Chapter 1

Is This Any Way to Choose an Advisor?

Imagine that you're on a hospital gurney, having just been wheeled into an operating room to undergo surgery to remove a brain tumor. You're understandably anxious. Your surgeon appears and greets you. Everything about him inspires confidence, from his impeccable credentials to his confident demeanor, right down to his square jaw. He's your

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man. Your surgeon seems to have come straight from central casting, and you experience a wave of comfort.

Just as the anesthesiologist adds a sedative to your IV, you notice something strange. Your surgeon's scrubs are covered with patches of major company names—patches just like those that NASCAR drivers wear to promote their sponsor companies. Instead of the logos for Pennzoil or Walmart, though, your surgeon's patches bear the logos of corporations in the medical field—device makers, pharmaceutical companies, even insurance companies.

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. . . this surgery is brought to you by my sponsors . . .

The anesthesiologist just asked you to start counting backward from 10, but your mind is racing with unsettling questions: Is this surgeon focused on his sponsors or me? Will every choice that he makes during the next several hours be based purely on improving my odds of survival? Or is there a chance that he will choose one drug or device over another just because a certain pharmaceutical or device company cut a sponsorship deal with his practice? Might he use surgical instruments that are second-rate? Might he even cut corners to please the insurance company, lining his pockets in the process or in order to earn his right to attend the next Hawaiian boondoggle?

Then, just as you lose consciousness, you feel a flashing sense of betrayal: *Why were you not told that your surgeon answers to corporate sponsors?* He should answer to his patients only, and his focus should be on saving lives—period. He shouldn't have even the slightest appearance or thought of a conflict of interest. And if those potential conflicts of interest do exist; they damned well shouldn't be hidden until it's too impractical to change surgeons.

Bad Financial Medicine

Luckily for all of us, this kind of scenario is pure fantasy. Sure, medicine has its flaws like every profession. But surgeons certainly aren't known for putting their patients' lives at risk for a few extra bucks.

If only the financial advice industry were the same. In survey after survey, Americans report that their financial health is their second highest priority, just behind the importance of their physical health. And yet the industry that Americans turn to for advice about how to manage their wealth, safeguard it, and pass it on to their loved ones is predominantly riddled with conflicts of interest.

In fact, I'd say that the financial advice industry has more built-in conflicts of interest than almost any other industry. I should know—I've been in the industry for more than 20 years and I founded one of the largest independent financial advice firms in the country, catering to some of the world's wealthiest families. Based on my experience, I can assure you that a huge percentage of financial advisors live in a world where doing the right thing for the customer is usually *not* the most common course of action.

Sadly, most people have no idea that's the case. If Americans knew how the industry works, they would be far more selective in choosing advisors. By the time you finish reading this book, you'll understand just how conflicted the financial services industry is.

You'll also find out how you can bypass most, if not all, of the conflicted advisors and find the ones that work purely in your interests—and yes, they're out there. You may even find out that managing your own investments is the best route for you.

Here's a simple example of a pervasive conflict of interest in the financial advice industry. Let's say your advisor is affiliated with one of the big, prestigious Wall Street firms. He's decided that your investment portfolio should include a mutual fund that invests in international companies. He recommends a fund to you and explains the reasoning for the investment, and you give him the green light to buy shares of that fund for your account.

Perhaps what your advisor didn't tell you is that the mutual fund he just recommended carries a higher sales fee than several other appropriate funds. The sales fee comes right out of your account and typically goes right into the broker's pocket—a simple but clear conflict of interest. Perhaps he didn't tell you that his firm receives a fee—more colorfully called a *kickback*—for having that fund on its menu of investment options (the industry calls this *paying for shelf space*).

The advisor hasn't violated any laws. Although he calls himself an advisor—a term that suggests he's in the business of giving objective advice—technically he's a broker. And, since brokers are typically paid some form of commission, they are, in effect, salesmen. According to the law, brokers can sell you any product that's deemed "suitable" for your needs. Now, that international mutual fund that was suggested was indeed suitable: It made your portfolio more diversified, which in theory will bolster your overall investment performance and/or reduce risk. What that broker didn't tell you is that several other mutual funds of the same type were suitable, too—and they might have cost significantly less. In fact, the funds your broker passed over may have not only been less expensive, but also better managed than the one he recommended. Again, your broker has not broken the law. In fact, brokers have no duty to tell their clients that better funds are available.

Trust me, this sort of conflict of interest plays out all the time in the brokerage business. It is the rule, not the exception. The majority of the industry is set up to push advisors into making decisions that put their interests ahead of those of their customers. Even advisors who want to do the right thing are prone to make the wrong decision and then rationalize that decision. They're human, after all, and humans are extremely good at talking themselves into decisions that make them money. And make no mistake, advisors' tainted decisions, added up over time, can make those advisors big money. The problem is that the consumer typically pays the price.

As a consumer, this dynamic can make reaching your long-term financial goals far more difficult than necessary. For one thing, paying unnecessarily high fees creates a tremendous drag on returns as investors try to reach their goals. In addition, conflicted investment advice often leads to poor performance. Conflicted advice is a problem for all consumers, from the working class to the very wealthy. It endangers everything from clients' standard of living to the amount of money they'll leave to their heirs or to charity.

A Murky Industry

Perhaps the world of financial advisors should be more like the world of NASCAR. Sure, sponsor emblems on advisors' suits may sound ridiculous, but at least that would tell consumers exactly where advisors' loyalties lie. It would be a welcome change to an industry that is not only highly conflicted but is also notorious for its lack of transparency.

Conflicts of interest, such as those involving sales fees, are only one murky part of the industry. There's a whole raft of important information that advisors simply don't have to disclose. And the information that regulators do require advisors to reveal is usually buried within long documents written in impenetrable legalese. The bottom line is that instead of providing consumers with truly useful information, the industry buries the information under a ton of irrelevant and confusing information.

An easy illustration of perplexing legalese is the ADV, the main disclosure form that SEC-registered advisors are required to produce. And these are supposed to be the good guys! If you think the disclosures will explain in plain English, as they're supposed to, whether an advisor has a consumer-friendly business model: Think again.

To me, advisors' disclosure forms are all about covering their asses, period. The typical disclosure form reminds me of those pages of tiny boilerplate print that accompany drug ads in magazines. No consumer can understand the technical mumbo jumbo—and the reality is that it's not written to be understood. Pharmaceutical companies publish the disclosures because, first, they're required to by the government, and second, because they serve as a shield against potential lawsuits. In the same way, the legal nonsense that passes for "disclosure" in the financial advice industry exists to protect advisors and product producers, not to inform consumers.

And the fact that Americans lack the clear, straightforward information by which they might evaluate their advisors is really bad news. It means the people that we as consumers turn to for advice on the critical subject of financial success can operate largely in the dark, putting their interests ahead of our own and hiding behind perplexing "disclosures." The perpetrators include advisors affiliated with well-regarded Wall Street firms or banks—in fact, as I'll explain later in the book, they're typically the worst offenders—as well as the smaller guys scattered throughout the system.

The confusing, consumer-unfriendly system that's in place means we don't know when an advisor is steering us to a certain investment just to collect a higher sales fee. It means we don't know when Wall Street firms are pushing our advisor to sell complex, expensive products mainly designed to make those firms—and those firms' shareholders—a bundle at our expense. It means we have no simple way to tell whether our financial advisor is truly on our side.

But the problems with the system don't end there. When consumers choose a financial advisor, they almost always do so without critical information about the very viability of the advisor's business.

Does the advisor who wants to manage your wealth have a large enough client base to succeed? Is her practice properly insured? Does he have a solid succession plan so that his clients won't be stranded in the event of his untimely death? Will her firm keep your assets at an independent, third-party custodian, or will it hold them in-house—the arrangement that allowed Bernie Madoff to perpetrate his Ponzi scheme?

This is just a sample of the basic, factual information that should always be used when choosing an advisor. It's the equivalent of knowing the model, gas mileage, and warranty terms before buying a car. Yet clear information about advisors is a mystery to investors. In fact, most consumers don't even *know what they need to know* in order to choose a financial advisor. So they end up selecting advisors in a way that makes little sense, and is in fact dangerous to their financial wellbeing. And, mind you, none of these topics touch on the fees and where they are clear versus buried in mysterious structures or small print.

"You Should Meet My Guy"

Let's go back to medicine for a moment, and imagine another high-stakes scenario. Suppose your spouse or your child or another person you care deeply about is diagnosed with that life-threatening brain tumor suggested earlier. You learn that tumors of this sort can be successfully removed, but that the procedure is extremely sensitive—brain damage or even death on the operating table are very real possibilities.

You need to choose a surgeon. How do you proceed? Do you simply go to the local hospital? Do you ask your friends if they or their friends know of a brain surgeon they "like"? Do you choose the most handsome doctor? How about one that took you to the Knicks game courtside? Of course not. You do some serious research when making a decision of this magnitude.

You find independent rankings of the best medical centers and best surgeons. You research each doctor's education and experience. You investigate their surgery outcomes. You check their backgrounds for cases of malpractice. You use every single resource at your disposal. You are as thorough as you can possibly be.

It's hard to conceive of someone putting their loved one's fate in the hands of a doctor based on an advertisement or a recommendation from the friend of a friend. Yet *this is exactly how consumers select financial advisors*.

Financial advisors, including me, get the vast majority of their new clients through referrals from existing clients. Some advisors are shrewd marketers, and the most savvy have built huge businesses through well-funded advertising or even direct-mail campaigns.

Once an advisor gets to meet with a person who's been drawn in by a referral or an advertisement, it's very easy to turn that person into a client. Any successful advisor knows that, once a prospect is sitting across from them, it's like shooting fish in a barrel. At the point of sale, the universe of choices for the investor is typically reduced to a few recommended advisors and, most often, it's the best salesman that wins. It's pretty much a personality contest.

It's implied that advisors almost always know more about investing, estate planning, and other financial matters than their prospective clients do. So once they start spouting facts and figures with confidence,their position as an authority figure is quickly established.

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Looking like an advisor doesn't hurt, either. There's a reason for dark suits and a clean, buffed complexion—advisors dress to make an impression.

Closing the deal is typically a function of salesmanship. The trick, as any salesperson worth his salt knows, is to get the prospective customer to start agreeing with him or her. "I assume you want to protect your lifestyle." Yes, of course—the prospect nods his head. "Do you want the minimum-risk portfolio required to meet your objectives?" More nodding. "Do you want to be able to pass on as much of your wealth as possible to your loved ones rather than to Uncle Sam?" More enthusiastic agreement—the prospective customer starts to think: *This guy really understands me!* In fact, no one in their right mind would answer "no" to these sorts of questions—which is precisely why the advisor asks them. Once an advisor gets you nodding your head, you're on your way to being their client.

More often, the wealthiest families exercise a little more diligence. They may interview multiple advisors and choose the one that most impresses them. But the dynamic is the same: They almost always choose the advisor who makes the best impression, the one who's the most persuasive. In other words, they choose the best salesman. It's as simple as that.

You'd think that potential clients really grill me and other financial advisors before entrusting us with their fortunes. In fact, they often don't know the right questions to ask. They ask "softball" questions about how we invest, how we'll make them money and protect their capital. Because these questions are open-ended and based on emotion rather than facts, it's easy to tell clients exactly what they want to hear.

"How can you protect me from another market crash?" a client might ask—that's their fear talking. "Can you make me more money than the other guy?" another might ask—a question rooted in greed. "I'm conservative. I don't want to lose money." (I still haven't had a prospect come in and say, "I want to lose money." And I'm not holding my breath.) Most advisors are very good at persuading potential clients that they can successfully steer them through a market crash or beat the market. The truth is that most believe it, and their sincerity in conveying that belief to potential new clients is a big reason that those "prospects" so often become clients. Few advisors are able to understand their own limitations, and fewer still are professional enough to acknowledge them.

What should truly matter to consumers is not whether an advisor seems sincere. Rather, their focus should be on whether an advisor has the goods to deliver solid advice, performance, and service. Finding that out requires consumers to ask for quantifiable, factual information. But they rarely do. I'm almost never asked detailed questions about how I'm paid and how much my services cost. Rarely am I asked whether I am legally bound to put clients' interests first and foremost. (Legalese for this desirable behavior is "acting as a fiduciary.")

Potential clients too often fail to ask me or my peers the factual, non-emotional questions such as where their assets will be custodied, whether our businesses are large enough to survive major turmoil, and what would happen if you or I were to die suddenly.

I wince when I think of how typical consumers "vet" advisors because I know that it makes them vulnerable not only to second-rate advisors but to outright crooks. Bernie Madoff's Ponzi scheme absolutely wiped out client after client after client, costing those who trusted him $65 billion in all (including fictitious gains that people believed they had actually earned). Most, if not all, of these folks were wealthy and sophisticated. I know a number of them. Investors flocked to Madoff because what he offered answered their emotional needs. He provided little information, just enough to entice the greedy instinct of his victims to engage. Many investors simply reassured themselves with thoughts such as, "Well, if it's good enough for [*insert rich person's name*], then it's good enough for me." The relatively high returns appealed to investors' greed, and the year-in-year-out consistency of those returns answered the universal fear of market sell-offs.

Madoff was a smooth, masterful salesman selling irresistible—even a little too good to be true—results. But one simple, fact-based question would have ruled out Madoff as a prospective advisor: "Do you keep your clients' assets with an independent, third-party custodian?" Madoff did not, of course—he kept clients' assets in his company's own account, and used them to pay fictional returns to other clients. Asking that question and heeding the answer could have prevented Madoff's clients against the destruction that he wrought.

Why is it that people who would leave no stone unturned in researching a surgeon to protect their health, or even doing extensive research before purchasing a new car, are so incredibly cavalier in selecting an advisor to manage their financial wealth? Choosing the wrong financial advisor can dramatically alter your future and the future of your family. At the very least, consumers should be more rigorous in evaluating advisors because they pay those advisors very well to look after their interests.

But while consumers definitely need to take the process of selecting an advisor more seriously, they're not the only ones to blame. The industry and regulators together have created, and are maintaining, an environment where conflicts of interest are built in—and hidden. And together they've created a status quo in which it's impossible to distinguish the advisors you should avoid from those who deserve your business.

Key Points

- The majority of the financial service providers are conflicted.
- While the significant majority of "financial advisors" are conflicted and economic conflict often gets in the way of good advice, there are many good advisors out there who truly put their clients' interests first.
- With some simple tools and some discipline, you can separate the true "fiduciary" advisors from the folks who may have ulterior motives.

- Consumers don't know what they don't know.
- The first tool in the arsenal of "product pushers" is *small print* and confusing language.
- All advisors are conflicted when trying to make the sale. However, once you hire a fee-only advisor, that conflict can be reduced or eliminated.
- Sadly, the industry has stacked the odds against consumers, despite their objections—and claims—to the contrary.