size of the trades they make.

Ignoring What You Keep: Your Net Returns

Many physician investors focus primarily on management fees and expenses when evaluating advisors. For most investors, the annual fees might range from 50 basis points (0.5%) for a very large portfolio in a fee model to 300 basis points (3.0%) for mutual funds or broker transaction costs. Although this large variation in expenses is one reason why we recommend the annual-fee model described, it is not an investor's largest expense; rather, taxes are usually the largest expenditure for investors.

The cost of federal and state income and capital gains taxes on a portfolio depends on many factors, including the underlying investments, the turnover, the structure in which the investments are held, the client's other income, the client's state of residence, and more. For higher-income investors, taxes will nearly always be high. To gain perspective of how much taxation reduces your returns, consider that from 1987-2007, stock mutual fund investors paid, on average, 16% to 44% of their investment gains to taxes.[1]

The 9-year recovery of the stock market has exacerbated this problem for those in the top tax bracket. All-time highs in the S&P 500 mean mutual funds are no longer carrying losses to offset gains, and many funds passed on significant capital-gain distributions to investors in 2017. Although investors are losing between 17% and 50% of their gains to taxes, mutual funds provide no tax advice to investors, even when they claim to be value-added investment firms. Stockbrokers, money managers, hedge fund managers, and financial advisors at the nation's largest or most prestigious niche firms do not offer tax suggestions because they are prohibited from doing so. Tax advice could include specific techniques for limiting tax consequences of transactions or more general tax diversification in portfolios. Because of these limitations, most investment clients are not getting the tax suggestions they want.

Consider which matters more: the gross return your investment firm boasts in its marketing materials or your net after-tax return? Unless you generously want to give more to state and federal governments than you need to, the net after-tax return is the only measure that truly matters.

With full disclosure, our firm is one that understands the focus on after-tax returns. That is one of the reasons we have a certified public accountant on our team. Because capital gains taxes remain the same under the current 2017 Tax Cuts and Jobs Act, we recommend that physician investors look for tax expertise on their investment teams as well.

Conclusion

We advise investors to remain vigilant and constantly evaluate their plan and advisors. If you focus on the right factors, you can make intelligent well-informed decisions. ■

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1. Mutual fund tracker Lipper, quoted on CNN/Money.com 4/17/07.

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