Why You Should Discount Discount Brokers

A heavily edited version of a very long WSJ exposé that appeared on the front page of Thursday's edition:

Discount Brokers Push Pricier Services

At Fidelity, Schwab and TD Ameritrade, employees win extra pay and other incentives to put clients in products that are more lucrative for them, and the firm

By Jason Zweig and Anne Tergesen Jan. 10, 2018

Investors who seek advice from discount brokerage firms might assume the counsel they get is impartial, given how these firms have rejected the old Wall Street model of working on commissions.

In fact, advisers at some of the biggest discount brokerage firms make more money if they steer clients toward more-expensive products, according to disclosures from the firms and people who used to work at them. That means customers could end up with investment products and services that are costlier than they need.

"Clients hear the representative doesn't work on commissions, and they think that means a rep doesn't work on incentives," said Jeff Weeks, former manager of a Fidelity Investments branch in Austin, Texas. "You're omitting certain facts that the client would probably appreciate understanding before you launch into a sales pitch on why you think this product is better."

The Wall Street Journal interviewed dozens of former employees of the three largest discount brokers by assets, Fidelity, Charles Schwab and TD Ameritrade - all known for bringing low-cost investing to the masses. Nearly all the former employees said compensation practices encouraged workers to sell products that were more lucrative both for the firm and for the employee - and cost customers more.

Fidelity representatives are paid 0.04% of the assets clients invest in most types of mutual funds and exchange-traded funds. They earn more than twice as much, 0.10%, on choices that typically generate higher annual fees for Fidelity, such as managed accounts, annuities and referrals to independent financial advisers.

"If I was sitting in front of someone and there were 20 different avenues we could choose from," said former Fidelity financial consultant Sean Gray, "and we could choose Fidelity's managed accounts—that is what paid us more—in my mind, that created a conflict. And that's one of the reasons I left." Mr. Gray, who worked in a Fidelity branch in Atlanta from 2011 to 2016, now is at a wealth-management firm in Georgia.

At Fidelity, sales incentives not only enhance pay directly but also help representatives win "Achiever" bonuses that can be tens of thousands of dollars a year. At Schwab, employees can win an award including a trip to such destinations as Florida or Hawaii ....

Discount brokerage firms originated in the mid-1970s when stock-trading commissions were deregulated. The higher payouts for brokers at traditional firms led to a series of scandals in which investors were sold risky assets that collapsed or underperformed, including tax shelters in the 1980s, certain in-house mutual funds in the 1990s and private real-estate trusts in the mid-2010s (A Red Flag we highlighted in a November 11, 2017 Worth Sharing: http://www.hughescapitalmanagement.com/2017/11/11/first-financials-turn-non-traded-reits-are-a-red-flag-111117/).

Many customers come to discount brokers to avoid such conflicts and to keep the costs of investing low.

The discount brokers, while disclosing their employees' pay incentives on websites, said they don't require the employees to talk about these incentives with clients. Former employees said they almost never did.

Internal controls

The firms say they have extensive policies and procedures designed to make sure their representatives, often called financial consultants, act in clients' interests and don't unduly push any product or service. ...

The products and services for which employees of Fidelity, Schwab and TD Ameritrade are best paid charge an annual fee—a percentage of assets—to offer advice. The advice business is an increasingly important one for brokerage firms, given steep declines in trading commissions in recent decades. Discounters also find growing demand for advice from retiring baby boomers and investors scarred by the 2008 meltdown.

Many former employees the Journal spoke with pointed to managed accounts as products they were urged by supervisors to sell. These are baskets of investments often combined with a financial plan and advice. They may cost clients of discount firms anywhere from 0.20% to 1.7% of assets annually, depending on factors including what the underlying investments are....

"If you brought in a $1 million account and that person bought stocks and bonds, that wasn't an attractive client to Schwab," said Bill Parrott, formerly a Schwab employee who dealt with corporate executives. "The incentive was to move them to managed accounts and advisory services."

Molly Stanifer, a financial planner in North Carolina who worked at several Fidelity branches from 2008 to 2013, said if a customer had at least $50,000, "you had to lead off" by recommending a Fidelity managed account, "and if you didn't, you had to have a reason for it." ...

All three firms pay incentives to representatives for referring clients to independent investment advisers. These advisers charge clients an annual percentage of their assets, and the discount brokerage firms receive up to 0.25% annually on assets committed to the advisers. (A practice that HCM has no part in.)

Philip Snyder, president of his own investment-advisory firm in Timonium, Md., worked at TD Ameritrade from 2007 through early 2016. "We were incentivized to bring in assets, but more so to refer clients to advisers and to sell managed accounts of mutual funds and ETFs," he said. "So those were the two options we would use."

What's best?

It can be hard to determine exactly which product or service is best for an individual investor. Even former discount-broker employees who are critical of these incentive structures say many customers may be better off paying more for advice. Alternatives such as going it alone or using an even-more-expensive traditional brokerage account could lead to underperformance, they said.

Still, "there is no way I can be a true fiduciary" acting in a client's best interests when paid more to sell some choices than others, said Mr. Gray, the former Fidelity employee. "If a target-date fund was suitable for a client's situation and a Fidelity managed account was also suitable, the fact that a managed account paid more created a conflict of interest and made it impossible to act in a true fiduciary capacity."

Fidelity, Schwab and TD Ameritrade said their advisory businesses comply with federal rules by acting in clients' best interests. Lawyers unaffiliated with them said the compensation practices are permissible under the rules so long as the complexity of products is taken into account, potential conflicts are disclosed and the firms pledge to put clients first.

Together with customer feedback, Fidelity employees' variable compensation counts toward annual "Achiever" bonuses. In 2016, according to an internal compensation plan reviewed by the Journal, these bonuses could amount to as much as $92,400 a year, jumping by thousands when incentive pay hit thresholds.

Upping the bonus

A financial consultant who earned incentive pay of $129,579 to $136,191 qualified for an Achiever bonus of $71,500. Earning a single dollar more in underlying incentive pay could raise the Achiever bonus by $11,000, to $82,500.

Several former Fidelity employees said financial consultants were highly motivated to reach the next Achiever level and often favored products that paid them more to get there faster.

Fidelity said: "Recognizing financial consultants who achieve high client satisfaction and who help clients invest and grow their assets with the right solutions is not under any definition a conflict of interest." ...

At Schwab, employees with exceptional service and client satisfaction can qualify for the Chairman's Club, winning a trip to a Hawaii or Florida resort. For advisers, sales volume also can be part of the calculation. The firm's compensation practices could create "a financial incentive to recommend [managed accounts] over other products and services," said a 2016 Schwab disclosure of compensation practices.

TD Ameritrade discloses in a document on its website that sales bonuses could give financial consultants "an incentive to make recommendations for asset retention with a view to their compensation rather than the best interest of clients." ...

A practice called "sandbagging" occurred at TD Ameritrade, according to Mr. Snyder and other former employees of the firm. As the end of a calendar quarter approached, financial consultants who had hit their targets for new assets might delay accepting or investing fresh client money until the next quarter. That got them off to a better start toward earning the next quarter's bonus, but meant leaving client money temporarily uninvested. ...

Our thoughts

My first deep-dive analysis of a potential client's portfolio was shared on 5/24/14, before HCM's website was launched. Here are the relevant portions:

3 Cardinal Sins & HCM's Solution

"The market, like the Lord, helps those who help themselves. But, unlike the lord, the market does not forgive those who know not what they do. " Warren Buffett

Hughes Capital Management's (HCM) newest client came to us with a $250,000.00 portfolio, of which $50,000.00 was in an IRA, needing $600.00-$700.00 income per month. Before examining our recommended portfolio, it may be beneficial to family and friends to share our shock at what their Edward Jones Advisor had wrought:

Sin #1 - Leverage

Their Joint Account had $220,000.00 in equity and over $157,000.00 in margin debt! That is over 70% LEVERAGE. ... HCM however, does not recommend the use of margin.

Sin #2 - Loads

Loads are the purchase fees Mutual Funds, more precisely Open-End Funds (OEF), apply to certain classes of shares in order to take money from your pocket and place into that of the Advisor. That is their only purpose, and they are entirely avoidable. Not only did their Edward Jones Advisor exclusively use load funds for all their positions, but he chopped their Joint Account into 7 positions in order to make sure they paid the highest (5.7%) or next to highest (5%) load, which typically decreases with the amount of the investment. HCM never has a client pay a load, and, when available, attempts to get our clients into Institutional shares, which have the lowest management fee. ...

Sin #3 - Fixed Income

Their Advisor had over 60% of their Joint Account in 2 Fixed Income Funds. Some advisors will adjust the typical asset allocation of a 60/40 split between Equities and Bonds based on age. Warren Buffett dealt with this in a 3 minute segment of this May 6, 2013 interview: http://video.cnbc.com/gallery/?video=3000166399 These same financial advisors will call for periodic rebalancing, as though that will compensate for, in this case, 60% of your portfolio being, at best, "dead money." If you watch Buffett's prophetic interview, you might notice that our 10-year Treasury was yielding 1.7% at the time. The yield is currently 2.5%. As Jim Grant of *Grant's Weekly Interest Rate Observer has* observed, government bonds now offer **"return-free risk"**. ...

I was approached last November by another potential client. She had two managed accounts, the larger by Fidelity and the smaller by an Edward Jones advisor. What I expected to see - another Edward Jones rip-off and some underperforming, vanilla package of funds from Fidelity - turned out to be wrong. The Edward Jones advisor had done a reasonable job of Asset Allocation with no-load OEFs. However, her Fidelity portfolio was another matter. An edited version of my analysis follows, while the full version is posted on our website: http://www.hughescapitalmanagement.com/2017/11/18/fidelitys-turn-diworsification-111817/

Fidelity’s Turn (Diworsification) — 11/18/17

In legendary investor Peter Lynch's first book, ‘One Up On Wall Street’, he coined the term diworsification. A potential client recently provided us with the worst case we have seen: ...

She has 36 Funds and ETFs in her Fidelity account .... This might be reasonable if each of these positions were individual stocks, but as they are funds each typically invested in hundreds of stocks, this “diversification” only serves to increase broker commissions. Further, many of these funds are in the same category. For example, she has 3 funds dedicated to Large Domestic Growth, and 4 dedicated to Large Foreign Growth. If one wanted to invest in Large Growth stocks (which in itself is questionable), this could easily be accomplished by a maximum of 1 or 2 Funds, not 7. As detailed on our website, there is strong academic evidence that Value beats Growth over time. However, there is absolutely no justification for buying a bunch of Value, Growth and Blend Funds, when you can effectively buy the market with a single index Fund at much less **Exp**. ... Want to be able to vary the allocation between Domestic, Foreign Developed and Emerging Markets? Three Funds can get the job done. As can be seen on our website under the Worth Sharing tab, we highly recommend International Diversification for all clients. That goal is currently being accomplished by no more than 4 Funds, and one of those is a Global Real Estate Fund, an Asset Class that is conspicuously missing from Fidelity's smorgasbord.

Bonds

Bond funds make up 21% of her portfolio. At 28 years old, they should make up 0%. In a rising interest rate environment, they provide "return-free risk." If you are concerned about reducing the Risk of your portfolio there are much better ways to do so. For example, QMNIX ... has outperformed the S&P 500 since inception (which we don't expect to continue) with 0 Risk when defined as relative Maximum Drawdown.

Load Fees

Five of the funds (MGIAX, MDNLX, SHMMX, MTBAX, and MTBAX), representing 12% of her portfolio, have load fees ranging from 4.25% to 5.75%. As I have written in a previous article (https://medium.com/@DevinLHughes/when-is-it-time-to-shop-for-a-new-investment-advisor-f39776dbd729):

"In order to entice investment advisors and brokers to offer their vehicles to clients, mutual funds often offer a variety of share classes, many of which have Load fees. The idea behind the Load fee is for it to serve as a sort of sales charge, compensating the advisor and his firm for their expertise in assisting you in purchasing the fund shares. In practice however, the sole purpose of Load fees are to further enrich the advisor at the expense of the client."

There is never a good reason to be in shares with a load fee, as most Funds offer share classes with no Load. Take her MGIAX with its 5.75% load, an Open-end Fund (OEF) invested primarily in large foreign companies with an emphasis on growth. Within its Category it has a good track record, although both GPIIX, an actively managed OEF, and ISCF, a multifactor Exchange Traded Fund (ETF), the 2 Funds we are currently recommending for Foreign exposure, have outperformed it. MGIAX has multiple share classes, including Institutional Shares without a load. We always place our clients in the institutional shares when possible, which also typically have lower expenses than the other share classes. Even the "A" share class that Fidelity placed her in has an option for its load fee to be waived.

The other four funds are focused on fixed income, meaning most (if not all) of their return will come in the form of interest. These funds have yields ranging from 2.6% to 3.9%. This means that with loads of 4.25-4.50%, and annual expense fees of 0.66-0.93%, it will take these positions more than a year (and for a couple of the funds more than two years) to break even.

Concluding thoughts

The academic evidence shows that over a sufficiently long time horizon, small stocks outperform large and value outperforms growth. The equity portion of her portfolio has 84% dedicated to large stock funds, and only 21% dedicated to value. This is not conducive to long term outperformance or even matching market returns before commissions, loads, expenses, and other fees, which will further dampen her return.

This certainly isn't the worst portfolio I have seen, and much of it unfortunately appears to be standard practice among brokers, who do not have a fiduciary responsibility to their clients (meaning they don't have to act in a client's best interest, but instead meet a significantly lower "suitability" standard). That being said, the portfolio has several egregious elements that should never be acceptable.

For the DIYers out there, who at this point might be feeling pretty good about their decision to go solo, Meb Faber:

Office Hours Summary…You Are Not Alone

January 9, 2018

... Not long ago, I held another round of "Office Hours." For those unaware, this is when I open up my calendar, sharing 30-minute phone calls with anyone interested. We discuss markets, various portfolios and strategies, the Broncos, good beers, whatever.

There were some interesting takeaways from these chats. First, nearly everyone I talked with seemed to believe that his or her fears/goals/portfolio/market challenges were largely unique…

They weren't.

In general, many of you are often in the same situation, which, in a nutshell, is:

1. Your portfolios are a bowl of soup of random investments, seemingly cobbled together over time
2. Despite the fragmented, random nature of these portfolios, you are emotionally-wedded to your current holdings
3. You tend to have a binary view on investing, meaning think in terms of either 100% in an investment, or 100% out (ie "should I keep it, or should I sell it?")
4. You harbor a secret desire to gamble, and are looking for me (or someone else) to forecast the future so you can satisfy this desire ...

I found this last point to be particularly amusing as I recently had a client ask how to invest in Bitcoin and now from my newest client, "I have friends ... investing in these marijuana ETF's. What's your thought on those? I don't think they fit into your plans, but they do interest me. Seems like the whole world is smoking dope!" Meb's solution:

... Let's now address your gambling bone…

Have a hot tip on a biotech that's going to cure aging? Your son is sure that Bitcoin is going to $50,000? Have a hunch about that one stock you've been watching sink lower and lower for the last 15 months…but it's about to pop now, you're sure of it…

Pick a percentage of your investable assets to allocate toward gambling. The only criterion is it must be an amount no greater than what you could lose without having it affect your sleep at night. Whether that's 0.05%, 2%, or 20%, be honest with yourself.

Next, turn the percentage into an actual dollar amount based on your portfolio size, then image burning that cash. Are you still comfortable? If so, great. If not, adjust the amount lower.

Our final thought for this Worth Sharing

It is a **caveat emptor** world out there.