

Due Diligence: The Five Key Rules To Heed Before Hiring a Financial Adviser

By Jonathan Clements
Updated May 31, 2006 12:01 a.m. ET

This should be the golden era of financial advice.

In the years ahead, millions of baby boomers will roll out of the work force, clutching their 401(k) balances and looking to generate maximum retirement income. That's a tricky task -- and a good financial adviser could be a great help.

But, unfortunately, the investment-advisory business just doesn't inspire confidence. In fact, given a choice between signing on with the typical financial adviser and simply dumping everything into a hodgepodge of Treasury bonds, it's an easy decision: I'd take the Treasury's every time.

Sound a little harsh? Before half of Wall Street sends me hate mail, let me concede two points.

First, financial advisers often write to me, arguing that many investors don't have the savvy and self-discipline needed to manage their own money. So let's agree: Many investors aren't fit to manage their own money.

Second, advisers often write to me, complaining that I dwell too much on the damage done by crooked and mediocre advisers, without noting that there are many fine brokers and financial planners. So let me say it: There are, of course, many fine brokers and planners.

What we need, of course, is for know-nothing investors to end up with these top-notch advisers. But will they? If investors, on their own, are incapable of building a simple portfolio of no-load mutual funds, they probably won't put in the serious work needed to find a great adviser.

Instead, many will likely wander into the local brokerage office or sign on with their sister-in-law's financial planner. And the odds are, things won't work out well. As a financial planner once joked to me, "The problem with our business is that 98% of investment advisers give the rest of us a bad name."

No, your local broker or planner isn't likely to be a crook. That's a relatively rare occurrence. Rather, as I see it, there are five pervasive problems with the investment-advisory business. Looking for an adviser? You've got to keep these five pointers in mind.

Many advisers earn their keep by collecting commissions on the investments they sell. That means they have an incentive to get clients to trade and to buy the highest-commission products.

I am not arguing that these advisers are always hell-bent on squeezing the maximum commission out of their clients. But why risk it? If you don't know enough about investing to judge the quality of your adviser's recommendations, you certainly don't want your adviser to have an incentive to sell you the wrong stuff.

Your best bet: Use fee-only advisers, such as those who charge an hourly fee, a percentage of your portfolio's value or a fixed annual retainer.

Most advisers have had little formal financial education. For instance, maybe 5% of brokers, financial planners and insurance agents have bothered to become a certified financial planner, or CFP, which has become the basic credential for any half-decent adviser.

To ensure your adviser is knowledgeable, stick with CFPs or, alternatively, folks who have qualified to be chartered financial consultants, chartered financial analysts or certified public accountants-personal financial specialists.

That brings me to today's fun fact. In Malaysia, to call yourself a financial planner, you must be qualified, such as earning the local equivalent of the CFP or the chartered financial consultant designation. But in the U.S., to hang out a shingle as a financial planner, all you need is a shingle and a place to hang it.

Advisers don't necessarily act in their clients' best interest. This issue has been brought into sharp relief by the heated debate over the Securities and Exchange Commission's so-called Merrill Lynch rule. Under the rule, fee-based advisers at brokerage firms often aren't considered fiduciaries, meaning they are supposed to recommend products that are best for their clients.

Instead, they are held to a lower "suitability" standard, which means they are only required to recommend products that are a reasonable choice for their customers. To protect yourself, avoid advisers who won't commit to acting as a fiduciary.

Many advisers offer investment advice -- and that's it. But there is much more to managing money than picking stocks and mutual funds.

You might also want help with your mortgage, college costs, insurance, taxes and estate planning. If so, before you sign on with an adviser, make sure the adviser is committed to assisting you with these other areas.

Most advisers charge too much, especially when you consider the limited advice they offer. Whether you're paying fees or commissions, your adviser's services might be costing you 1% of your portfolio's value each year. Tack on the fees charged by the mutual funds and other investment products you end up buying, and your total annual tab might be 2% or even 3%.

Result: If your adviser recommends a balanced portfolio of stocks and bonds that returns 7% a year before costs, you could pocket less than 5% after all fees are paid.

That doesn't mean a good adviser couldn't garner you a better rate of return, while also helping you with the full array of financial-planning issues. But is your adviser truly helping your finances? Not sure? Remember, you can always buy Treasury's bonds instead. These days, that will also earn you around 5% -- with a whole lot less hassle.