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Follow the Fees

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How your adviser gets paid can make the difference between investing success and failure.

In my last column, we explored the distinction in regulation between securities brokers and independent registered investment advisors (RIAs), specifically regarding fiduciary duty. Compensation is another area of distinction. While an investment adviser is compensated directly by the client for advice, brokers are generally paid in the form of commissions from the broker/dealer whom they represent.

The successful investor makes herself acutely aware of the types and magnitude of fees paid to her adviser—as well as to others in the investment food chain. It's extremely important to be cognizant of all costs embedded in your portfolio on account of the distribution channel.

Here are some specific compensation practices to watch for when evaluating a financial adviser.

Selling Away.

A registered representative's allegiance to the employing broker/dealer requires adherence to the NASD rule against "selling away." This rule prohibits the recommendation—or even suggestion—of products that the firm does not offer, even if your broker believes you would be better served by looking elsewhere.

Summary: Follow the Fees

Investors benefit themselves making themselves aware of all costs and fees within their portfolio.

The moment there's suspicion about a person's motives everything he does becomes tainted.

—Mahatma Gandhi



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Specific firms mentioned are illustrations only and are not recommendations. Past performance does not guarantee future results.

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Your Way to Prosperity

Sales Incentives.

Brokers are motivated by a variety of sales incentives, depending upon what, how and how much they sell. For example, brokers may earn more for selling proprietary products. Retroactive commissions pay more when annual sales thresholds are reached—which should make you wary of buying a product toward year's end.

Also, look for “pay to play” arrangements, in which outside firms pay for “shelf space.” As in grocery stores, certain products are prominently displayed and others—even of better quality or lower prices—are positioned less favorably.

Alphabet Soup.

Broker-sold mutual funds come in different share classes—identified by letter—representing the “load” for purposes of compensating the adviser. Securities regulators have recently disciplined a number of brokers for recommending B shares when A shares (which carry a larger up-front load but lower ongoing payments) would have been more economical.

The least expensive way to buy mutual funds is “no load” funds, either directly from the fund company or from a “fund supermarket,” such as Schwab, Fidelity or TD Ameritrade. Even if you go that route, you can still obtain advice from a professional about that portfolio; the cost of the advice would be separate from your purchase of the funds themselves. A good resource on mutual fund fairness issues is www.funddemocracy.com.

Fee-Based Accounts.

In the last several years, brokers have offered fee-based accounts, allowing an unlimited number of trades for an annual fee of 1% to 1.5% of assets. Regardless of whether such a

strategy makes for effective investing, these accounts eliminate the broker problem of “churning” the portfolio to increase commissions.

On the other hand, in accounts with minimal activity, you may save by paying commissions—particularly as your broker does not have a duty to monitor these accounts on your behalf. The NASD is cracking down on some of these accounts as well. Fee based accounts should also be distinguished from engaging a “fee-only” advisor to whom fees are paid directly by the client for all investing and planning advice.

Wrap Accounts.

Among the latest fads on Wall Street are so-called Separately Managed Accounts (SMAs). These accounts purport to offer affluent investors the same cachet as those of their broker's wealthiest and institutional customers. The pitches include access to the “best” managers, direct stock ownership (not fund ownership), and tax management.

Unfortunately, SMAs can have high fees. Typically, the broker's fee is “wrapped around” those of all the investment managers. Plus, an “overlay” manager, who coordinates the activities of multiple managers, may add a fee. Total fees can exceed 3%, and the accounting makes it difficult to determine who gets which part of the fees.

Recent research indicates that brokerage firms often fail to deliver on the hype associated with these accounts. Investors find themselves in standard portfolios without the promised customization or individual tax management. And, investors get nowhere near the diversification provided by a portfolio of low cost mutual funds.

Do Your Homework.

In the current financial environment, it is up to the investor to research what fees are involved and who receives them under which circumstances. By understanding advisers' motivations—and potentially saving 1% or more in fees—doing your homework can significantly impact the outcome of your investment plan.