

Chapter 8

The Myth of Investment Experts

None of our men are experts. We have unfortunately found it necessary to get rid of a man as soon as he thinks himself an expert - because no one ever considers himself expert if he knows his job.

Henry Ford

Investment experts are everywhere, especially during a bull market. Are you looking for expert advice? The next time you are at a social gathering, just mention to a few people that you are interested in investing in the stock market, but know little about it. More experts than you ever imagined will soon surround you.

Since the bull market began, the number of paid investment advisors has proliferated to nauseating proportions. During the 1990s, more people entered the investment advice business than any time in history. As a result, the number of licensed stockbrokers has grown to hundreds of thousands. The number of people paid to give investment advice explodes even higher when you add in financial planners, independent investment advisors, and insurance agents. If that isn't enough, thousands of accountants, lawyers, and bankers now offer investment advice in addition to traditional services.

With so many people offering their investment expertise, you do not have to search for an advisor because one will find you. However, if you are looking for a competent advisor it may take a lot of time and effort. The level of knowledge and experience varies greatly in the industry. Unfortunately, the average advisor has a level of investment expertise that is disgustingly low. Few have any educational background in finance or economics beyond what is needed to pass the simple exams required to get into the business. To put the investment industry in perspective, more training is required for a 16-year old to get a drivers license than for a person to become a legally licensed investment expert.

Types of Investment Advisors

There are three broad categories of advisors that work with individual investors. These folks can be classified as traditional stockbrokers, financial planners (FP), and registered investment advisors (RIA). The way you tell them apart is by the way they get paid. Brokers work on commissions. Pure financial planners work on a dollar-per-hour or project based flat fee. Registered investment advisors receive a small percentage based on the amount of the assets they manage.

Insurance salespeople and banks fall under the realm of stockbrokers because they generally work on commission. Accountants and attorneys normally fall under the category of RIA because they collect management fees. However, some accountants and attorneys also collect commission kickbacks or referral fees, so they may be acting as broker or solicitor.

As you read the detailed descriptions below, you will notice there is a blurry line between brokers, FPs, and RIAs. In many ways the blur is by design. Advisors want to be whatever their clients think they should be, so titles change frequently. Nevertheless, in one way or another all advisors are paid based on the products and services they sell or the amount of money they manage, not the quality of advice they provide.

Stockbrokers (commission sales)

In 1998 there were over 60,000 active stockbrokers working for large national and regional firms. The average stockbroker at a national firm earned about \$150,000 in 1998, and the top 5% of brokers made over one million. There are also thousands of people claiming to be independent brokers, which means little except that they work for smaller firms and trade through obscure sounding companies. Regardless of the size of a firm, all registered brokers must place their license with a brokerage firm that is a member of the New York Stock Exchange (NYSE) and the National Association of Security Dealers (NASD). The firm that holds a broker's license also oversees all sales activity, or at least is supposed to.

The high potential income of being a broker lures many people from all walks of life. However, the competition is intense in the business. Only 40% of rookie brokers survive the first three years of selling, and far less are around after five¹. Since turnover is so high, there is always a need for new brokers. That is not a problem for Wall Street because there are only a few requirements to enter the field. For example, one requirement is that you need to be sponsored by an active broker-dealer. This can either be through a large brokerage firm as a full employee, or through a small firm that sponsors you as an unpaid independent. A second requirement is to apply for and take a securities exam, such as the Series 7 Registered Representative exam offered through the National Association of Security Deals (NASD). The exam application asks about criminal records, lawsuits, liens, and other problems you may have had. It does not ask about your experience or education background in the investment field. Knowledge and experience are not requirements to get into the investment field. After a few weeks of study and possibly a crash course on the subject of investing, you take and pass the exam. Now you are fully qualified to sell investment products and services to the public. You are an investment professional.

¹ Mark Sutton, director of Pain Webber's private client group, *On Wall Street*, January 1998, pg. 20.

Once you are in the field, you will not be calling yourself a stockbroker. Very few people in the industry call themselves brokers anymore. It does not sound good. Besides, ten years ago brokers sold mostly investment products, now they sell everything from checking accounts to home mortgages. Due to their expanding role, most brokers call themselves a *Financial Consultant*, *Financial Advisor*, *Investment Counselor*, *Investment Specialist*, *Financial Coach*, and even *Personal CFO*. Regardless of the name change, most brokers are still paid the old fashioned way, by commissions and fees

Here is the bottom line on brokers. It is impossible for anyone being paid a commission to offer objective advice when their personal income is tied so closely to the products they sell. I was a broker for ten years and this is an absolute fact. The conflict of interest that exists between offering objective investment advice and getting paid is overpowering. In the end, getting paid always wins over objectivity.

Financial Planners

The title Financial Planner (FP) has been greatly bastardized over the years. Financial planners used to be people who only wrote detailed financial plans for clients at an hourly rate fee or flat fee. They did not sell investment products or directly manage their money for fees or commission. Nor did they sell insurance or insurance products. These “pure fee-only” planners are still around, but they are very hard to find.

Nowadays, the title of FP is used by a much broader group of people, for better or worse. Like stockbrokers, “fee-based” FPs are more interested in selling investment products and insurance than offering objective financial planning advice. They are, in a sense, independent stockbrokers, but they prefer to call themselves financial planners for marketing reasons. Like a broker, a commission-based planner goes through the securities exam process and places their licenses with a licensed broker-dealer. Insurance agents also fall under this category because they are paid commission to sell investment products. Although most FP’s still offer financial plans, they only do it to the extent that it leads to a product sale or an ongoing money management relationship.

Another type of FP is called “fee-only”, although in this case the “fee” is not for writing a comprehensive financial plan. These fee-only of FPs are looking to be paid an ongoing annual management fee for investing their clients’ money. Most fee-only planners use no-load mutual funds and put an advisor wrapper on top of fund costs (see Chapter 4). They meet with clients on a regular basis to discuss the performance of the funds and make necessary changes. Accountants and attorneys sometimes fall under the fee-only type of advisor, although in many instances, they do not actually make the investment decisions themselves. Accountants and attorneys often refer clients to an outside advisor and expect to get a portion of the advisors fee as a referral payment.

If you are going to use a financial planner, I recommend searching for a “pure fee-only” one. Go to someone who charges by the hour for financial advice and does not sell products. An objective planner can help develop long-term investment strategies, review insurance needs, advise you on taxes, and help with estate planning. Just remember that there should be no conflict of interest between the planner and your plan. Look for someone with the Certified Financial Planner (CFP) designation and a four-year college degree in finance. This ensures they have dedication to their practice.

Registered Investment Advisors

If becoming a broker sounds easy, registering as an investment advisor is a snap. Almost anyone can become a Registered Investment Advisor (RIA) and collect fees for investment management services. There are only a handful of rules and regulations that must be followed to get into the business. Most States require applicants to pass a simple hour-long Series 65 test. Traditionally, the test did not cover investment concepts. It only covered procedures and laws surrounding the investment industry. However, due to the large number of lawsuits, some states are starting to require that people taking the test have some rudimentary knowledge of finance and economics.

Advisors with less than \$25 million under management need only register with the states they do business in. Investment advisors who manage more than \$25 million dollars must register with the SEC, which means completing another application and sending in another fee. Registration does not mean Government approval or certification. Nor does it imply the advisor is ethical, competent, or safe. Registration simply means the advisor has submitted the appropriate forms to the government and has paid a filing fee. This is the same as registering an automobile with the Department of Transportation. Just because a person registers a car does not mean that the car runs, or that the person who registered it knows how to drive with any proficiency. The “registered” in RIA simply means the bill was paid-in-full.

Since there are few barriers of entry to becoming an RIA, the field attracts all sorts of people. You will find former journalists, physicists, teachers, bankers, real estate brokers, actors, Nobel Laureates, and even barred stockbrokers who had their Series 7 license pulled by the NASD for unethical or illegal acts. In 1998, there were over 25,000 RIAs registered with the SEC, and a great many smaller advisors registered with states across the country. Ironically, other than state or SEC registration, large investment advisors such as *Fidelity* are on equal footing with small advisors, such as *Joe’s Barber Shop & Investment Firm*.

Advisor Titles and Designations: The Good, the Bad, and the Worthless

Education and experience vary widely in the investment advice field. Many financial advisors may have minimal education and experience while others have extensive backgrounds and education. The only way

to tell the difference is to ask for a resume and check credentials. Generally, at a minimum you are looking for at least an undergraduate degree in business or economics, plus a meaningful professional designation such as Certified Financial Planner (CFP) or Chartered Financial Analyst (CFA). Be careful of firm designations such as Vice President or Senior Consultant. They are meaningless marketing gimmicks.

Designations

Advisors think they appear knowledgeable if they have lots of letters after their name. Typically, these letters take the form of acronyms such as CFA, CPF, CPA-MA, ChFC, CIMI, or something similar. A few of those titles are very prestigious, meaning they require years of hard work, academic study, and job experience. Others are best described as Mickey Mouse. Many designations are earned by simply paying a fee to a financial marketing group. No tests or class work is involved.

One recognized title in the financial community is the Certified Financial Planner (CFP) designation. It signifies a well-rounded education in the area of personal finance, and the holder has to have at least three years of experience in the field. The program requires a candidate to complete five courses covering insurance, investments, estate planning, taxation, and other areas, and pass a comprehensive exam. It usually takes a candidate 18 months to complete the program if the candidate has prior work experience. The insurance industry has an equivalent designation called a ChFC (Chartered Financial Consultant), and the CPA community has a distinguished title called CPA/PFS (Personal Finance Specialist).

A second prestigious designation pertaining mostly to investment analysts and institutional money managers is the Chartered Financial Analyst (CFA) designation. The CFA requires several years of advanced academic study and practical experience. The CFA designation has the stature in the investment industry as a CPA in accounting, a JD in law, or an MD in the medical field.

After the CPF and CFA designations noted above, the level of relevance drops off considerably. Most other titles require little or no academic work and can be earned in a few weeks. There are even mail order titles that people can attain by taking a simple exam or joining a marketing organization. To their credit, most reputable Wall Street firms do not recognize these Mickey Mouse designations, and stockbrokers cannot place them on a business card. However, independent Advisors are a different story. Independents can quickly purchase an alphabet soup of designations and hope their clients don't recognize the fact that the ink on the business card is worth more than the title.

Vice President and other Useless Firm Titles

While brokerage firms do not allow mail order designations on business cards, they do hand out meaningless firm titles to everyone. It is a widely known fact that many clients feel more comfortable working with an officer of the firm. Therefore, almost all brokers are given the title of Vice President. As a result, Wall Street firms have tens of thousands of VPs scattered in every office around the country. The VP title may sound impressive, but it has nothing to do with broker's experience, knowledge, or client satisfaction. It is strictly a marketing designation and reflects the amount of commissions generated by the broker, not the quality of his or her investment advice.

The more money a broker makes for his or her firm by selling investment products, the more prestigious that person's VP title becomes. Titles that signify a higher level of sales may include Executive Vice President, Senior Vice President, or Managing Director. A new stockbroker can easily become a Senior Vice President in a short time if one wealthy relative generates a lot of commission business. A big commission broker will also qualify for free trips and prizes, which are worth much more than any VP title.

Experts Lacking Knowledge

The supreme end of education is expert discernment in all things - the power to tell the good from the bad, the genuine from the counterfeit, and to prefer the good and the genuine to the bad and the counterfeit.

Samuel Johnson

Can you imagine a world where doctors are not required to attend medical school and lawyers do not have to go to law school? Would you hire an accountant that does not know how to read the tax code? What if your child's teacher did not finish high school and was a functional illiterate? Chances are you will not be satisfied with the results. Yet this is exactly how the investment industry operates. There are no educational requirements to enter the investment business or any accredited education needed to stay in.

Academic Background of Most Financial Advisors

The typical financial advisor is hired into the investment business because they have sales skills or social status, and is thought to be able to bring in large, wealthy clients. They are not hired because they have a financial background or investment acumen. The shocking truth is that a person does not even need a high school diploma to become a stockbroker or investment advisor, as long as they pass a few simple requirements noted earlier.

Obviously, Wall Street firms do not want to put financial illiterates into their offices. So, when rookies come on board, many investment firms send them to in-house sales training classes. This training usually takes place off site, and can last several weeks. While at “boot camp”, rookies familiarize themselves with the firm’s products and services. They also learn how to make cold calls and practice other sales skills. If time permits the larger firms may actually teach a class or two about finance and economics, but that is unusual. After sales boot camp is complete, a rookie returns home to start their careers as investment salespeople and are now familiar with their firms high-cost, company recommended products and services. This is the extent of training most brokers will ever get.

Over the last few years the SEC has put pressure on investment firms to provide ongoing education to brokers. The continuing education program (CE) grew out of an unprecedented number of complaints and lawsuits against stockbrokers and other advisors in the industry. While the CE requirement is a step in the right direction, it does not address the real problem. Most classes I attended as a broker at Smith Barney in the late 1990s concentrated on refining sales practices and knowing the legal loopholes in SEC working in an effort to reduce the number of lawsuits against the firm. CE does very little to educate advisors on the basics of finance, economics, and portfolio management.

Insurance salespeople and mutual fund salespeople also misuse continuing education programs. To see how ridiculous the CE programs can become, here is one real life example that happened to me:

A few years back, I took a college graduate course on portfolio management at an accredited college. Just out of curiosity, I called the compliance department at Smith Barney to see if the firm would allow this course to count toward the new CE program that the firm was starting. SB would not allow the course to count because the college I was attending had not applied to be approved by the firm. The very next week, an insurance representative was in our office trying to push his high cost products. As part of that push, he offered to take a group of brokers to lunch at a very expensive restaurant. As extra incentive to sell his product, he told us that his insurance company was recently authorized by Smith Barney to issue CE credits, and if we listened to his sales pitch on annuities while eating a free lunch, we would all “earn” three credit hours.

Higher Education has Low Priority

You don't need a fancy diploma to be successful in this business. If your clients think the market is going up, agree with them and sell them more stocks. If they think it's going down, agree with them and sell more bonds. Just tell people what they want to hear and you will become rich.

Manager at a large brokerage firm where I worked

As professionals, you would expect most investment advisors would continuously seek courses that lead to advanced degrees and meaningful professional designations. Surprisingly, there is no evidence to support that notion. I estimate less than one quarter of all brokers ever take a class outside of their firm. Many Wall Street firms are neutral on the subject of a professional education, and some office managers flat out object to the idea. From management's perspective, a broker's job is to sell products and services. A detailed understanding of the markets and the economy is not essential to that job - in fact, education hinders sales. I have been told more than once as a broker, "Your job is to sell what makes us money as long as it keeps us out of trouble." It has also been whispered to me why analyzing investments reduces sales, "Never let the facts get in the way of a good story." No Wall Street will ever admit that the most educated brokers often make the least profitable brokers. But that truth is widely known by the office managers who hire brokers.

Unfortunately, a new broker is not in a position to pursue higher education even if they wanted to. Most rookie brokers earn meager amounts while in a training status, and when training is over, the meager salary starts to diminish. By the end of the second year, rookie brokers are typically expected to be on 100% commission. As a result of the loss of salary, rookies spend all of their time prospecting for new clients, and trying to sell anything to anyone who will listen. Recall that only 40% of new brokers make it past the three-year mark. Any thoughts of pursuing an academic education must take a back seat to putting food on the table.

Conclusion

The public has a little knowledge of the way Wall Street works. Large brokerage firms have hundreds of analysts covering thousands of investments, plus dozens of economists following the economic beat. This impressive network of brainpower gives many people the impression that stockbrokers and other financial advisors are very knowledgeable and offers superior advice. This is not the case. Most brokers only know enough to stay ahead of their clients and sound like they are informed.

The fact that advisors are not well trained is evident in the DALBAR data shown in Figure 8-1. Notice the small difference in return between investors who buy funds through advisors and those who buy direct from no-load fund companies. The results are almost identical, and well below the market. After accounting for commissions and other fees, brokerage investors likely performed below direct market no-load investors.

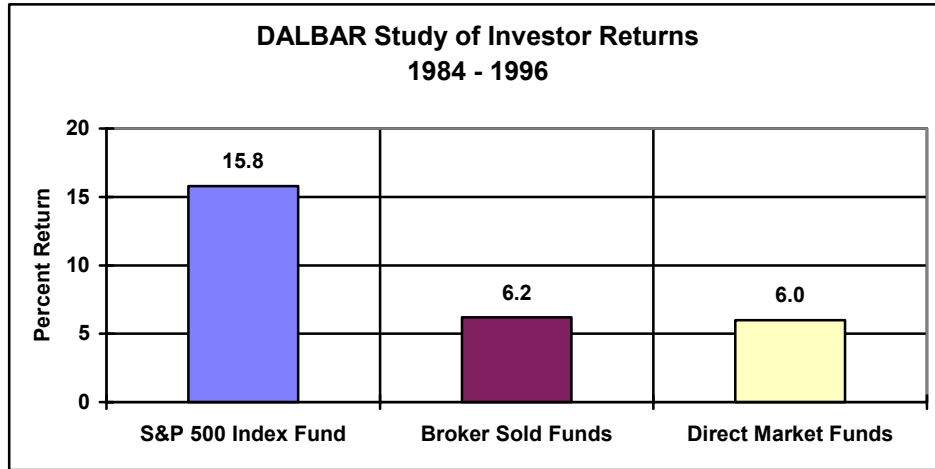


Figure 8-1 Source: DALBAR Financial Services

Despite the illusion of expert advice, the average financial advisor is no better at picking investments than the typical investor, which is not saying much. It has been my experience that advisors fall for the same mistakes as individuals, i.e. market timing and chasing the hot dot. If Wall Street firms decided to train their salespeople on academic knowledge, perhaps they could be of greater assistance to their clients and begin to close the performance gap.

Obviously, the DALBAR study reflects the average advisor and the range of competence varies greatly. The challenge is being able to tell the difference between a good advisor and a bad one. Now that bankers, lawyers, accountants, and the local barber have gotten in the investment advice business, the task of finding a competent advisor has become more difficult. Astute investors should research the background of an advisor before employing their services.