Redefining “Suitable ” Financial Advice

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An audit revealed conflicts of interest between financial advisors and their customers.

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People looking to make the most out of their retirement portfolio often turn to professional financial advisors for help. But those advisors are incentivized by commissions and fees rather than their clients' financial well-being, and clients are not always able to distinguish the good advice from the bad.

Summary

Investing is complicated. The average consumer often lacks the time and expertise to make optimal investing decisions. That's why many turn to financial advisors for assistance. However, advisors are incentivized not to maximize returns for clients, but to steer them toward funds with more expensive fees and commissions.

Although investment brokers are required by law to provide "suitable" investment advice, it's a vague guideline. Extensive academic research reveals that the conflict of interest in the financial investment industry costs Americans 17 billion dollars a year, with consumers' returns averaging 1% lower at the individual level.

Along with researchers Sendhil Mullainathan, Markus Noeth, and Antoinette Schoar, we set out to understand whether this inherent conflict of interest prompts financial advisors to provide investment recommendations based either on their potential to earn commissions for themselves or to yield the highest return for the consumer. To do this, we set up an audit study to review the quality of financial advice provided.

Highlights

- Conflict of interest in investing costs Americans 17 billion dollars a year
- Advice given by advisors may have a negative impact on the client's returns
- Only 7.5% of financial professionals in this audit encouraged low-fee investment strategies such as index funds

The audit

In this study, financial advisors refer to those that the average consumer can access via their bank, independent brokerages, or investment advisory firms. These are advisors who are normally paid based on the fees they generate from sales and not from the performance of a portfolio.

Men and women of different income levels, ages, and portfolio sizes were hired to portray customers of such advisors. Between April and August of 2008, these anonymous customers audited four different investment strategies over 284 customer visits. Researchers randomly altered the type of investment strategy represented in the portfolios of the selected customers. Additionally, the researchers worked closely with a financial audit firm to provide the logistics of monitoring and scheduling these visits, to set up the online survey forms, and to select people to portray the customers. After these auditors or "customers" were given a short training on financial literacy, they set up in-person meetings with their assigned financial advisor and tracked the information that was asked of them as well as the investment advice given to them. After the appointment, the auditors had 24 hours to fill out an online survey to further extract high-quality information from these appointments.

The researchers then analyzed the reported information to determine the most common investment advice given to average consumers.

Four investment strategies represented

	Benefits Client	Harms Client
Benefits Advisor	Control	Chasing Fund Returns
Harms Advisor	Diversified low-fee portfolio	Employer Stocks

The following are the four common types of investment strategies represented in the selected customers' portfolios—all based on harmful misperceptions around investing. The strategies vary by the amount of money a customer could lose if the financial advisor doesn't correct the customer's biased misperceptions, and whether or not there is a conflict of interest between the financial advisor and the customer.

1. **Chasing fund returns:** In this first scenario, the assigned customer holds a portfolio where 30% of the funds are in a sector that has performed well over the past year. The customer indicates to the financial advisor that they are looking for additional sectors with a similar history of high performance. Because it is not possible, on average, to predict the stock market, this returns-chasing behavior historically leads to significantly lower returns compared to a buy-and-hold strategy. However, clients may be tempted by such a strategy thinking that if it worked in the past, why not going forward? The client would benefit by retaining the current diversified portfolio, but the financial advisor would benefit from the client's desire to chase fund returns and therefore generate fees through buying and selling.

2. **Employer Stocks:** In this second scenario, the customer holds a portfolio containing 30% of their employer's stock. Individuals often feel more comfortable with stock in companies they already know—and who do they know better than their employer? But over-investing in company stocks can lead to risk and under-diversification. If the company suffers a setback they might lose their job and with it their financial assets. In this scenario, the incentives of the investor and advisor are aligned; it will help both if the advisor convinces the client not to hold on to the company stock. The investor will benefit with a more diversified portfolio and the financial advisor will benefit by moving money out of this stock and generating a fee.

3. **Diversified low-fee portfolio:** This is the most balanced and efficient portfolio that consists of index-funds and stocks. The client would benefit to stay in this fund, but the advisor would benefit by moving money out to generate a fee. Researchers were looking to see whether advisors would recommend moving clients out of this portfolio (which is the closest to the allocation recommended in most financial textbooks).

4. **Control:** In this final scenario, the customer holds cash and does not indicate any particular preconceived investment preference and simply desires to increase risk in order to gain higher returns.

Self-interest plays a key role financial advice

The results of the audit demonstrate that self-interest on the part of advisors plays a key role in the quality of advice provided to customers. The guidance that financial advisors provided did not educate clients or help them overcome their perceptual biases. In fact, the advice given may even have a negative impact on the client's returns. The majority of financial professionals in this audit did not correct, but actually supported, investment misperceptions that helped them maximize their own commissions. By recommending more actively managed funds (which involve more frequent buying and selling) they created more fee income. In fact, actively managed funds were recommended to almost half of the customers, even for those customers with an already well-diversified index fund—a superior and beneficial option for most people's needs. Additionally, fees associated with managed funds were routinely downplayed during the meetings, obscuring the advisor's financial incentive to the customer. By comparison, only 7.5% of financial professionals in the audit encouraged low-fee investment strategies such as index funds.

Putting customers first becomes law

The financial professionals in the audit were not doing anything illegal or violating existing regulations. In fact, their advice could be considered "suitable," even if it didn't maximize returns for clients. The market-based consumer model pits consumers' best interests against the profits of the financial advisor, creating a natural conflict of interest in the industry.

However, a new regulation introduced by the US Department of Labor became partially effective in June 2017 and requires financial advisers to recommend the option that is *best for the customer* when providing advice about retirement accounts. The new rule requires a larger group of investment professionals to act as fiduciaries, meaning that they legally must put their customer's interests first and the firms must disclose any conflicts of interest on their website. While this fiduciary rule applies only to retirement accounts, it is a step in the right direction. Many firms have already changed their internal guidance to advisors in anticipation of full enactment of the rule. This rule could, ideally, serve as a foundation for additional regulations across different investment accounts to reduce conflicts of interest between financial professionals and customers.