Advisers make worse choices than independent investors, study says

by Lynn O'Shaughnessy

I've received thousands of e-mails since I began writing this column 2 1/2 years ago and, by far, the most frequent SOS I get is from readers who want to know where they should turn for financial help.

At this time of year, there are probably even more investors eager for an expert to examine what may look more like a skillet of scrambled eggs than a functional portfolio. Acknowledging the need for help is a healthy development for investors who feel guilt-ridden whenever they take a peek at their portfolios. Or, more likely, when they are too scared even to look. Ultimately, seeking out a professional's opinion can also increase your net worth, as well as your financial security. If anyone ever devised a 12-step program for wayward investors, finding an adviser would surely be No. 1.

Consequently, I'm going to devote some columns at the start of 2007 to discussing where you can turn for help. Just as importantly, I'll explain what business cards you shouldn't accept. While the country is awash in financial advisers, here's a reality you will rarely see discussed: You may be better off on your own than turning to certain professionals. I've believed that for a long time, but now I can point to a devastating study that provides data to support my opinion. The research should make anyone who uses a stockbroker or a commissioned financial adviser extremely nervous.

The authors of the research, two Harvard Business School professors and an academic at the University of Oregon, aimed to measure whether Americans who rely on commissioned professionals to select their mutual funds prospered from their investment picks. They began their research by assuming that these folks did provide valuable service because so many people rely on them.

But it turns out that Americans' financial herding instincts are flawed.

The ambitious study, which examined the money moving in and out of 4,000 mutual funds from 1996 to 2002, looked at the cost and performance statistics of funds that brokers selected versus those that individuals bought. The stock funds pushed by brokers earned a meager annual return of 2.92 percent (net of expenses) versus a much more impressive 6.62 percent for the funds that investors bought on their own. With bond funds, individuals also kicked butt. Brokered fixed-income funds generated a yearly performance of 4.87 percent, compared to 6.07 percent for the average Joe investor.

The cost of this appalling underperformance was stunning. The researchers calculated that the professionals' mediocre investment choices cost their clients close to $9 billion a year!

The brokers' sins transcended their lousy fund picks. The professors examined whether brokers and other commissioned professionals provided superior advice on asset allocation. That is, what mix of stock and bond funds were these guys recommending to their clients?

They also looked at whether brokers were effective in taming investors' desire to chase after the hottest funds. Investors routinely sabotage their portfolios by loading up on the previous year's breakout fund performers. They also love to jump in and out of the market after listening to the lame predictions of financial talking heads or perhaps after consulting a Ouija board or tea leaves. Investors would be so much better off if they ignored prognosticators and simply divided their portfolios among different asset classes, such as large and small stock funds here and overseas, as well as bonds.

The evidence from the study, however, showed that brokers weren't successful in keeping investors from running after the hot money. Equally important, they didn't provide wise advice on how investors should spread money inside their portfolios.

"On average," says John M.R. Chalmers, study co-author and professor at the University of Oregon, "brokers aren't picking better funds and they aren't helping you have a better asset allocation."

So what are these professionals doing to justify their commissions? Actually, the researchers documented that they are putting their clients into more expensive funds, even if you disregard the cost of the commissions.

I can only imagine what the brokerage industry thinks about the research, which one consultant has dubbed the "study of the decade," because they aren't talking. When I contacted several of the nation's major brokerage firms for a story in a professional publication, the press handlers couldn't produce anyone willing to be interviewed.

You can download your own copy of the study, "Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry," by Googling the title. If you read the lengthy report, you might well come to this conclusion: If you want to pay high fees for underperforming mutual funds, look for someone who will charge you a commission. If that sounds ludicrous, you should look elsewhere.

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