February 24, 2015

I am looking forward to a forthright discussion of this issue, particularly as regards compensation. AUM as the key to compensation does not attract the best financial advisors, it appeals to the best salespeople. This standard has been adopted by NAPFA in their compensation policy as paraphrased is clear-cut:

"A financial adviser acting as a fiduciary cannot be compensated based on the outcome of any transaction where the client is relying on the fiduciary's advice."

This is not complicated, nor can it be dismissed by a declaration that "all methods of compensation have conflicts of interest." If the advisors' compensation is directly dependent on the clients taking the investment advice, the client is not getting unbiased advice.

Simply disclosing that AUM is the basis for a client's fee is not sufficient, in my opinion to overcome the blatant conflicts of interest which most clients don't understand, even if they are able to read their monthly broker statements (which few are). Advisors are attracted to the AUM model primarily because it obfuscates the fee, the percentage seems minimal to the layman, and their fees automatically increase over time more than time without the client being aware of it.

I have attached a paper outlining the abuses I have encountered in my practice with clients who have been using an AUM advisor. My experiences confirm the findings of the SEC, noted in the last paragraph As Americans age and their retirement depends on impartial comprehensive financial advice of the funds they have accumulated, we have approached a critical point. Also interesting is the recent paper from the Whitehouse in Washington D.C. cataloguing "The Effects Of Conflicted Investment Advice on Retirement Savings" q.v. http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

Since stockbrokers have adopted the AUM model, and they consider themselves 'comprehensive' because they refer client out for financial related issues such as estate planning, tax planning, insurance, etc. (and often receive a kickback in the process), it is impossible to continue using this method of compensation and convince the public that we are different than investment salespeople.

This is of course why the wirehouses are fighting this aggressively, including Schwab, Fidelity, Ameritrade, etc. This method of compensation assures them of attracting aggressive sales force. It is time to take a strong stand against this way of doing business, and start promoting other compensation methods which do not make the client's investments become the pawn of the advisor's compensation. I do have some ideas, and approaches used over the past 40 years, which provide adequate compensation without conflicts of interest.

Of course the Investment Advisers Act of 1941 protects the use of AUM by law. It is imperative that this act be amended so that "investment Advisors" applies only to Money Managers as originally intended. Those covered should be governed by FINRA, and include stock brokers, investment managers, etc. All designations implying comprehensive services are offered by an unbiased professional (e.g. 'trustworthy") must assure the clients that the person providing the advice is a fiduciary, not a salesperson. The public must be easily be able to distinguish who hold themselves out to the public as performing in a fiduciary capacity (i.e. trustworthy) and money managers who only handle investments.

Thank you for your dedication in making this critical change in our profession. I plan to be on the call on at 4pm EST 2/26.

Bert Whitehead.

Fiduciary Duty Impacted by Charging AUM

Giving Rise to Conflicts of Interest

In reviewing and researching issues affecting financial advisors who calculate client fees based on the amount of Assets Under Management (AUM), there appears to be a widespread practice which has arisen over the past 5-7 years which I recommend should be addressed.

Because interest rates have dropped substantially since 2008, most often the percent of assets which is charged to the client usually exceeds the amount which assets invested in cash and bonds are yielding.

Obviously the client would not want to pay 1.0% or 1.5% of AUM for cash or bond funds with a yield of 0.1% to 1.0%, particularly if 40-70% of the portfolio was invested in low risk interest earning assets. The way this conundrum is being handled by a number of advisors is to agree to manage cash and bonds in the client's account for free, or a nominal amount of, e.g., 0.25%

This practice of charging different fees on different types of assets results, however, in an inevitable ongoing conflict of interest: the advisor is incentivized to invest more in stocks on which the client is charged a higher fee. A recent case came to my attention where a client preparing to retire within a year had a portfolio allocated 3% to bonds and 97% to stocks.

Interestingly, when I asked the advisor (who claimed to be a 'fiduciary') the explanation I received was, "Well, how am I supposed to know what else the client has in his portfolio?" The advisor pointed out that clients are not required to divulge all of their assets.

I have verified this is now a widespread practice, and that it is a common practice for clients not to disclose assets to their advisors to avoid being charged higher fees, especially low risk assets.

A number of my clients who worked with AUM advisors in the past have specifically mentioned that they were continually pressured to move assets from other custodians, and so clients would not to disclose these other investments.

I don't know how we, as fiduciaries, can purport to provide comprehensive financial planning and manage asset allocation for clients' portfolios unless the clients agree to disclose all of their assets to us. This suggests that, if we are holding ourselves out to be fiduciaries, our contracts with clients should require that they must disclose all of their assets to us even if we are not paid to manage them.

In addition it would seem that a disclosure should be made, and accounted for quarterly, when different percentages are charged for different asset classes with an appropriate caveat that this differential could constitute a conflict of interest.

Finally, I would suggest that lists of good and bad practices are not meaningful to our clients, nor to many advisors. Several years ago NAPFA adopted this simple fiduciary standard to apply to compensation. Widespread Implementation of this standard would address the vast majority of fiduciary issues related to compensation:

"A financial adviser acting as a fiduciary cannot be compensated based on the outcome of any transaction where the client is relying on the fiduciary's advice."

Thank you for the opportunity to offering this for consideration.

Bert Whitehead, M.B.A., J.D.

President

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