How Financial Advice Should Work

John Rekenthaler 01 May 2018

1,000 Pages

Last month, the SEC released new rules for governing financial advice, in a document artfully entitled, "SEC Proposes to Enhance Protections and Improve Choice for Retail Investors in Their Relationships With Financial Advisors." (The next 1,000 pages read similarly.) The SEC's report follows a similar proposal from the Department of Labor, about which I have written in the past.

This time, I will abstain. Even as fiduciary recommendations go, the SEC's new report is difficult to parse--to the point where even the agency's commissioners disagree. One, Kara Stein, voted against the proposal, labeling it as "Regulation Status Quo." A second, Hester Peirce, supported the proposal but stated that it was misnamed. The new standard should not be termed Regulation Best Interest, she said, but instead "Suitability Plus."

If the commissioners themselves are not sure of what they passed, then analyzing their suggestions surely exceeds my competence. ... Thus, I will take a step back and approach the topic more broadly. Setting aside the specifics of the current proposals, how should financial advice work? How should the industry look?

The Outlier

The first step is to acknowledge the current state of affairs. Put the broker, doctor, and lawyer in the same sentence, and the overwhelming response from the general public will be that the first item does not belong. The reason behind that reaction answers this column's questions.

The issue that prevents advisors from being viewed similarly to doctors and lawyers is education. Doctors attend medical school for four years, then enter residency. Lawyers undergo three years of law school. Brokers ... not so much.

(It is true that financial advice also carries a poor ethical reputation. However, although important--and to be addressed later in this column--ethics are not the primary problem. When polled, the public views lawyers as being just as ethically challenged as brokers. ...)

Muddled Terms

To which it will be objected that *broker* is not synonymous with *financial advisor*. Some financial advisors have Ph.D.s in the subject. Meanwhile, brokers can be hired on the spot. Professional financial advice occupies a spectrum, which I have compressed, thereby presenting the many as if they were one.

Fair enough. But in doing so, I have spoken for the crowd. Few investors realize that one investment advisor might have several years' worth of advanced training and that another might have almost none. How could they? Terms like *broker, financial advisor, investment advisor,* and so forth are hopelessly muddled.

Consider the SEC's current proposal. It governs broker/dealer behavior, while stating in its title that it applies to ... "financial advisors."

The Solution

In clearing up the confusion and improving its reputation, the answer for financial advice is not to emulate the other two industries by creating a single and high barrier to entry. Perhaps someday that will be the answer. The history of investment services has been the history of automation. Professionally managed mutual funds have supplanted stock selection; ... robo-advisors (see Jason Zweig's column below) are replacing personal meetings. Over time, the business may evolve that relatively few investors will be served by a small group of highly trained financial advisors, with the remaining investors addressed by technology.

Today, however, is not that day. Many who seek financial assistance seek the traditional method of support: a face-to-face discussion. At least for the foreseeable future, there are more such customers than there are top-end advisors to serve them.

Thus, there should be two tiers of financial advice, defined by education. The top level would likely not require as much training as a law degree and surely not as much as obtaining a medical license. For today, it would look something like the prerequisites for the Chartered Financial Analyst designation. Over time, the requirements could perhaps grow if those practitioners wished to make their field even smaller and more elite.

Ethics for All

The second, larger level of financial advisor would resemble today's brokers, albeit with stiffer ethical standards. I see no problem with the current, modest educational requirements. Such advisors could mostly (or entirely) give solutions that were packaged by the home office. However, the fiduciary requirements would need to be raised to match those of the higher-end advisors. People don't expect nurses to act any less in their interest than doctors do. The same logic should apply to financial advice.

The line between these two tiers *must* be clearly marked and made widely known to the investment public. This means that the definitions for the two tiers, ultimately, must be sanctioned and enforced by the SEC. The CFA Institute has valiantly attempted to make the everyday investor understand the difference between those who carry its ~~Certified~~ (Chartered) Financial Analyst designation and other financial advisors. In that task, it has struggled. For protecting its occupation's brand, an industry organization can accomplish only so much.

These recommendations may sound like where the industry has already gone--with one, higher tier of financial advisors being those who assume fiduciary responsibilities, and the other being those who do not. To some extent that is true. However, there are two differences. One, I propose to couple the top tier of advisor to an educational requirement. Second, I do not believe that there is any reason to have two fiduciary standards. All financial advisors should represent the best interests of their clients.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

As for robo-advisors, THE INTELLIGENT INVESTOR By Jason Zweig from this weekend's WSJ:

The Robots Are Here, So Keep an Eye on Them

Not many people would keep adding money to a brand-new investment that has lost 9% in its first four months. But a robot will.

That’s what has been happening at Wealthfront Inc., the automated online investment manager, or robo-adviser, that manages about $10.5 billion. In January, the firm launched Wealthfront Risk Parity, a mutual fund that invests across stocks, bonds and commodities around the world. For many clients with at least $100,000 invested at Wealthfront, the firm has been automatically moving as much as 20% of their assets into the fund — unless they stipulated that they don’t want it to.

Wealthfront has amassed $690 million in the fund and says it expects to hit $900 million soon. Some $440 million came in last month, according to Morningstar Inc., even as the fund lost 2.6% while the stock market and comparable risk-parity funds were up slightly.

As Wealthfront’s vice president for research, Jakub Jurek, rightly points out, four months is “just noise,” far too short a period to draw any conclusions about the success of a long-term investment strategy. And a similar approach has worked reasonably well in the hands of such leading investors as Bridgewater Associates, the world’s largest hedge-fund manager, and AQR Capital Management, which oversees $30 billion in similar strategies.

Even so, as Wealthfront continues frog-marching investors into the fund despite its poor initial performance, confusion reigns.

Its prospectus says the new fund should be used only by investors who understand complex securities, are highly risk-tolerant and who “intend to actively monitor and manage their investments in the fund.”

The whole point of using an automated online firm like Wealthfront, however, is that you don’t intend to actively monitor and manage your investments. You want its computers to do that for you, using exchange-traded funds that track the markets, minimize your costs and maximize your after-tax returns.

Unlike Bridgewater and AQR, the Wealthfront fund won’t own the underlying assets directly — and that could lead to some gaps.

As one of its hedges against inflation, it may own an ETF that holds energy stocks. So far this year, the Energy Select Sector SPDR Fund is up 9.7%, whereas crude oil has surged 18.3%.

As of its latest available regulatory filing, the Wealthfront fund was paying financing rates between 1.88% and 2.18% for its total-return swaps, the contracts it exchanges with banks to replicate the performance of various assets. Under accounting rules, those costs aren’t reported in the fund’s expenses, but they do come out of its net return.

That means the fund, which reduced its annual expenses to 0.25% from 0.5% last month, will need to earn better than 2% a year just to break even — a high hurdle.

The prospectus also says the fund may trade rapidly and could produce higher short-term capital gains than other strategies, potentially raising investors’ tax bills. Using swaps that mature in 13 months should enable realized profits to be taxed at the lower long-term capital-gains rate, Mr. Jurek says.

It isn’t clear that everybody wants the risk-parity approach. At its heart, risk parity is simply a way of diversifying not by how much money you have in each type of asset, but by how much risk you are taking overall.

Stocks are far riskier than bonds. (Wrong, as we have repeatedly warned.) If you have 60% in stocks, they could account for 90% or more of your portfolio's total riskiness. Under risk parity (which we don't recommend), you borrow money to buy more bonds, commodities and other assets that reduce the risk of holding stocks — and may well make your overall portfolio safer.

Still, that makes sense only for people who are comfortable investing with borrowed money — and a lot of folks would rather take a nap on a bed of nails. ...

Clients come to Wealthfront not just for its automation and low cost, but "because of the sophistication we are able to offer them," says spokeswoman Kate Wauck. "So to us, offering risk parity is consistent with our clients' expectations and our ethos as a firm."

Still, she says, "we could have done a better job rolling this out and explaining it to clients."

Mr. Jurek says the new fund squares with Wealthfront's traditional automated approach because the firm will manage the portfolio with a "rules-based strategy" rather than subjective judgment.

Looking back at decades of data, Wealthfront tested the hypothetical results and found the strategy would have produced a "very attractive risk-adjusted, long-term rate of return," Mr. Jurek says. (Funds that use a "rules-based strategy" aren't rolled out if the strategy doesn't back test well.)

That multi-decade test, he says, "speaks much more loudly to us than any one month."

In the long run, this fund might turn out to be a decent idea. In the short run, it's a reminder that hiring a robo-adviser instead of a human adviser doesn't mean you no longer need to pay attention.

Our thoughts

It is and always has been a Caveat Emptor world out there. Registered Investment Advisors (RIA), like HCM (and unlike Brokers), have a fiduciary duty to their clients, and yet last week I shared a deep dive analysis of a RIA that placed their clients in OEFs with loads and sold them variable life insurance while acting as an agent for the insurance company. So will the SEC's proposed new rules governing financial advice fare any better than the Department of Labor's attempt? If adopted, would they make any real difference? Are robo-advisers a solution? We are dubious.