Broker's first loyalty to company, not you

by Lynn O'Shaughnessy

About a year ago, Smith Barney, the brokerage giant, announced that it would start calling its stockbrokers "financial advisers." Most Smith Barney clients, if they heard this pronouncement, probably greeted it with some variation of "duh." These investors already assume that the brokers, who handle their accounts, are advisers.

While the clients would have been puzzled by the need for a press release, many of the investment advisers who belong to the National Association of Personal Financial Advisors were apoplectic. NAFPA, which has 1,000 or so members, is the financial industry's little engine that could. Despite its small size and diminutive clout, the organization of fee-only advisers starts tossing china plates when one of the Goliaths in the financial industry does something dastardly.

Peggy Cabaniss, the NAPFA chairwoman, rightly called Smith Barney on its linguistics shenanigans. "The term 'financial adviser' should be reserved for professionals who give objective financial advice and who always put the interest of their clients first," Cabaniss wrote. "It should not be co-opted by salespeople whose only loyalty, both financial and legally, is to their employer."

Millions of people who rely upon stockbrokers for investment advice won't know what the heck Cabaniss is talking about. And that, of course, is the problem. The brokerage industry has worked hard to erase the distinctions between brokers and investment advisers. And Smith Barney isn't the only linguistic contortionist. Just try finding any brokerage firm that hasn't embraced honorific titles for its brokers. If you pick up any stockbroker's business card today, you will find that they've morphed into financial consultants, wealth managers, retirement specialists and all sorts of other titles.

Playing loose with titles wouldn't matter if they were inconsequential, but they aren't. You see, the stockbroker who handles your stock trades and perhaps sold you some annuities is essentially a salesman. If you're only buying shares of Apple Inc. or whatever other company you take a fancy to, maybe this won't matter. But if you expect your financial point person to provide you with a comprehensive plan that could include how you're going to fund your kids' college education and your golden years, you may have walked through the wrong door.

You could be puzzled by what I am saying if you value the advice you receive from your broker. There are some very intelligent, conscientious brokers in the field today. I've talked to plenty of them. But while these brokers may impress you with their educational background, their investment acumen, their alphabet soup of professional designations and their promptness in returning calls, many of them can't compensate for one glaring omission on their vitaes: They can't call themselves fiduciaries.

It's not that many brokers wouldn't love to be fiduciaries, but many firms routinely forbid it. In fact, ferocious battles have been waged by the brokerage industry in Washington, D.C., over something informally called the Merrill Lynch rule, to make sure that their sale forces don't have to behave as fiduciaries. If you're wondering who is winning the war, it sure isn't the investor.

Before you can appreciate why the brokerage industry is keeping its howitzers fully loaded, you have to understand why you should seek advice from a fiduciary, which has become the investment world's latest buzzword. First and foremost, a fiduciary must act in good faith when making decisions for clients. A fiduciary will only recommend investments that are in an investor's best interests. A fiduciary, who must set aside personal interests, discloses all his or her fees.

So who are these fiduciaries? The Investment Advisors Act of 1940 obligates registered investment advisers to behave as fiduciaries. One requirement of these advisers is filing an annual ADV form with the U.S. Securities and Exchange Commission, which provides information on such things as an adviser's background, compensation and size of the firm. If your financial professional is an RIA, he or she can provide you with his or her annual ADV form, which you should definitely read.

You may be wondering how a broker's responsibilities compare with a fiduciary's. For starters, a broker's first loyalty is to his employer. Rather than recommending the best investments to their clients, brokers can skate by with the lower standard of suggesting "suitable" investments. This might not sound egregious until you hear examples of how this works. Would you rather, for instance, have your broker recommend inexpensive mutual funds with a solid history of performance or stick you with a "suitable" in-house mutual fund dogged by high fees and a hideous track record? Sure, you'd be hurt financially, but the brokerage firm would benefit when your broker unloaded a bow-wow fund on you.

If you don't think this happens all the time, guess again. A few years ago, according to Bob Veres, who is a respected financial industry observer, Morgan Stanley Dean Witter bragged that 70 percent of its broker fund recommendations were for in-house mutual funds. About three years ago, Merrill Lynch was using portfolio evaluation software that was designed to prohibit any portfolio recommendation for a client that didn't contain at least one Merrill Lynch fund.

Because they don't need to worry about fiduciary niceties, brokers also don't have to disclose fees and conflicts of interests. Brokers also don't have to worry about trading bonds and stock for clients at the lowest price. In fact, they are free to steer customers to high-cost trades that would benefit their firms. Some brokers will recommend individual bonds to clients because it's especially easy to hide exorbitant costs on fixed-income trades.

My point here isn't to pick just on brokers. It's to stress the importance of finding an adviser who is a fiduciary. What I find truly sad is that so many educated people don't even know what kind of folks they are relying upon for advice. Do you know if you are using a broker, a registered investment adviser, an insurance agent, or somebody else?

And just because your financial guy doesn't work for an identifiable firm like Merrill Lynch or Smith Barney doesn't mean he isn't a broker. Many brokers are affiliated with broker-dealers that aren't household names. Some of these independent brokerage firms allow their reps to serve as a fiduciary, but others won't.

One way to determine if you have a traditional broker is to see if the materials you have filed away contain this statement: "Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid both by you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits and our salespersons' compensation, may vary by product and over time."

If you don't know who is managing your money, guess what your homework is for this week.