

NOTE 127 INVESTMENT ADVISOR 37 POINT CHECK LIST

Don Gimpel, February 2014 Rev. May 2014

Myth #1 – You Get What You Pay For [1]

Most investors outsource their portfolio to professional Money Managers who supposedly perform better because, well, they're "PROFESSIONALS"! But the money management business is just like any other competitive business. Not everyone can be great at it. And research shows that over 80% of professional mutual fund and hedge fund managers underperform a correlating index. The reality on Wall Street is that most professional money managers cannot outperform an index and add very little value over buying a simple index fund. Those extra fees you're paying for are often times a sunk cost.

[1] "5 Wall Street Myths That Hurt Investors," Orcam Alternative Perspectives, Orcam Financial Group, info@orcamgroup.com, October 1, 2012

WHAT WE'RE TRYING TO DO

It's no sin to be naïve about investing or anything else but its no great honor either. (Tevya, "Fiddler on the Roof" Act 1) There will often come a point where you don't want to do the investing horse work any more and are willing and maybe even anxious to have somebody else do the job. The problem is to find somebody – a person or an institution – that can do the job at a price you can afford and with whom you have some measure of trust and that's the real problem.

These fellows are out to make a living and you can't fault them for that but making a living selling investment advice can be difficult and the temptation is always there to take short cuts, promise more than you can deliver and do the least work possible.

There's one more problem. If something happened to you, would you trust that person or institution to deal fairly with your widow. This is a rhetorical question because you already know the answer. This checklist categorizes the things you to ought to know about the advisor and lists clues that might tip you off to his behavior if the worst ever happens.

Here is a suggestion for your widow. Avoid advice from brokers unless you have one that you trust well enough to rely on him for your entire financial future. There is always the temptation to churn your account or to put you in investments that are inappropriate. Avoid bank trust departments because they are impersonal and your portfolio is likely to be small in comparison to other funds that they manage. Think about selecting a low fee based large reliable institution that will not merge your account with others. Morningstar is one such an example.

GETTING ACQUAINTED

	The question	Comments
1	How did you learn about the service?	If you were told about the service from a friend, is the friend qualified to have an opinion and does he profit from the referral?
2	Does the Manager have an office?	The session must be in his office so you can determine for yourself that he has an office and that he is not simply renting a desk, receptionist and conference room. Avoid people who are willing to meet you in your own home for your convenience.
3	Does he have a back up?	What happens if the manager becomes incapacitated? Is there a knowledgeable back up there to take over your account if and when necessary?
4	Do not be misled by your surroundings or simple politeness.	The meeting might take place in a paneled office with a highly polished conference table and with comfortable chairs. Your being offered coffee served in an English bone china cup versus a mug and being offered Danish has more to do with the advisors judgment of your investable net worth than with you as a person.

WHAT HE WANTS TO KNOW ABOUT YOU

1	What is your net worth and how much is in cash or investments?	It's important for him to learn whether or not you have other investments and investment managers because if so he might suggest pooling under his direction – for a fee. He will use the argument that your overall portfolio requires coordination and there is some truth in that argument.
2	How much do you plan to invest with	He must know at the outset whether you meet his minimum portfolio

	him?	size requirements. Is he flexible about the minimum size requirement? If so, that tells you something about how hungry he is. Remember that he is likely to pool your account with other investors. This means that his incremental costs for your account are minimal and almost all profits.
3	Do you have special tax or trust requirements?	If you have any special trust requirements you must see your own attorney.
4	Do you need to withdraw money from time to time and how large are the withdrawals?	If you must withdraw money for living expenses, this means he has additional administration expenses. He might be forced to sell investments to meet your needs and the sales might not be at a convenient time.
5	What is your risk tolerance?	This is the essential question for unless he knows this he will not know enough to invest your money or if he offers multiple master portfolios, which portfolio would make you the most comfortable. He might ask you directly about your risk tolerance. These is a poor way of finding an answer to this question because people sometimes lie even to themselves or provide an answer that they hope will impress the manager. The best way is for you and for him to learn about your risk tolerance is for you to take a formal well-designed test. Does he offer such a test?

WHAT YOU NEED TO KNOW ABOUT THE ADVISOR AND HIS SERVICE

1	How long has he and his firm been managing investments?	Its good if he and his firm have some sort of real history as opposed to a back-tested record which might have been optimized to meet past conditions. This why financial consultants often have a disclaimer that states “Past performance is not indicative of future returns.”
2	Do they do their own research or buy it from a service?	There are many firms that specialize in providing research to money managers. Such research might include which investments to Buy/Sell and macro-economic forecasts regarding the market and they economy. The advisor’s role might simply be that of a middleman salesman and that raises the question of the worth of his services. His market wisdom might come from mouthing other peoples work.
3	Are they simply brokering money management?	They might not do their own research and may simply be farming out management to others. If so they will usually make the claim that they’re value added is their experience in picking others.
4	Who handles the money?	This is an immediate deal breaker. An independent institution must handle the money. This prevents fraud and theft. If he handles your money, terminate the conference and on the way out, make sure you get your parking ticket stamped.
5	How often are summary reports distributed and by whom.	Look for reports at least once a quarter and be suspicious of any undue delays.
6	What is the nature of his service?	Is he offering a limited partnership in an investment and if so who is the general partner? Is he just offering advice for a fee? Does he handle the complete transaction through an institution or does he simply have the ability to make trades within your existing account, as does Morningstar with their Hare and Tortoise portfolios.
7	Does he require a performance incentive?	Some managers want a percentage of any profits made as against charging no fee for any portfolio losses. This is a very bad deal for you because it opens the door to abuses and management failure. Think it out. On the average over time, the S&P 500 has gone up about 8-10% per year. What if he just buys the S&P 500 and then does nothing. He will be making good money by doing nothing.
8	Has the manager ever been accused of fraud or have complaints about him ever been filed?	Do not take his word on any fraud or complaints. It’s easy enough to check a complaint or compliance record with FINRA.com. Are there any pending suits or compliance actions against him or his firm? This is all part of your performing your due diligence.
9	Who audits their reports?	You might consider calling their auditor to see if the manager or his firm in fact employs them.
10	What are his fees and are they on a sliding scale against the amount	Avoid accepting statements like “Their fees are high but they are worth it.” Avoid fees based upon future profitability. Fees are a significant

	invested?	factor in investment profitability. You can get first-rate performance for a 0.5% annual fee.
11	Are they offering a choice of portfolio styles or are they offering a single portfolio that they consider best suited for your needs?	Are you being pushed toward one resource and if so why? Ask to see their full range of independent outside financial advisory services./
12	Is your portfolio being pooled or individually managed?	It is relatively easy for your portfolio to be pigeonholed into one of a number of slots. What if you don't fit any of their slots?
13	Ask them about their responsibility to you.	If they are broker-dealers or part of a brokerage house they do not have a fiduciary (legal term) responsibility to you. They are simply bound to offer what is suitable. At the least, they must keep accurate records. Ask for and save any receipts. An investment advisor is held to a fiduciary standard which requires them to (1) act in their clients best interests, (2) not subordinate a client's best interests to his, and to (3) disclose conflicts of interest.
14	What are you paying for?	Some advisors believe that you are paying for their investment picking prowess and that you are responsible for making the "In the market/Out of the market decisions. Those advisors are usually invested 100% of the time. Do not look to them to take you out of the market when the market is going down. Others believe they are being paid for the "safe haven" decision. You must understand the advisors policy on this matter.
15	Always read the fine print.	If everything goes well you will be asked to sign a legal service contract spelling out all the terms and conditions that the advisor requires. Read the fine print – all of it. There might be a few surprises buried there like the use of an arbitrator of their choice to settle disputes. Signing that contract is a bit like saying "I do." in a marriage ceremony and just as difficult to get around.
16	What happens if a conflict occurs?	Chances are that if a conflict occurs the fine print will specify arbitration but who picks the arbitrator. If they pick their house arbitrator, you have a good chance of losing.
17	Consolidation pitch?	Did the advisor make a pitch to consolidate all your accounts under one management (his) so he can watch them for you? It's a good bet he wants a commission for this service or he finds flaws to persuade to consolidate all the accounts under his direction.

DO THEY HAVE AN INVESTMENT STRATEGY

1	Do they have an investment strategy and are they willing to tell you what it is?	Most managers do have an investment strategy but some consider it proprietary and will not provide details. This is sometimes called a "Black Box." Sometimes they don't have a strategy and provide the proprietary Black Box excuse to hide this lack.
2	Do they explain the strategy in simple terms and do you understand what it is?	Sometimes an offered explanation is incomplete, obtuse and misleading in an effort to give the client some explanation without telling him anything valuable. Recognize when that is happening to you and it tells you a lot about the organization. It is easy for them to hide behind a flood of words while saying nothing and making a client feel stupid and guilty for not being able to understand what is going on and ashamed to ask for a simple understandable explanation. This is also a tactic commonly used by those who really do not want to say anything or have nothing to say.
3	Do you feel comfortable with the strategy? Does their strategy fit your needs?	Can you live with a Black Box explanation? Can their strategy be made to work for you.
4	Have all the "risk factors" been explained?	All investments have risk in one form or another. Make sure you understand those appropriate for your suggested portfolio.
5	Is the strategy "active" with the ability to get out of the market when necessary or are they always fully invested?	Some services assume that you are paying them to be fully invested and that if you are concerned about the market or their performance that you will adjust the size of the portfolio accordingly. Are you willing and prepared to get out of the market if you are uncomfortable. If they make

	that decision, where do they put the money? As an example, most ETFs are “Plain Vanilla” in that they simply follow a strategy. Some ETFs have the ability to exit the market to safe investments when the index declines. ETFs with this ability are termed “Active ETFs.” Some other ETFs follow an index which in itself is a complex strategy. These are called “Strategic ETFs.”
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HOW WELL HAVE THEY DONE

1	Ask about their total return over the near and long term.	<p>Smart managers do not lie because if they do and get caught it can be the basis of a reputation-destroying lawsuit. On the other hand, they can and sometimes do mislead and obfuscate relying on the investor’s thinking that they know a lot when they really don’t. Examples follow.</p> <ul style="list-style-type: none"> • Do they attempt to “Build the Mountain” by using a linear Y-scale over a wide time-span? Mountains look good but don’t mean much. • Do they use widely spread data points such as annual data at odd times of the year. This can easily hide large drawdowns. • Is their data smoothed to hide volatility? • Do they define what they mean by “Total Return.” The phrase has a number of meanings and they differ in impact. The most conservative of all in a rising market is “Cumulative Annualized Return” (CAR) and is the one they should use. <p>Every advisor has a performance disclaimer, which usually reads, “Past results are no guarantee of future performance. Its there for a reason.</p>
2	Have you ever heard of “Survivor Bias.”	The strategies offered are the result of “survivor bias.” They are the ones offered today because the manager thinks that they are effective today. You’re not going to find out about the strategies that didn’t work and were dropped. Maybe today’s offering will be in tomorrow’s portfolio of dropped strategies. You must be comfortable with what is being suggested.
3	Ask about their drawdowns and make sure you understand their explanation.	How do they define drawdown? At what intervals do they provide performance data? If the intervals are large as, for example, a year, then it is possible for them to hide large drawdowns.
4	Ask about the number of trades per year.	Avoid any situation involving a large number of trades because they may be churning the portfolio to obtain transaction fees. This does happen even with large brokerage houses and particularly with trusting clients. See the comments about “widows” at the start of this note.

WITHDRAWALS

1	Do you understand exactly how to make a withdrawal?	Sometimes withdrawals can only be made at specific time intervals. Some advisors have been known to rely on their client’s forgetfulness. Sometimes a withdrawal becomes a valid request only if submitted in some particular way, i.e., in writing and not by telephone. A notification window is a very common tactic used because it works to their advantage.
2	Make sure that you understand how to close the account.	Find out what can you do if you are really dissatisfied? If their service has been lousy, they already know it and don’t really care. Do not confuse being glib with competence.

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