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Brokers in Sheep's Clothing

By EDWARD P. MAHAFFY

IS YOUR TRUSTED ADVISER really just a salesperson? Sometimes it's hard to tell, given all the titles used by brokers: financial adviser, financial consultant and financial planner, to name just a few. Many of these sound quite similar to "investment adviser" -- but there's a big difference. Investment advisers, unlike brokers, have a fiduciary duty to their clients. That means they have a legal obligation to place the client's interests ahead of their own, and to clearly identify all sources of compensation, the amount of compensation and any potential conflicts of interest. It's all laid out in the Investment Advisers Act of 1940

A broker has no such obligations, unless the client has given him discretionary authority to trade without the client's approval. Many brokers, however, masquerade as investment advisers. Television ads by brokerage firms trumpet "objective" advice and make the firms sound more like trust companies. The firms try to project an image of having a fiduciary duty without actually having one. But how can any sales organization offer truly objective advice?



Dave Klug

As an independent broker and investment adviser with more than 20 years of experience, I've had ample opportunity to see how brokers operate. My conclusion: Although there are many honest and knowledgeable brokers in the world, the nature of their compensation and the relationship with their employer can seriously diminish clients' chances of having fee-efficient, tax-efficient, well-performing portfolios. Here are five things to watch out for:

MOST BROKERS ARE PAID by a formula that increases the broker's portion of commissions and fees as revenue increases. For example, a broker might be paid 30% of revenue of up to \$249,999 -- and 35% of revenue above that amount. This is retroactive to the first dollar, so when revenues hit \$250,000, the broker effectively gets a bonus of 5% of the total, or \$12,500. Some brokers will sell *anything* to *anybody* before year-end to cross that threshold.

And the products they will rely on the most are the ones with the highest fees and the highest commissions, such as variable annuities and mutual funds with "loads," or front-end sales charges. The situation is even worse if a broker has been offered an increased payout as a bonus for switching firms. For instance, he or she might be offered 80% of revenues for the first 12 months.

A BROKER'S SALES MANAGER also presents conflicts. Sales managers tend to reward the brokers that sell the products that fatten the firm's bottom line -- load funds, variable annuities or perhaps the firm's proprietary products. Few brokers will confront management over such tactics for fear of reprisal. The brokers that "play ball" are often the ones that make the most money because management assigns them the best accounts. Those that choose not to play ball often receive fewer new accounts and are marked by management as troublemakers.

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FEE-BASED ACCOUNTS, which allow clients to trade as frequently as they wish for a fee of usually 1% to 1.5% of assets, can eliminate a broker's temptation to "churn" the portfolio to increase commissions. But the accounts, which are increasingly popular, encourage another form of abuse: The broker may suggest one for a client whose trading

activity is low. Such clients would probably find it more sensible to pay a commission each time they trade. Morgan Stanley recently agreed to pay \$6.1 million in fines and restitution for allegedly overcharging for fee-based brokerage accounts. The NASD said the firm, from 2001 through 2003, failed to identify customers in its Choice accounts who would have paid less in traditional, commission accounts. Morgan Stanley neither admitted nor denied the charges.

SO-CALLED SEPARATELY managed accounts, a popular form of customized portfolio, can lead to unusually high fees. With these accounts, the broker charges a "wrap fee," with the broker's fee wrapped around the fee of the investment manager. And the broker's fee is often a good deal more than the manager's fee -- sometimes twice as much. Total annual fees can exceed 3%. When the fee is debited from the account each quarter, the broker's portion is not itemized, so the client is in the dark on exactly what the broker received.

SWEEP ACCOUNTS, the brokerage industry's alternative to money-market funds, are very profitable for the firms. They make much more money on sweeps than they would by farming out your cash to a money-market mutual fund. In a sweep account, the brokerage makes similar short-term investments with your idle balances. But the rates are usually much lower than for money-markets funds -- typically 2.7% nowadays, versus 3.1% for the funds. And a money-market fund has a fiduciary duty to provide the best rate possible for its shareholders, while a brokerage firm does not.

There's no need to be intimidated by all this. If you do choose to deal with a broker, request a full accounting of how much you are paying in fees -- and try to negotiate them lower. Point out that E*Trade offers to rebate 50% of your mutual funds' 12b-1 fees, which are recurring commissions. If your broker suggests moving you into a fee-based account, ask for a comparison based on past and proposed commission activity to see if it's right for you. Insist that any wrap fee be lowered by at least 15% to 20%. Most brokers can afford that in order to keep a good customer, since the fees are so high to begin with. If your broker suggests mutual funds with loads, ask about lower-cost exchange-traded funds. If he recommends a variable annuity, request a comparison with a no-load fund.

In my view, the better route is to pick a bona fide, fee-based or fee-only investment adviser. They are not completely free of conflicts, of course. Like brokers, they may steer you toward a certain family of mutual funds because the fund company has a revenue-sharing agreement with the adviser's firm. But unlike the broker, they are legally bound to disclose this information, as well as all sources of compensation. You should request a comparison of getting charged by the hour, by the project or as a percentage of assets.

Advisers belonging to the National Association of Personal Financial Planners are especially notable, because they must submit their work for peer review and adhere to a code of ethics. You can find one at www.napfa.org. An adviser like this might just save you a bundle.

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