

Your Investments

Who Can You Trust?

April 2007

Overview

Investors today find themselves in greater control of their financial future than ever before. For assistance, they often seek the guidance of a financial advisor. Hidden fees, mysterious commission arrangements, and inherent conflicts of interest leave investors wondering if their advisor can be trusted. The lack of transparency behind the advisor's actions is an obstacle for an investor trying to achieve his or her financial goals. This white paper will clarify various relationships available to investors today. This paper supports the position that working with a fee-only investment advisor can eliminate conflicts of interest and lead to a successful investment experience.

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Where did all this money come from?

Investors now control more savings than ever. Yet they are finding themselves on the cusp of retirement without sufficient funds to last throughout their life expectancy. Though this seems as if it happened overnight, it really has gradually taken place over the last 30 years. The following are three primary reasons that this has occurred:

- **Pension Funds** - There has been a shift away from pension funds to self-directed retirement plans such as 401(k)s. This, in effect, has transferred the responsibility for retirement security from the corporations to the individual. In 1980 there were 564 mutual funds with 4.6% of the US population investing in them. In 2005 there were 7,977 funds with 53.75% of American households investing in them.¹
- **Baby Boomers** - There are more people looking for advice because now there are more investors. The oldest baby boomers are now in their early sixties with retirement at the doorstep. According to the U.S. Census Bureau, the 55-64 age group is projected to increase by 11 million persons over the 2004-14 period, to 40 million by 2014. As the boomers reach retirement, there will be an unprecedented number of people looking to their self-saved nest egg to secure their retirement.
- **Longevity** - Life expectancies have increased. From the turn of the 20th century through 2002, life expectancy at birth increased from 48 to 75 years for men and from 51 to 80 years for women. Life expectancy at age 65 has also increased since the beginning of the 20th century. Among men, life expectancy at age 65 rose from 12 to 17 years and among women from 12 to 20 years.² Currently, the joint life expectancy of a couple 60 years of age is about 30 years.³ The investor lifetime is not until they reach retirement age, it is life expectancy.

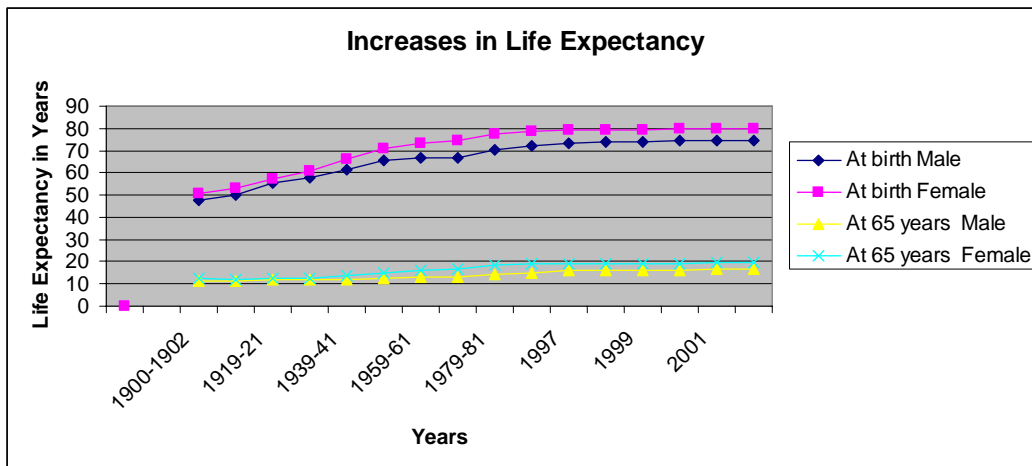


Figure 1⁴

So not only are more people responsible for managing their own nest eggs, they are challenged with making this money last for a longer period of time. Investors on the eve of retirement are confronted by the question: "How do I make this last a lifetime?"

Hire an Advisor?

The scenarios and challenges listed above turn more and more people to financial advisors for assistance. As the need has grown, so has the number of advisors. Advisors can approach investing and financial planning from a multitude of angles, and choose from a myriad of strategies. But one underlying factor is crucial for an investor to establish a sound relationship with an advisor. The investor must have a clear understanding of how the advisor is compensated.

Which advisor is best for me?

In spite of the many angles and strategies an investment advisor can use, a client's relationship with a given professional will take one of two forms.

- The advisor works on a commission arrangement, based on product sales or transactions,
- The advisor works on a fee-only basis

Commission Based Financial Advisors

Traditionally, financial advisors have worked on a commission basis, collecting commissions from the product providers in a variety of ways. The ways that many of these commissions are assigned are not readily discernable. Sometimes the advisor is awarded a percentage of an initial purchase, like a mutual fund load. The percentage, in these cases, can be as much as 5.75%. Or commissions can be based on a transaction, such as when a broker places an order for a stock. Many forms of commission are hidden, such as the ongoing fees charged annually on annuities, or various classes of mutual funds like class A, B, or C shares. An investor may not see a significant dollar amount of the fees an investment advisor is collecting during the course of representing him.

“The broker is not your friend. He’s more like a doctor who charged patients on how often they change medicines. And he gets paid far more for the stuff the house is promoting than the stuff that will make you better.”⁵

Warren Buffet

A challenge with the commission-based approach is that the engagement between the advisor and the client is primarily transaction-based versus relationship-based. Once a commission-based financial advisor sells a product or transaction there is very little incentive for him to provide service going forward, unless there is another product sold or another transaction occurs. The advisor's lack of incentive creates a false sense of security for the investor. The investor may believe the broker is monitoring a portfolio or financial plan on an ongoing basis, when in reality he is not. The nature of the commission-based compensation arrangement causes these advisors to spend much of their time drumming up new business and generating sales for their company quota rather than spending time monitoring the portfolios or financial plans for their existing clients.

Commission-based financial advisors have an inherent conflict of interest. Some products offered to consumers pay a higher amount of commission than others. When an investor works with a commission-based advisor, he has to ask himself whether the advisor recommended the product because it was the best fit for his portfolio or if it was because the product offers the highest payout to the broker.

Fee-Only Investment Advisors

Fee-only investment advisors introduced a new approach to building an investment portfolio for their clients. Rather than accepting commissions from the product providers, fee-only advisors receive compensation exclusively from their clients. Some charge hourly or on a project-fee basis and others charge as a percentage of the assets managed. The primary difference is that the only revenue a fee-only advisor receives comes directly from the clients. This relationship creates what is known as a fiduciary duty, or legal obligation, for the advisor to do what is in the best interest of the client.

With a fee-only investment advisor, one can be assured that their advisor truly represents the client and is not forming advice based on incentives offered by the product providers. Fee-only advisors are not collecting kickbacks from fund families; they are not paid per transaction or by commissions attached to products. Since the advisor's approach to investing or financial planning is not tied to the products or providers, the client can be sure that the advice is founded with the client's best interest in mind.

Copy Cats?

What's the difference between fee-based and fee-only?

More and more brokers are trying to copy the fee-only model within the brokerage industry by calling their services **fee-based**. Though the name sounds similar to fee-only, fee-based advisors lace their transactions with product sales and conflicts of interest. The only way a firm can claim that it is fee-only is if 100% of the compensation the advisor receives comes directly from the clients. In the brokerage world, that is simply not the case.

How can you tell?

One sure way of knowing whether an advisor is fee-only is to see whether he is a

"If you have more than \$50,000 to invest, you should fire your broker and find an investment advisor. Brokerage firms would like you to think that they perform the same functions as investment advisors. Many brokers call themselves "financial consultants" or "financial advisors". But they're not the same as independent investment advisors. An investment Advisor's fiduciary duty is on a higher plane, like that of a lawyer, a trustee, or the executor of an estate."⁶

*Arthur Levitt, Chairman
Securities Exchange Commission, 1995-2003*

member of The National Association of Financial Advisors Association (NAPFA). To become a member, an advisor must adhere to strict criteria and demonstrate a commitment to a fee-only business model. Ellen Turf, the CEO of NAPFA, was recently asked why fee-only advice is important. "Fee-Only advisors are able to provide objective advice and have the least amount of conflict of interest because they do not sell products." When asked to describe the ramifications for using a commission-based broker instead, she stated, "Limited choices and even those choices may be based on the compensation they receive."

The National Association of Securities Dealers, an organization in which a commission advisor must register, has over 660,000 registered representatives. Many of which offer advice at banks, insurance companies, brokerage houses, and financial planning firms. Financial advice is readily available, but the right kind of advice may not be. There are just over 30,000 partners in fee-only advisory firms

and a mere 1,100 NAPFA Registered Financial Advisors nationwide.⁷ For more information on NAPFA, visit www.napfa.org.

What's in it for me?

The primary benefit for those who seek the guidance of a fee-only advisor is clearly the objectivity and transparency of the relationship between the advisor and the client. In a recent survey conducted by a fee-only advisory firm, 168 clients were asked about their relationship with their advisors. Of the respondents, 71% said that implicit trust or fiduciary duty was the most important factor in their relationship. This outweighed other important choices such as investment performance, competitive fee schedules, and communication. If having implicit trust in an investment professional is a goal for an investor, then a fee-only advisory firm should be considered.

Conclusion

When faced with the difficult task of having assets last throughout life expectancy, engaging the services of a financial consultant could be helpful. Though there are many ways for a client to obtain financial advice, the only way that an investor can reduce potential conflicts of interest is to engage a fee-only advisor. This paper was designed to give investors an introduction to fee-only investment advice.

"Brokers get paid when they sell products, so first consider seeking advice from a fee-only planner."⁸

*Susan B. Garland, Editor
Kiplingers Retirement Report*

What is Arcadia?

This white paper was researched and written by an advisor at Arcadia, a fee-only Registered Investment Advisory Firm. Arcadia's goal is to help clients achieve and maintain financial independence. By adhering to the fee-only business model, Arcadia eliminates potential conflicts of interest. Since Arcadia's inception in 1996, the only revenue Arcadia has ever received has come directly from its clients. The objectivity and transparency of the fee-only model allows Arcadia to create financial plans and manage investment portfolios with the client's goals and objectives first and foremost.

For more information about Arcadia Investment Advisors or to set up a meeting for you to get acquainted with one of Arcadia's advisors, call (800) 448-5151 or visit www.arcadiaia.net.

Notes:

¹ The Advisor Institute, 2005.

² United States Census Bureau
<http://www.cdc.gov/nchs/data/hus/hus05.pdf>

³ Internal Revenue Service, *Publication 590*,
<http://www.irs.gov/publications/p590/ar02.html>

⁴ Center for Disease Control,
<http://www.cdc.gov/nchs/data/hus/hus05.pdf>

⁵ Arthur Levitt Jr., *Take On the Street: What Wall Street and Corporate America Don't Want You to Know*, Pantheon, New York, NY, 2002, p 18.

⁶ Arthur Levitt Jr., *Take On the Street: What Wall Street and Corporate America Don't Want You to Know*, Pantheon, New York, NY, 2002, p 31.

⁷ NAPFA (page 6)

⁸ Susan B. Garland, "Bad Advice Destroys Early Retirees' Dreams," *Kiplingers Retirement Report*, Volume 13, Number 3, March 2007, p. 5.