The Problem With Brokers

I've seen my fair share of brokerage statements from Big Name Brokers cross my desk over the years. Very often I'm appalled by what I see. Why? I often see brokerage accounts stuffed with scatter-shot investments (often excessive amounts of large cap US stocks) with little regard for clients' risk tolerance and for their overall financial needs. Brokers often populate accounts from a list of "recommended shares" passed down by management, and call clients with "talking points." Lost in the mix is even a cursory glance at clients' other accounts (for example, their 401k plans or other "held-away assets").

When accounts bulge with a 50-100+ holdings, clients can't understand how they're invested. Brokers get away with this because they adhere to weaker standards of conduct. A recent 6/5/19 ruling by the SEC ("Regulation Best Interest or Reg BI) requires brokers – in theory – to avoid putting their interests before the clients' interests but the "F" word ("Fiduciary") is avoided and clients continue to be exposed to broker investment advice with no fiduciary accountability. In other words, brokers are off the accountability hook when selling investments.

On Oct 1, 2019 regulations tightened on Certified Financial Planners™ (CFPs) who provide financial planning services. This is good for the public because ALL CFPs – whether Fee-Only or not – will be required to offer a Fiduciary standard of care that puts the needs of the clients first when financial planning is provided. *However,* brokers who aren't a CFP® and who simply manage investments (with NO financial planning services) aren't held to this standard. Brokerage houses may offer financial planning services only if the client is large enough ($3 million or more – it depends upon the broker) to merit an "upgrade." Even then, the higher level financial planning team at the brokerage house may push in-house products (e.g. more expensive mutual funds) instead of lower cost alternatives.

This way of working is *a world away* from how Certified Financial Planner™ (CFP®) Fee-Only Advisors work. CFP® Fee-Only Advisors typically offer low cost, diversified investments that are consistent with a client's risk tolerance *and* they provide extensive financial planning support. **In my opinion, clients lose access to meaningful financial planning support when they chose to work only with a broker.**

CFP® Fee-Only financial planners look at ALL of the clients' investments (not just the ones that they manage and invoice on) and financial planning is provided at all times. Financial planning means: insurance reviews, tax planning, education planning, retirement planning, estate planning, pension planning….etc. Since Fee-Only planners do NOT sell products, there are fewer conflicts of interest. *In my opinion, decent investment management design rests upon an understanding of the client's entire financial picture*. When was the last time your broker reviewed your insurance needs or picked up the phone to talk with your estate attorney or CPA?

Here are some of the things that I find especially appalling about some of the brokerage statements I've reviewed:

1. <u>Incoherent scatter-shot investing</u>: As mentioned, accounts often hold dozens of individual shares and mutual funds that give the illusion of diversification. Brokers frequently buy/sell positions to give the impression of being "busy" and "active." Invariably these portfolios look very similar: a large serving of stocks in well-known large US names and little/no exposure to other asset classes. It often doesn't seem to matter if a client has a low risk tolerance or not – it's still the same excessive exposure to large US companies. Studies show that individual stock investing

increases risk in portfolios. Real diversification means investing across many asset classes. This can be done efficiently and effectively via low cost mutual funds.

2. Poor differentiation between taxable and tax-deferred accounts. Some investments are better held in e.g. IRA accounts and some are best held in taxable accounts. The taxable and IRA statements I see often mirror one another with little or no regard to the tax impact on the client.
3. Relatively expensive mutual fund holdings (some with a 5.75% up front one-time commission paid to the broker). "Expensive" mutual funds have annual expense ratios that exceed 1.2% or more (sometimes they exceed 2% per year). Investors never see these fees on any statement of account – the fees simply are deducted from the annual return.
4. **Zero financial planning.** ***This is a big omission.*** All my clients require some kind of financial planning, not to be confused with "investment planning." Examples include tax-efficient gifting methods, how to handle college expenses, recommended savings a family needs to prepare for retirement, analysis of when clients can afford to retire, a deep dive into existing vs. recommended insurance coverage, how investments should shift over time to address cash flow needs, etc. *Brokers typically provide none of this input, leaving the clients to flounder and make financial planning mistakes along the way.*
5. Lack of fee transparency. Brokers charge in a variety of ways (e.g. commissioned loads on mutual funds). There aren't enough brokerage account clients asking brokers "how are you paid?" before signing up with them. *Unbelievably, I've had clients tell me their brokers told them that their services were "free."* And then there are "Fee-Based" advisors who *sound* like Fee-Only advisors but they charge BOTH an assets-under-management fee AND a also sell commissioned products

like A, B and C mutual funds. These charges together can well exceed 2% per year for clients. I believe this way of charging fees should be illegal.

6. <u>And finally – other product sales – such as annuities</u>. Low cost annuities may have a role in some clients' portfolios but expensive annuities typically are oversold and disappoint due to high fees. Commissions are still temptingly high on annuities and clients can be tied up for years in such products.

In sum, there's a world of difference between the way brokers often handle investment accounts and the way Fee-Only Certified Financial Planner™ Advisors invest/provide financial planning support. Clients always tell me their brokers are "very nice people" but I think inertia (failure to budge) keeps many clients working with their broker – even though they're beginning to understand there's a better alternative to the standard, broken broker model that recent SEC rulings have not fixed.

Written by Eve Kaplan, CERTIFIED FINANCIAL PLANNER (TM)