Fee or no-fee, advice isn't free

by Lynn O'Shaughnessy

If you are bewildered by the number of mutual funds on the shelves, selecting a financial adviser has got to be an even more excruciating process. The nation's inventory of mutual funds exceeds 8,100, and if you multiply that number a few times, you'll get some idea of the staggering number of people trying to make a living in the advice business.

Unfortunately, too many people who portray themselves as financial experts aren't. The threshold to get into this business is too low to cull out the clunkers, so you just might need your weed whacker. You can start the elimination round by reviewing last week's column and reminding yourself why you should reject any adviser who isn't a true fiduciary. Working with someone who puts your interests first is so important - and obvious - that I'd urge you to be pigheaded on this requirement. If a financial adviser won't acknowledge a fiduciary duty to you in writing, move on.

Once you've eliminated people without fiduciary credentials, another obvious way to significantly shrink the candidate pool is to decide how you want to pay for the advice you receive. Based on how investment professionals are compensated, you can divide the players into three categories. First, you've got the commissioned crowd. You won't pay commissioned brokers or planners directly, but they will be compensated by the sales charges generated by the mutual funds, annuities and other investments they select for your portfolio. Second, you've got the fee-only professionals, who get paid by you. Lastly, you have the fee-based folks who can try to have it both ways. They charge a fee, but you also might find commissioned products in your portfolio.

If I were searching for an adviser, I'd ignore the folks who earn their living either partially or totally through commissions. My preference is to pay for what you get, which means I enthusiastically endorse the fee-only camp. Here's my take on the three ways to pay:

- Commissioned professionals. If you aren't sure how your adviser is getting paid, chances are good that he or she is earning commissions.

I believe many people end up with commissioned planners or brokers because it's so easy to slide into a relationship when it doesn't seem to require any financial commitment on their part. You meet a guy who seems to be offering to help you for free. He's not asking you to write a check. You will never see an invoice. There may never be a discussion about the cost. How great is that?

Not great.

What a lot of people don't realize is that they will pay; they just won't know it. You see, the commissioned guy is only going to hook you up with mutual funds, annuities and other products that trigger a sales charge and/or ongoing higher expenses. And that's only fair, because he needs to earn a living. By restricting you to commissioned funds, however, you won't have an opportunity to invest in some excellent low-cost options.

A commissioned adviser, for instance, isn't going to sell you Vanguard index funds because these inexpensive mutual funds don't spin off commissions. What's more, some of these folks are going to be unable to resist signing you up for dubious investments that generate megacommissions that might allow them to buy, with just one fortunate sale, a mighty fine plasma TV. It's the siren call of fat commissions that I'd suggest prompts the sales of expensive and inappropriate equity indexed annuities and variable annuities.

If you choose a commissioned adviser, you need to ask for specifics on how he is paid and the amount of the compensation. There are good funds that charge sales commissions, but you need to know the cost of adding them to your portfolio. Ask what share class of mutual funds that he or she is recommending and why. With commissioned mutual funds, so-called A shares are almost always the preferable route.

When investors are clueless about the compensation, they are more likely to continue paying long after the point where they would normally kick up a fuss. The way some commissioned mutual funds are structured, investors will pay continually higher charges to compensate a broker or adviser even if he is long gone. I liken this to paying a taxicab driver many years after he dropped you off at the curb.

- Fee-based advisers. I can't help but think that the folks that came up with the term "fee-based" were trying to befuddle investors. It's far too easy for people to confuse "fee-based" with "fee-only." The major brokerage firms embraced fee-based services a while ago in the hopes of keeping clients from defecting to discount brokerage firms, where they can take advantage of low fees. With fee-based accounts, brokers can charge customers a flat fee or a figure based on the amount of cash in their account.

Too many investors, however, are being gouged by fee-based accounts. And that's what Eliot Spitzer, in his final salvo as New York attorney general, alleged when he filed a civil suit in December against UBS Financial Services, a major Wall Street player, for putting thousands of clients in fee-based accounts when regular commissioned-based accounts that charge per trade would have been far cheaper.

In the suit, Spitzer, who is now New York's governor, cited all sorts of examples. An account of a woman in her 90s, for instance, was allegedly charged $35,000 during a two-year period even though only four trades were executed. UBS denies all the allegations.

- Fee-only advisers. More financial professionals haven't embraced the fee-only model because, at least initially, it's a tougher way to make a living. People unfortunately balk at writing a check for advice, even though they can ultimately pay far more if they don't choose the direct route.

I admire fee-only veterans because they clearly have commanded enough respect and word-of-mouth referrals to build up a sizable practice. When you rely upon a fee-only adviser, you can happily eliminate a humongous conflict of interest. You don't have to worry about your financial point person recommending something because he's going to capture a fatter commission. The fee-only adviser works exclusively for you.

These advisers will typically examine your entire financial status, from your retirement dreams to your cash flow, and develop an investment plan tailored to your time horizon, risk tolerance and goals. Fee-only clients typically pay the adviser a percentage of their assets annually to manage their money.

Some investors, however, don't need this constant hand-holding or find it too expensive. For those folks, it is possible to find fee-only planners who charge by the hour. Next week, I will explain how you can find these professionals and what questions to ask when you start shopping for advice.

Fee or no-fee, advice isn't free by Lynn O'Shaughnessy