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Financial Managers and Their Duty to Society

The definition of wealth is an abundance of valuable possessions or money. When you look around at society today, if you were to ask someone if they wanted to be rich or wealthy, I think everyone would say yes. There are a lot of people who want to be millionaires and have enough money to last them for retirement. The question is how do you achieve that? For most people they think that if you work for 40 plus years, put money in a 401k, and save then you will have enough money for retirement. But, another way that people generally underestimate to achieve wealth is to invest. Due to compound interest which Warren Buffett has called the 8th Wonder of the World, your money is able to work for you over time and grow into a large amount.

Many people feel like they don’t have the competence or skills for investing. They think that only someone who is a professional in the financial field is able to understand the complexities of investing. While there are simple ways like a low-cost index fund, most people tend to turn elsewhere. This is where a financial manager or advisor comes into play.

The role of a financial advisor according to (Investopedia) is to give advice or guidance to customers for compensation. Financial advisors, or advisers, can provide many different services, such as investment management, income tax preparation and [estate planning](https://www.investopedia.com/terms/e/estateplanning.asp). While a financial advisor can be very helpful for someone trying to reach their financial goals, they also have gotten a bad reputation for charging high fees, not generating returns greater than the market index, and not abiding by fiduciary standards.

 In this paper I will discuss and analyze the fiduciary standards for financial advisor’s vs the suitability standard, disclosure with clients, what churning is, ethics involving the CFA exam, commission vs fee-based compensation, new laws affecting financial advisors, and the role of market volatility in retirement planning.

Research by digital wealth manager, Personal Capital, an online financial advisor service found that nearly half of Americans falsely believe all advisors are legally required to always act in their clients' best interests. That is shocking to think that if you give someone your money to invest and grow it, they may not be doing the best thing for you. This means that an advisor could be giving you a package of investments or products that bring them in more money based on fees that those products charge while lowering your portfolio value. When choosing an advisor one of the first things you should look at is to see if they are a fiduciary.

According to the Securities and Exchange Commission, which regulates registered investment advisor as fiduciaries, “The fiduciary duty says that fiduciaries must act with undivided loyalty and utmost good faith. They must provide full and fair disclosure of all material facts, defined as those which a reasonable investor would consider to be important. They also are not allowed to mislead clients and they can’t use the client’s assets for the advisor’s own benefit or the benefit of other clients. One of the biggest issues that a fiduciary must abide by is that they have to avoid conflicts of interest like when the advisor profits more if a client uses one investment instead of another and they must disclose any potential conflicts of interest. If I were someone looking at picking a financial advisor there is no way I would pick someone that is not a fiduciary.

As the smart investor, you know that when choosing an investment advisor you should look for someone who is a fiduciary. But, someone who isn’t as savvy as you might end up with an advisor who operates using the suitability standard. According to (Forbes) The suitability standard requires that a broker make recommendations that are suitable based on a client’s personal situation, but the standard does not require the advice to be in the client’s best interest. That means that if a time comes where this a conflict of interest, they don’t have to do what is best for you. They can recommend something that is “suitable” for you but really isn’t the best available option out there and most times will put more money in their pocket.

That can lead to a lot of personal interpretation on the advisor’s side and if not required by law most people will always act in their own best self-interest. *(Global Financial Private Capital)* In a way, when a broker checks the suitability of a potential buyer, they are measuring how much financial product can be sold, not the needs of the investor. You can be losing out on many gains that you could be making and also paying more in fees and taxes then you really should be. (*Global Financial Private Capital)* Brokers that abide by the suitability standard also offer products that are usually carried by the company that they represent and are paid a commission calculated as a percentage of the amount of money invested into the product. These brokers are more like salesman instead of someone who can help you reach your financial goals.

One of the ways that advisors who operate under the suitability standard can make money is through a practice called churning. Churning is a term applied to the practice of a broker conducting excessive trading in a client's account mainly to generate commissions. Churning is an unethical and illegal practice that violates SEC rules (15c1-7) and securities laws. While there is no quantitative measure for churning, frequent buying and selling of securities which does little to meet the client's investment objectives may be evidence of churning. *(Investopedia)* This usually benefits advisors who are commission based and not fee based, which is why advisors who are fiduciary’s do not usually do this. However, there is also something called reverse churning which is when there is little to no activity to justify the fee. When a broker engages in churning, it usually has a negative effect on your own personal investments.

One of my role models is Warren Buffet. For many reasons he has set the standard for investing and is considered to be the best investor of all time. Through reading books on him and research, he recommends the buy and hold strategy. That means you buy stocks and hold them for a very long time and watch them appreciate. You do not engage in frequent buying and selling but engage in a pretty boring process of sitting and waiting. The reason for this is you minimize paying the transaction costs and also tax implications that come from frequent buying and selling. The reason why churning is such a negative is that it triggers many of these expensive fees that overtime decrease the value of your portfolio and have no real benefit. Avoiding advisors that engage in the practice of churning is another reason choosing someone that operates as a fiduciary and not by the suitability standard is a better choice in the long run.

Another thing to look for when you are looking at different advisors is to see if they are CFA certified. CFA stands for Chartered Financial Analyst. It is one of the hardest certifications to get and is in very high demand. There are three levels of the exam and the pass rate for all three levels is about 53% and you must have at least 48 months of qualified work experience before you can take it. It takes around 300 hours of study per level and about four years to obtain this certification.

According to (*Investopedia*) “The program gives candidates and CFA charter holders a strong foundation of advanced investment analysis and portfolio management skills. The emphasis is on real-world application and not academic theory. It is considered by many to be the top investment management designation available.” The topic areas that make up the CFA are ethical and professional standards, quantitative methods, economics, financial reporting and analysis, corporate finance, equity investments, fixed income, derivatives, alternative investments, and portfolio management and wealth planning. As you can see, this is a very useful certification to have if you are going to be an investment advisor. I am going to focus on the ethical and professional standards that CFA’s operate by.

The Code of Ethics and Standards of Professional Conduct (Code and Standards) are the ethical benchmark for investment professionals around the globe.  Part of being a CFA holder is you have to complete a Professional Conduct Statement to disclose any potential violations of the Code and Standards. While you are a CFA member you are equipped with tools to help you along the way. There is the Standards of Practice Handbook which covers the concepts in the Code and Standards for practical use. You are able to use this handbook for guidance on how to navigate ethical dilemmas that you might face in your daily professional life. There is also the Standards of Practice Guidance for Members which contains the Code of Ethics and Standards of Professional Conduct with related guidance and examples illustrating application of the Standards in the day to day professional activities of members and candidates.

These ethical standards are very important because as we have learned in class this semester, we are faced with ethical dilemmas all around us and having a guide on how to act in these situations is very important. After the 2008 financial crisis, they added a chapter in the handbook called, "Why Ethics Matter."  This was very critical because it came at a time where investment managers were acting very irresponsibly and in turn had a very negative impact. According to *(Investopedia),* “This section addresses the importance of understanding the long-term impact of investment decisions on market integrity and sustainability. Recent events have revealed unethical behavior not just within investment firms, but also rating agencies, corporate boards, accounting firms, financial technology products and more. The chapter emphasizes the interconnected, global nature of finance today.”

Along with choosing whether you want to work with a fiduciary or someone who operates under the suitability standard, another thing to consider is whether they are fee or commissioned based. While some advisors can use a combination of both fee and commission based, the main two are either fee or commissioned based. Fee-only advisors are either a flat or hourly rate, on a per- service basis or as a percentage of assets under management. They do not earn commissions or trading fees, so their compensation is independent of the investments they recommend *(US News).*  Commission-based advisors are paid from the sale of investments. They may also receive a fee from their financial institution for selling a particular product, collect a percentage of the assets a client invests or be paid per transaction *(US News).* If you are a fiduciary, you can’t be paid by commission but if you are not, you can be paid either way.

This leads us to the issue of high fees and how that can eat into your portfolio returns as an investor. As I mentioned earlier in the paper, there are two ways of investing, invest using low cost index funds which are pretty low maintenance and have low fees, or hire a manager who is usually engaging in an active strategy where they are trying to beat the benchmark. It is hard to beat the benchmark and most managers underperform so for most investors, going with a passive strategy and investing in low cost index funds is the best bet for them.

To show an example of this, in 2007 Warren Buffett said that the S&P 500 stock index would outperform hedge funds. The length of this bet was 10 years, and in the end, Warren Buffett won. The S&P 500 returned 7.1% while the hedge fund only returned 2.2%. Part of this is because the fees that an active manager or hedge fund has to take out for actively managing the investment can take a big chunk out of your overall return. Especially if the active manager that you hire is underperforming, you can be getting a very low return for your money compared to what you could be getting by investing in a low-cost index fund. Actively managed fund fees on average cost around 1.1% per year (*Forbes*) while the average fees for a low-cost index fund is around 0.2% per year.

The reason that investment fees for actively managed funds are such a big deal is because they hurt you twice. An investor pays an ever-increasing amount in fees as account balances grow, because the fees are based on a percentage of assets. And fees also strike a blow to the portfolio’s returns. That’s because every dollar taken out to cover management costs is one less dollar left to invest in the portfolio to compound and grow (*Nerd Wallet*). By using a numerical example, we can get a better understanding about what paying high fees really looks like.

In a fictitious scenario we are going to look at different investing scenarios for a 25-year-old who has $25,000 in a retirement account, adds $10,000 to the account every year, earns a 7% average annual return and plans to retire in 40 years.



As you can see the difference in fees and ending portfolio after 40 years is very substantial. After 40 years if you were invested in the actively managed portfolio with a 1.02% annual expense ratio your portfolio would be worth 1.77 million. That is still a large amount but if you compare it to what your portfolio would be worth after 40 years investing in a low-cost ETF fund with an annual expense ratio of 0.09% you would have 2.30 million. That is a $533,000 difference! Using the 4% safe withdrawal rate that they recommend you use while retired that is the difference between living off $70,800 and $92,000. You might have to work a few more years to get to that same level and you could have been in a better position if you had chosen to go with a portfolio with a lower fee structure.

As a financial advisor, you always need to stay up to date with new laws that may affect how you do your job. These laws can change how you deal with your clients and the investing decisions that you make for them. Recently in the news, The House is nearing a vote on bill that would free financial advisors to report senior fraud. This news came out March 16, 2018 so is very recent. This vote is about the Senior Safe Act and is designed to encourage advisors to report senior financial abuse which is said to cost senior investors some $3 billion annually. This new law will be protecting them from liability and the violation of privacy laws. This law is important from an ethical perspective because it is granting legal immunity to those who report suspected abuse of seniors to regulators and law enforcement authorities. Another bonus of the new legislation encourages financial services firms to provide standardized training to frontline employees and producers to help them identify and report instances of suspected abuse (Financial Advisor News).

Elderly people are easy victims because they are vulnerable and seem like easy targets to take advantage of and defraud. They are not always in the best mindset which make them easy to prey on. This is why this new law is so important because now people have the ability to speak up and do something about it when they see it. People shouldn’t be taken advantage at any time but especially not if they are elderly because many times they don’t know what’s going on until it’s too late. I think this would be a good section to add to the ethics handbook for CFA because it is very relevant and as more baby boomers are retiring and aging, it is something that people need to be aware of and know how to act if they are in the situation.

Another big issue in the news is the fact that soon, all advisors will have to be fiduciary’s. Right now, not all advisors have to be fiduciaries and act in their client’s best interests. As I discussed earlier in the paper, that can be a very big issue when there are conflicts of interest. However, the Department of Labor has partially implemented the rule with the rest of it in full effect in 2019 (CNBC). This is a good sign for investors because now advisors will have to act in client’s best interests. They will also have to disclose matters fully with them and this should prevent advisors from recommending products that may not be the best for the client but in turn, boosts their own commissions.

Both of these new changes in law are aimed at helping the people. The financial industry can be very complicated and for many people even simple terms like bonds, and stocks and how to allocate them in a portfolio are deemed as “too difficult” to understand which is why they put their trust in financial advisors. This gap in learning and understanding is where people can be taken advantage of and what laws like the Senior Safe Act and the Department of Labor’s law want to prevent. When people work their whole life and give someone their money and resources, after doing their due diligence, they should be able to trust that person that they are going to do the right thing. As an advisor, you should also want to treat your clients the right way and do the job that you are supposed to do even if that means you don’t make as much money.

As I previously said, many people aren’t as savvy with finances and me, you, or a financial advisor. Because of this, if you were to try and manage your own portfolio through market volatility without a high level of expertise it would probably be very difficult. Another job of a financial advisor is to manage your retirement plan through market volatility so that you don’t experience massive losses. Despite what people think, markets aren’t always moving up. Markets go up and down in cycles.

Recently we have been in a long bull market and people have experienced great returns on their stocks and investments! We did have a small correction which did give people a scare but for the most part, the markets have been pretty strong. In 2008, we had the mortgage crash and things were very bad for investors and people had significant drops in their portfolio value. When people see that their portfolio value has gone down 40% they panic and begin trying to sell of their stocks which makes things even worse. As a financial advisor one of your main jobs is to help people navigate their emotions even in the midst of chaos like 2008.

Advisors can help you capitalize on market downturns. Warren Buffett has said, “When others are greedy be fearful, and when others are fearful, be greedy.” Essentially that means that when things are going really well and people are buying a lot and thinking that stocks are just going to keep going up and up you should be careful. But when people are scared about the market going down and start selling, that can be a great buying opportunity for you because stocks are essential on discount and a smart financial advisor should realize that and help you capitalize on those opportunities.

Another way an advisor can help your retirement plan get through market volatility is through diversification. Diversification in investing means that you diversify your investments across a couple of areas to reduce risk and the effect of market volatility on your portfolio. Not only can you diversify across asset classes by purchasing stocks, bonds, and cash alternatives, you can diversify within a single asset class (*Ameriprise Financial*). By not being too heavily invested in one asset class you are able to protect yourself from market swings and still see positive returns. Diversification basically eliminates unsystematic risk which is the risk that is in the industry or company that you invest in. If you are heavily invested in a company with a bad CEO and their stock drops you won’t be protected, but if you have one bad CEO and all your other stocks have good CEO’s, the losses of the stock with the bad CEO will almost be eliminated. However, with systematic risk, you can’t diversify that away and all companies are affected by it because it is essentially market volatility.

Another factor that can help protect against market volatility is your risk tolerance. As someone who is younger and around my age of 22, I have a higher risk tolerance than my parents who are closer to 60. A financial advisor would probably recommend me a portfolio more heavily weighted in stocks than bonds and I would look for close to an all stock portfolio right now. because That way if I do have losses, I have time to recover from it, but I also want to be aggressive while I’m younger and see greater returns. Compared to my parents, they are looking to retire so an advisor would want to have their portfolio more heavily weighted in bonds than stocks because they want to make sure their portfolio value is relatively safe.

In today’s society, the role of a financial advisor is very important. Choosing one that meets your personal needs and goals is the most important and you should always make sure that they are a fiduciary, so they act in your best interests. However, with the recent introduction in the past 10 years of low cost index fund, the need for them might be slowly declining. Because of the high fees associated with having an active manager, putting your money in a low-cost index fund has been shown to leave you with more money in the future. However, for people that still want someone to manage their money for them, a financial advisor is very important and although many financial advisors get a bad reputation, there are still many out there that abide by a high ethical standard and want to do their best job for you so you can reach your goals.

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