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Your Financial Adviser – Best Friend or Worst Enemy?

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Mr Tan receives a call from Janice, his financial adviser, "Mr Tan, I have good news for you! The unit trust that you invested in 9 months ago has now gone up by 6%. I think it would be good to take profit now and get into another exciting fund that is expected to do very well."

Being a very busy professional, Mr Tan is pleased to have such a dedicated adviser serving him and looking after his interests. So he readily agrees; an apparent win-win situation. So, what is the problem here?

What actually happens is that once the trade is executed, Janice gets to pocket 5% sales commission in addition to the 5% she had earned from the earlier trade. If this happened within a 12 month period, Mr Tan would have paid about 10% in sales commissions and would therefore need his fund to return at least 12.5% just to break-even with the guaranteed return on his CPF Ordinary Account funds. So, did he make a right investment decision? And was he properly advised? Of course, the example is simplistic, and Janice actually pockets less than the 5% sales commission, as part of the commissions are kept by the financial institution, or financial advisory firm which Janice is representing.

This practice, also known as 'churning' in the industry, is what the regulators, or the Monetary Authority of Singapore ("MAS"), frowns upon. Of course, my fictional character here – Janice – could also be an insurance agent acting for an insurance company or a relationship manager acting for a bank. They all sell similar products and the tactics used are generally the same.

What is wrong was not the action itself, but rather the way in which it was carried out. Did Janice have a 'reasonable basis' for making the recommendation? Did she properly disclose to Mr Tan all the sales commissions he was being charged? Was she acting in the interests of Mr Tan… or herself?

Engaging a financial adviser is one of the most important decisions an individual needs to make. The adviser will quite likely influence almost all important financial decisions that an individual makes, which will ultimately determine whether his financial goals, aspirations, and financial independence are achieved. Therefore, it is critical that one takes proper care in selecting an adviser. Your money is at stake!

Your best friend?

So what exactly does a financial adviser do for an individual? A good and responsible adviser will listen, analyse and design a strategy that suits the individual's particular circumstances and which helps to achieve his financial goals. The next step would be to help implement the agreed strategy by advising and recommending suitable products in that are in line with the client's objectives and risk appetite. Reviews should then be carried out periodically to ensure that the investment plans are on track to meet the objectives, and to ascertain if any part of the investment or insurance plan needs to be tweaked due to changing life circumstances. Quite easily said, but is it easily done? The bad news is that the odds are stacked against the individual's search for an ideal financial adviser. Let me elaborate.

Your worst enemy?

First of all, the remuneration structure prevalent in the industry promotes a sales-based approach. As all Human Resource pundits will tell you, a remuneration structure is designed to promote the desired behaviour in the recipient. So, a pure commission-based system will primarily promote a sales-based approach. The more sales one makes, the greater the commission. Result? You get advisers who are only interested in making the most sales. Of course, one can argue that the adviser is only trying to put food on the table and service his housing mortgage. The only way he can achieve that is to meet a certain volume of sales every month in insurance or investment products. So is it surprising that he meets every client or prospect with the singular goal of trying to sell them something?

Lest you think that this problem only affects the 'lower end' of the financial advisory business, the same is true even in the rarefied air of the private banking domain. I have often heard clients with private banking facilities boast that they don't have to pay any fees to their private bankers. How naïve! How else do private bankers get paid upwards of several hundreds of thousands a year? Private bankers are also under stress to meet their sales numbers, and burnout is high. If they fail to meet their numbers, their 'salary' gets revised downwards the following year, or, in certain cases, they are politely shown the door. Hitting sales targets are like bread and butter for almost every business. But if an adviser considers making a sale as taking precedence over imparting impartial and objective advice, then the consumer is not properly served. The introduction of the Financial Advisers Act in 2003 provides some protection to the consumer and a legal framework for the financial advisory business to operate in. However, it is not a 'cure all' for the malaise within the industry.

It is also not easy to be a financial adviser. First, you will need to pass the relevant licensing exams, and then get licensed by MAS. To get your licence renewed annually, you will have to fulfil at least 30 hours in Continuing Professional Development (CPD). If you also want to advise on General Insurance, you will have to fulfil additional CPD hours in general insurance. This is just the minimum. In order to properly advise the client on his investments, the adviser also needs to spend time understanding what is happening in the global financial markets and how various events and policies can affect a client's investments.

Furthermore, clients expect their financial adviser to be an insurance specialist, investment analyst, economist, loan, estate planning and tax specialist, all rolled into one. The firm expects the adviser to be all that plus super-salesman, and yet compliant with all the prevailing rules and regulations. So is it any surprise that it is hard to find a competent adviser?

Before you think that all is doom and gloom, and view all financial advisers as out to rip you off, there are many in the industry who do approach the ideal and who do earnestly take the interests of the client to heart. They are a credit to the profession and it is your job as a prospective client to suss them out. Allow me to share with you some objective and subjective considerations.

1) The financial adviser's operating framework

Often overlooked is the importance of the firm the adviser is representing. The firm sets the operating framework and provides guidance for the financial adviser to carry out his business. The firm determines the investment process, selects best-of-breed funds, decides on house positions in times of market uncertainty, does product analysis, etc. All this substantially aids the adviser in being more productive, effective and professional when advising his clients. Another critical aspect that the firm provides is setting the correct corporate culture and business values for the financial adviser to eventually imbibe as part of his psyche.

However, there is a price to pay. To set up a financial advisory firm that is able to provide such value-added services – to the financial adviser and ultimately the client – requires much higher overheads: for the hiring of qualified staff, administrators, consultants, etc. It is thus unfortunate that a number of firms have opted for the easy way out, that is, to let their financial advisers do their 'own thing'. Because of time constraints and their lack of expertise, the adviser would seek out third party sources and fund managers (which, of course, have their own agenda and sales targets) to decide which funds to recommend to their clients. Or they would sell insurance products with the highest commissions. So, an important criterion is to ask the financial adviser about his firm's capability in formulating investment strategies and processes, selection of funds and basis for product recommendation. The presence of a customer servicing unit also becomes important to the client when their financial adviser decides to quit. The reassignment of a new servicing adviser then becomes secondary as the investment approach remains the same.

2) Financial strength of the financial advisory firm

Would it not be logical for a financial advisory firm to be financially responsible itself? Ask for the firm's financial standing. Their Profit & Loss Statement needs to be positive so that they can continue servicing you for the long haul. No business can continue burning cash year after year and still be viable. Sounds like common sense, but most clients often forget to question this aspect.

3) Investment track record of the financial adviser and his firm

Financial advisory firms worth their salt should have proper investment processes, the ability to select good funds and the track record to prove it. Ask the financial advisory firm how ALL their clients' investment accounts have been performing over the past few years. What is the average return?

We believe that the investment strategy and process are paramount, not just the selection of funds per se. Getting it right would help clients be less affected in a severe market downturn and yet be positioned to enjoy the upside in a rising market. This knowledge and process surely cannot be resident in any one person, and a financial adviser will need competent people with specialised skills to implement their strategy. The selection of funds itself also requires a rigorous process and not just an individual's 'inituition' as to where the market might be going.

How about the financial adviser himself? How has his own investments been doing? If he is going to manage your hard-earned money, surely he should practise what he is preaching. How long has he been investing in the financial markets and what is his personal investment return? What insurance policies does he have? It is amazing how some clients can be so willing to park their money with a person who has little or poor investment experience. It stands to reason that a person who is successful in managing and investing his own money will also be able to successfully manage someone else's money.

4) Other attributes

This would largely be a judgement call. Personal attributes such as integrity, trustworthiness, dependability, personal expertise, etc. are important attributes of your ideal adviser.

Why is this important? Take, for example: an adviser recommends an investment linked policy that invests into a high risk fund (e.g. technology, commodities, etc) to a 60 year-old pre-retiree who has a low risk tolerance. By capitalising on the client's emotions of greed and fear, he makes the sale by telling him of the high returns he can expect, while concealing the risk inherent with such funds as well as the escalating cost of insurance associated with the product.

Why do financial advisers misrepresent information? One said that if he were to tell the whole truth, his clients would be unlikely to purchase the product. So he chooses to omit 'a little' information in relation to the investment. Other forms of information that advisers sometimes omit are fees, sales commissions charged and the non-guarantee of returns on the product. This is what you will get from an adviser who has no integrity. Unfortunately, it is not always easy to spot character flaws. That is why you must always read what you sign, ask questions and take the time to understand what you are buying.

Does the law protect you? The Financial Advisers Act and Regulations require all recommendations to have a reasonable basis and for proper disclosure to be done. In addition, MAS has recently announced the setting up of a public registry that allows consumers to check on their advisers. It will contain their personal particulars, what they are licensed to practise and their compliance records. This database is expected to be ready in 2008.

In summary, a good adviser is like your coach, giving objective advice, guarding you against your emotions of fear and greed and helping you remain focussed on your investment objectives. Ideally, he should also be like your best friend – knowing your dreams and aspirations, he watches out for you and helps you achieve your financial goals, so as to ultimately realise your dreams.

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