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TOOLS OF THE TRADE

By Dan Wheeler

House of Games

Wall St. is in the manufacturing business, not the objective advice business

INVESTORS LOOKING AT AN UNCERTAIN future will, at some point, turn to the financial services industry for help. That's good news for the industry, but it's not always so good for the investors.

The reason is simple: Too much of our profession is set up to ensure *our* success with little regard for the success of clients and customers. As a result, investors essentially are playing a game where the odds are not in their favor. But this sad state of affairs does provide you with the opportunity to educate your clients by shedding light on how the industry really works—and then demonstrating the value you bring by refusing to play the game.

Numerous studies have shown that today's investors want guidance. They hope that by working with an investment professional they'll get objective, expert advice that will enable them to make smart decisions regarding their investment capital. However, the problem with seeking professional investment help is that all too often the person sitting across from the investor as an "advisor" is there to make a sale, thereby generating revenue for his employer and a commission for himself. As with any business, the greater the revenue and the bigger the payout, the better it is for the firm.

Unfortunately, too many people think that Wall Street brokerage firms are there to provide investors with good advice designed to help them reach their financial goals. On the surface, this perception makes sense. After all, stockbrokers work for enormous firms that employ portfolio managers, economists, analysts, and other market watchers. That appears to put the Wall Street broker in an ideal position to tap into all that knowledge and deliver rock-solid advice backed by enormous research and insight.

The belief out there is that the financial services business is made up of professionals. A professional by definition is someone you hire because of their expertise—a doctor, accountant, lawyer, and so forth. By gaining access to that expertise, you receive something of value: better health, a lower tax bill, or a large legal settlement, for example. The relationship between a professional and a client is such that the professional is given incentives to help the client succeed.

The financial services industry spends huge sums each year—more than $700 million on magazine advertising alone—to persuade investors that they provide professional advice. The reality is that Wall Street is not in the business of providing objective, professional advice. Actually, Wall Street is in the manufacturing business. Like any other manufacturing business, the objective is to develop products that will sell, and so the firms hire salespeople to "move the products."

Of course, there is nothing inherently wrong with creating and manufacturing products and paying a sales force commissions to sell them. Most commerce functions this way. Investors, however, should not be looking to a manufacturer and its sales force for objective advice. In short, the business that much of the financial services industry is in is the wrong one for investors.

The Incentive Game

We all know that recent investigations into the financial services industry have exposed many unsavory practices. Such revelations underscore the fact that the industry has long been masking itself as a profession while in reality it operates as a sales-driven manufacturer of products.

These scandals aren't what should most trouble your clients and prospects, however. There's a more fundamental concern: The industry is not structured to give them advice—it's in the business of selling.

So how did this misconception come about? Wall Street firms began as investment bankers. Companies needing to raise capital would hire an investment banking firm with a skilled sales force to sell their stock to the public. Everyone understood that the broker was a salesperson hired to raise capital for the client. No one expected objective advice. They just wanted information about the company raising the capital.

But once a stock began to trade in the public market, investors began to demand advice about it. The investment banks realized they were well positioned to provide this advice and that it could be a huge source of new revenue. The problem, however, was that these firms had no fee-based advisors to work with clients. So instead of developing professionals to meet this need, they decided it was more profitable to simply present their sales force as "advisors."

The Product Business

As these companies began providing more stock recommendations, the public increasingly saw them as the source for the advice they craved. Brokerage firms now realized that they had a huge customer base to which they could sell products directly. It was a natural progression and one that made good business sense. After all, if you have customers in front of you,

why not sell them “packaged products” that probably carry higher profit margins than products made by someone else?

Once again, generally speaking, there’s nothing wrong with this approach. However, like any manufacturer, once a brokerage firm has a wide range of products to sell, it needs to create incentives among its salespeople. Historically, of course, that incentive has taken the form of a commission.

Here’s where the problem arises. Every manufacturer has some products that are terrific and very easy to sell—a top-notch mutual fund run by a revered manager, for instance. Conversely, some products aren’t nearly as good as the others, and take more effort to sell—such as a fund that’s managed poorly or that has high expenses. In order to move more units of the poorer-quality product, the manufacturer must create extra incentives for the sales team—that is, offer a bigger payout for selling the inferior product.

The result is an uneven level of compensation that gives a commission-based stockbroker a stronger financial incentive to sell investors a fund, stock, or other investment that may not be as good an option as another.

This arrangement is often found at firms that offer in-house funds along with funds created by outside firms such as mutual fund companies. In such instances, a broker may earn a bigger commission for selling his firm’s in-house funds. That might work out fine for investors if the firm’s proprietary funds are well-managed, are strong performers, and constitute the best fit for the investor. But as we all know, that’s often not the case. Even though the in-house offerings may be inferior—or at least not the most suitable options—chances are good that a broker will respond to the incentives created to generate the greatest revenue.

The people at big Wall St. firms aren’t corrupt. But they are not the right source of investment advice for investors

The industry’s recommendations regarding third-party products also may be suspect. That’s because many brokerage firms have long had a financial incentive to recommend certain mutual fund families over others with better performance and lower expenses. The fund companies began setting up these types of revenue-sharing, or “soft dollar,” arrangements as a way to get their funds on the brokerage firms’ preferred lists and encourage brokers to promote them more heavily than the competition’s. According to research firm Financial Research Corporation, the 50 biggest fund companies make approximately $1.5 billion in revenue-sharing payments to brokerage firms each year. Meanwhile, the Securities and Exchange Commission announced in January 2004 that 14 of the 15 brokerage firms it examined over the previous year took such payments from mutual fund companies.

Common sense, therefore, tells us that the incentive game is structured to help the industry win at the expense of the investor. For example, let’s assume that a broker has sold a number of his clients a certain mutual fund and earned his commission. Now let’s assume that the broker awakens one day to discover that the fund he sold has been hurting investors by allowing illegal market timing. Does the broker consider this to be good news or bad news?

On the one hand, his clients have been damaged. But this development has also created the opportunity to move the clients’ money and earn another commission. “We can’t trust these guys anymore and we need to sell your funds,” the broker might say. Would that happen? You tell me. The incentive and pressure to generate commission revenue is awfully strong.

Ask your clients to think about it like this. If you walk into a Ford dealership, you expect the salesperson to try to sell you a Ford. That’s what they get paid to do. You aren’t expecting objective advice regarding the pros and cons of a Ford versus a Toyota. All the participants in this process understand the game. This is why I indicated earlier that commissions are not inherently bad. The difference is that automobile companies are not spending millions to convince you they are giving objective advice.

The financial services business wants to have a commission-based compensation system and the respect that comes from acting as an objective professional. But they can’t have it both ways. This is why we have seen an explosion is the growth of the profession we know as fee-only investment advisors. Investors are becoming informed and demanding objectivity. As an aside, you CPAs who believe you can take commissions and maintain your professionalism are kidding yourselves.

I know the rules of the game, having worked as a broker at two major Wall Street firms. Almost from the moment I walked through the doors, I realized I had not been hired to give investment advice to my clients but to sell products. After three years, I had enough and quit—on my 40th birthday. I must emphasize that these people aren’t corrupt. They’re simply being led by industry practices to act in their own self-interest. But they are not the right source of investment advice for investors. The question your clients and prospects must ask themselves is: Do I really want to work with people who constantly are encouraged to put their needs ahead of mine?

Of course, once clients and prospects understand how the incentive game is played, it’s easy to communicate an important fact: As a fee-only advisor, you don’t play the game. Your business model and value proposition will be obvious to investors once they recognize the alternative. At that point, they’ll be highly motivated to work with you. As I always say: Do your job and the numbers will take care of themselves. IA

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