

THREE MISTAKES TO AVOID WHEN EVALUATING ADVISORS



The relationship with your wealth manager is important and one you should monitor regularly.

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As we wrap up the first quarter of 2023, we wonder how everyone is doing on their New Year's resolutions. Perhaps some of you made one of these two common resolutions at the start of the new year: "this year, I will take a closer look at my investment advisor's work," or "I will find a wealth advisor to help me and my family." Certainly, physicians are as prone as any investor to make these promises to themselves, and it's not too late to make good on that promise.

In this article, we outline the three common mistakes that investors make when evaluating advisors and provide suggestions on how to avoid making these errors.



REVIEWING A FIRM'S PAST PERFORMANCE

A common mistake many retail investors, including physicians, make when evaluating or selecting their investment advisor is to overrate the importance of an advisor's recent returns. There are several reasons why this approach is flawed, including the following:

- **The time frame may be too short.** When looking at an investment's track record, many clients will ask for gross returns (already a mistake—see Mistake No. 3) on a 1-, 3-, and 5-year basis. This is not enough data to make any reliable conclusions about skill versus randomness or even luck. Even 10 years may not be enough.
- **With investment results, you aren't comparing apples to apples.** Every investment portfolio is unique and comparing them is rarely an effective approach. Even the common question, "how did your portfolio perform last year?" can be misleading when portfolios are designed for individual clients. For example, clients often have customized portfolios based on risk tolerance, age, time horizon, tax bracket, objectives, and a variety of other factors. Because of this customization, it is entirely possible that Client A could see returns of 3%,

and Client B could have a portfolio gain of 20% over the same period. Both investors could be equally satisfied (or dissatisfied) and neither of these results may provide helpful advice about your own situation as Client C. A comparison is worthwhile only when two investors have very similar goals and circumstances.

- **Past performance is no guarantee of future results.** Anyone who has ever seen or heard an investment firm's advertisement is familiar with the phrase "past performance is no guarantee of future results." While this can be easily discarded by consumers as legalese, it is a fundamental concept that investors must understand.
- **Performance chasing can be detrimental to an investment portfolio.** You cannot tell which asset class will have the highest or lowest returns by simply looking at recent historical data. Thus, a strategy of chasing asset-class funds and managers based on their past results is dubious at best.



FAILURE TO EVALUATE YOUR RELATIONSHIP

It is easy to gravitate toward advisors who are friends, family, or friends-of-friends. It is also easy to become complacent in an advisor relationship and stay with someone longer than you should. Consider these factors when evaluating your relationship with your financial advisors.

A transparent and client-aligned business model is a must. Given the conflicts of interest that have come to light in the investment industry over the past few years, all investors (not just retina specialists) must work with financial firms that use a transparent business model that aligns the firm's interests with those of its clients. There are two key elements to look for in such an arrangement.

Independent Custodian: Ideally, an investment firm does not act as the custodian of (ie, hold) its clients' investments in the firm. Rather, the firm should have arrangements with

one or more independent custodians (eg, Charles Schwab and TD Ameritrade) to hold their investments for safe-keeping, while the investment firm manages the accounts. The inherent checks and balances of this model prevent the insular secrecy that allowed Bernie Madoff, Allen Stanford, and other criminals to operate.

Client-Aligned Fee Model: Today, many investors realize that a clear fee-based model works best for them, often known as the assets under management fee model. Under such an arrangement, advisors charge a transparent, clearly defined fee on assets they manage. Contrast this with the traditional convoluted transaction-charge model that most brokers use where a client pays based on trades in the account, regardless of whether the trade added value or not. In a fee-based model, clients understand the exact fee and that the firm's interest is the same as theirs—seeing the portfolio increase in value. The annual management fee the investment firm earns is a percentage of the assets you have in your account with them. The more money you have, the more money the firm earns. Ask yourself: do you feel more comfortable paying advisors a set fee or commissions based on the number and size of the trades they make?



IGNORING WHAT YOU KEEP—YOUR NET RETURNS

Many investors focus on management fees and expenses when evaluating advisors. For most, the annual fees might range from 50 basis points (0.5%) on the low end (very large portfolio in a fee model) to 300 basis points (3%) on the high end (mutual funds can be this high, as can broker transaction costs). This huge range is one reason why we are so adamant about the assets under the management-based fee model; also, investors can forget to consider that taxes often far exceed investment management fees as their largest expense.

The cost of federal and state income and capital gains taxes on a portfolio depends on many factors, including the underlying investments, turnover, state of residence, structure in which the investments are held, and other income.

Because physicians typically find themselves in the highest tax bracket, tax management of investments is crucial in both up and down markets. Unfortunately, mutual funds provide only 1099 tax statements to their investors with no accompanying tax advice. Even stockbrokers, money managers, hedge fund managers, and financial advisors at the nation's largest or most prestigious niche firms do not offer tax suggestions—and their compliance departments are glad they don't—because they are prohibited from doing so. Tax advice could include specific techniques for limiting tax consequences of transactions or creating more tax diversification in portfolios. Because of these limitations, many investment firms are not providing the tax focus and perspective that many investors want and need.

What is more important to you: the gross return your investment firm boasts in its marketing materials or your net after-tax return? Unless you want to give more than necessary to state and federal governments, the net after-tax return is the only measure that should truly matter.

KEEP WATCH

You should remain vigilant and constantly monitor and evaluate your plan and advisors. If you focus on the right factors, you can make intelligent, well-informed decisions. ■

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